HSBC BANK PLC

PCA / SME BANKING
MARKET INVESTIGATION

RESPONSE TO UPDATED ISSUES STATEMENT

11 JUNE 2015

CONTENTS

1. EXECUTIVE SUMMARY

1.1 HSBC welcomes the CMA's recognition in the updated issues statement (***UIS***) that market, regulatory and technological developments in the PCA and SME banking markets[1] are starting to bear fruit.[2]

1.2 A closer reading of the evidence now before the CMA reveals that competition in the PCA and SME banking markets is even healthier than the UIS suggests:

(a) **Concentration levels are declining and rivalry is increasing** both (i) amongst the larger banks and (ii) between the larger banks and smaller providers (including non-traditional providers) (see further paragraphs 5.16 to 5.20 below). This is clear from changing market shares and the array of product and service developments in recent years, as providers compete to acquire and retain customers.

(b) There is **significant recent and forthcoming entry and expansion of new providers** in both the PCA and SME banking markets, including new banks offering a range of products and non-traditional providers in the payments and lending space (see further paragraphs 6.2 to 6.12 below).

(c) **Rapid developments in technological innovation and digital banking** are increasing customer engagement and facilitating the entry and expansion of new providers: barriers to entry and/or expansion are diminishing (such as the costs of IT systems and need for a large branch network); and innovative new providers have opportunities to differentiate themselves from the established providers (see further paragraphs 3.14(a), 3.15 to 3.17, 4.11 to 4.12, 4.15, 4.45(c), 4.48, 6.6, 6.9, 6.24 to 6.35, 6.38 to 6.42, and 6.43 to 6.45 below).

(d) **Government initiatives and regulatory and legislative developments** are also increasing customer engagement and reducing barriers to entry and/or expansion: examples include (i) the Midata initiative, (ii) the Small Business, Enterprise and Employment Act 2015 (the ***SBEE Act***) and (iii) reforms by the FCA and PRA relating to the banking licence authorisation process and capital and liquidity requirements (see further paragraphs 3.5 to 3.14, 4.12, 4.15, 4.45, 4.48 to 4.51, 4.66 to 4.67, 6.16 to 6.17 and 6.53 below).

(e) **Falling PCA and BCA revenues**[3] demonstrate that costs for customers are falling, particularly in relation to overdraft charges (see further paragraph 5.17(c) below).

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1 Throughout this response, where HSBC refers to "SME banking markets", these include all of the markets for products within the CMA's Terms of Reference, namely BCAs and overdrafts, general purpose business loans, business deposit accounts, commercial mortgages, credit cards and other loan products (including invoice finance, asset finance and alternative finance).

2 See paragraphs 12 to 16, 39 to 45, 119, 122, 136, 148 and 156 to 157 of the UIS.

1.3 As explained in Section 2 below, these developments will drive ever-improving customer outcomes and should be given adequate weight in the CMA's assessment of the PCA and SME banking markets.

The CMA's evidence gathering and analysis

1.4 HSBC welcomes the CMA's fresh evidence gathering and analysis for PCAs, in particular the PCA survey research undertaken by GfK NOP (the ***GfK PCA Survey Report***). This will assist the CMA in properly testing its theories of harm. This contrasts with the position for SME banking, where HSBC continues to have serious concerns that the CMA is undertaking insufficient fresh evidence gathering and analysis. On the face of the UIS, there appears to have been **very limited development of the CMA's analysis for SME banking** since its Statement of Issues:

(a) The UIS reveals almost no new evidence for SME banking; and the list of planned working papers suggests that little more is on the way (given the apparent disproportionate focus on the PCA market).

(b) To the extent the SME banking markets are considered in the UIS, the focus is on BCAs (and, to a much more limited extent, on general purpose business loans). Hardly any evidence is adduced in relation to the other SME products within the terms of reference. In order to understand the state of competition for loans, the CMA must consider the significant competitive constraint from alternative forms of finance (including commercial mortgages, invoice finance, asset finance – including subvention finance[4] - and peer-to-peer lending).

1.5 The lack of fresh SME-related evidence gathering and analysis presents the risk that there will be an insufficient base of information to undertake a proper competition assessment of each of the BCA and SME lending markets and, if required, to prescribe any remedies. The only quantitative survey to which the UIS refers is the Charterhouse Business Banking Survey 2014. This survey does not present a full picture on customer engagement, as it provides limited evidence in certain key areas.[5]

1.6 Given the lack of new quantitative evidence, HSBC commissioned a survey of c.1,300 SMEs served by a wide range of providers (the ***Phase 2 BDRC Survey***).[6] This work builds on the survey HSBC commissioned at Phase 1 (the

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[3] See paragraphs 35 to 36 of the UIS.

[4] Subvention finance is where one party, usually the seller, offers a financial incentive to another party to encourage a sale. The benefit is typically passed on to the customer by offering finance at a rate which is lower than the market rate. In the context of vehicle finance, an example is where a manufacturer offers a vehicle for lease on terms that provide for subsidised interest payments.

[5] See AlixPartners' paper on the "*Analysis of likely gaps in customer research for SME banking*", which was submitted to the CMA on 3 December 2014. See, in particular, paragraphs 4.1 to 4.8.

[6] The sample surveyed by BDRC consisted of 1,311 SMEs, with annual turnover up to £25 million, who were contacted via an internet panel. BDRC has applied weightings to give a fair

Phase 1 BDRC Survey) and provides a more robust evidential base by covering the key areas absent from the Charterhouse survey. The results from the Phase 2 BDRC Survey demonstrate that competition and customer engagement are significantly healthier in the SME banking markets than the UIS suggests. HSBC urges the CMA to make full use of the new evidence from HSBC's Phase 2 BDRC Survey.

The UIS's three theories of harm

1.7 The UIS continues to focus on three theories of harm in relation to the PCA and SME banking markets. The CMA must separately assess whether the evidence taken together supports each of these three theories of harm for each of the PCA and SME banking markets. Within the SME banking markets, the CMA must distinguish, where necessary, between BCAs and SME lending to reflect differences in the competitive dynamics for these product markets.

1.8 In any case, the balance of evidence referred to in the UIS is insufficient to support these hypotheses in any of these markets, except in a very limited number of areas which are already being addressed by market, regulatory and technological developments.

Theory of Harm 1

1.9 The first theory of harm is that impediments to customers' ability to shop around, choose and switch products or suppliers are resulting in weak incentives for banks to compete. However, the evidence shows high levels of customer satisfaction and strong indicators of engagement in both the PCA and SME banking markets.

Customer satisfaction

1.10 The UIS recognises that there are high levels of customer satisfaction (91%) across both the PCA and SME banking markets.[7] Recent survey research supports these findings, including the Phase 2 BDRC Survey which also found that only a small minority of SMEs (9%) are dissatisfied with their main bank.

Customer engagement

1.11 The evidence also shows high levels of customer engagement, with customers able to **access**, **assess** and **act** upon information in both the PCA and SME banking markets. HSBC acknowledged at Phase 1 that the SME banking markets were at an earlier stage on the competitive trajectory relative to the PCA market.[8] HSBC noted at the time that there were already indications of

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representation of all SMEs in the UK based on age of business, turnover and geographical distribution. HSBC will submit a full copy of the underlying questions and both the unweighted and weighted to the CMA for further analysis.

7 See paragraph 58 and 79 of the UIS.

8 See paragraph 1.21 of HSBC's full submission to the CMA dated 23 May 2014 (the ***HSBC May 2014 Submission***).

increasing customer engagement. Over the past year, levels of customer engagement have continued to increase and there is now a significant body of evidence demonstrating strong levels of engagement. With further market, regulatory and technological developments (as discussed below), this trend can be expected to continue.

1.12 In the **PCA market**:

(a) **Access:** the GfK PCA Survey Report concludes that concerns about the difficulty of looking around and comparing providers are not a significant barrier to engagement. This is consistent with the increasing transparency and availability of information in the PCA market.

(b) **Assess:** recent and forthcoming developments – including digital banking and technological innovation, market-wide transparency initiatives, the Midata initiative and an open Application Programming Interface (***API***) standard - will address any remaining concerns about the ability of customers to assess and compare PCA offerings.

(c) **Act:**

(i) The UIS understates already healthy levels of customer engagement for the following reasons:

(A) High reported levels of satisfaction and trust in the PCA market go a long way to explaining relatively low levels of switching.

(B) Customer engagement must be measured not only by reference to absolute switching levels, but also multi-banking, other forms of soft-switching, new account opening and consideration of switching (regardless of outcome).

(C) A holistic reading of the evidence demonstrates strong levels of customer engagement.

(ii) Evidence from the GfK PCA Survey Report and the FCA[9] shows that, aside from high levels of customer satisfaction, current switching levels can be explained by customers' perceptions of the costs and "hassle" of the switching process.

9 See paragraphs 1.8 and 5.15 to 5.16 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015. The FCA research showed that 82% of PCA customers are very or fairly satisfied with the service they receive from their PCA provider and 81% with their PCA product. In addition, GfK Financial Research Survey found that 91% of PCA customers are extremely, very or fairly satisfied with the service they receive from their PCA provider, with only 3% expressing dissatisfaction. The FCA also notes that "*[a]ccount opening and switching processes (which are seen by consumers as one and the same process) are typically cited as the second most important barrier*" to switching.

This evidence also demonstrates a sizeable gap between customers' expectations of the difficulty of switching and the ease of switching in practice. This discrepancy could usefully be tackled through a renewed and concerted effort to increase awareness of, and confidence in, CASS.

(d) **Free-if-in-credit (*FIIC*) model:** one of the current areas of focus in the UIS is FIIC. Any regulatory intervention affecting FIIC needs to be underpinned by a well-balanced assessment of the merits of FIIC, relative to the possible alternative(s), on the basis of robust evidence. To date, evidence on how customer outcomes might materially improve under alternatives to FIIC is limited. Recent survey evidence suggests that UK customers do not expect to pay for a standard PCA, as they see this model as an implicit bargain in which they fund banks' activities through their deposits.[10]

1.13 In the **SME banking markets**:

(a) **Access:** BCA prices are generally transparent, as the UIS acknowledges. The Phase 2 BDRC Survey found no significant issues with SMEs' ability to access information relevant to BCA switching decisions. Furthermore, all finance providers are already required to meet extensive regulatory requirements on transparency for both BCAs and SME lending; and several recent and forthcoming measures are further increasing transparency (including the SBEE Act). HSBC is also separately taking steps to improve customers' ability to access data on their BCA usage (such as introducing proactive text alerts). SMEs therefore do not appear to have any material difficulties in accessing the information required to make an informed decision about their BCA provider. Although loan prices are transparent, as discussed below, they may not be readily and quickly comparable across a wide range of providers.

(b) **Assess:** recent and forthcoming developments – including digital banking and technological innovation, the Business Banking Insight (***BBI***) survey[11] and an open API standard - will improve the ability of customers to assess and compare SME banking offerings. Nevertheless, there remain limited tools for SMEs (particularly those on standard tariffs and/or terms) to compare the prices and services offered by different banks. Existing comparison websites are not as sophisticated as those used for other industries (including the PCA market), although improving customer awareness of the BBI survey is

10 See both the GfK PCA Survey Report and research conducted by M&S Bank in relation to the introduction of its fee-free PCA (see Question 43 of HSBC's response to the CMA's PCA market questionnaire dated 23 January 2016 (the ***PCA MQ Response***)).

11 This is a bi-annual independent survey of 15,000 SMEs on service attributes of different SME banking providers. See: http://www.businessbankinginsight.co.uk/.

likely to have a significant impact on the ability of customers to compare the quality of banking services offered by different providers.

(c) **Act:**

(i) The UIS understates the level of customer engagement for the following reasons:

(A) The UIS's assessment of customer engagement relies on data from the Charterhouse Business Banking Survey 2014. However, evidence from the Phase 2 BDRC Survey, as well as other market research, demonstrates that levels of customer engagement are significantly higher than the UIS suggests. In particular, SMEs are increasingly sourcing their finance needs from providers other than their main bank (including alternative finance providers).

(B) Customer engagement cannot be measured simply by reference to absolute switching levels. The CMA must also consider the impact of customer churn, multi-banking, new account opening, "try-before-you buy" behaviour, soft-switching and individual (re-)negotiation of terms and conditions, as these factors are all strong indicators of customer engagement.

(ii) The UIS suggests that SMEs' perceptions may be acting as a barrier to switching, including perceptions concerning: (i) the difficulties of the switching process (including the account opening process); and (ii) that switching may have implications for their ability to access future finance.

(A) In relation to SMEs' perceptions of the switching process, research by the Payments Council, and findings from both the Phase 1 BDRC Survey and Phase 2 BDRC Survey, suggest that many SMEs still (incorrectly) perceive this process to be difficult or time-consuming. This perception appears to stem from SMEs' general lack of awareness of or confidence in CASS (which applies to the vast majority of SMEs). Any discrepancy between the perceived and actual cost of switching may therefore be resolved through a strong industry effort to achieve increasing awareness and utilisation of CASS.

(B) In relation to those SMEs with concerns about the adverse effect of switching BCA provider on their ability to access future finance, the SBEE Act contains provisions requiring banks to share credit data on their SME customers with credit reference agencies. This increased access to credit data should make it easier for providers to lend to customers who are not their BCA customers on terms that are similar to those the customer's current BCA provider could offer. Over time, this is likely to diminish customers' perceptions that they cannot access finance on similar terms from providers other than their BCA provider. It should be possible to expedite this shift in SME perception through prominent publicity campaigns.[12]

1.14 It is therefore evident that recent market, regulatory and technological developments have all contributed to increasing levels of customer satisfaction and engagement across both the PCA and SME banking markets.

Theory of Harm 2

1.15 The second theory of harm is that current concentration levels give rise to market power for some banks leading to worse outcomes for customers. So far, the CMA has not put forward a sound economic theory – or any persuasive evidence – to support this hypothesis.

(a) First, the UIS tentatively sets out two alternative "mechanisms" through which it postulates that there might be a link between concentration and poor customer outcomes, neither of which is underpinned by sound economic theory or analysis:

(i) The UIS's first mechanism rests on two key propositions that (i) larger banks are more able to differentiate their products, and (ii) differentiation increases banks' market power by allowing them profitably to raise price above marginal cost and/or lower service quality. This theory is economically unsound as it fails to capture that differentiation is itself a critical dimension of competition (to deliver non-price attributes that customers value). This undermines both propositions (see paragraphs 5.3 to 5.9 below):

(A) First, the CMA cannot confidently conclude that size increases ability to differentiate as causality clearly runs in the opposite direction: successful differentiation (i.e. meeting customer needs for non-price attributes) allows banks to grow.

[12] Business Data Initiative is also seeking to transform the ability of an SME to use its data to access services. Business Data Initiative is a data routing, tagging and virtual holding company that enables businesses to share their private, commercial data with other counterparties. Those counterparties benefit from low cost access to the data they need in formats they can use. Businesses give permission to other parties to access their data, benefiting from greater control over their data. Business Data Initiative is focused on supporting business lending, KYC requirements and related information services.

(B) Second, it is incorrect to say that differentiation inherently conveys market power (by reducing "*the degree to which each banks products compete with other banks' products*"[13]), as this fails to capture that differentiation itself is a dimension of competition (funded by pricing above marginal cost).

(ii) The UIS's second mechanism is that banks have difficulty in differentiating between active and inactive customers, such that a price reduction to attract and retain active customers would be more costly for larger banks, resulting in weaker incentives for larger banks to compete. However, there is clear evidence that banks (both large and small) can and do price differentiate between active and inactive customers, and the CMA has previously accepted that such a finding fundamentally undermines this mechanism (see paragraphs 5.10 to 5.13 below).

(b) Second, there is no persuasive evidence linking the moderate levels of concentration in the PCA and SME banking markets to poor customer outcomes. Instead, there is substantial evidence which suggests that (i) concentration in these markets is moderate and declining and (ii) rivalry is increasing both amongst the larger banks and between the larger banks and smaller providers (including non-traditional providers) (see paragraphs 5.14 to 5.20 below). As highlighted below, this results in each bank being subject to a significant aggregate competitive constraint from a wide range of other providers.

Theory of Harm 3

1.16 The third theory of harm is that barriers to entry and expansion are leading to poor customer outcomes. However, the evidence shows that none of the barriers identified in the UIS is preventing or significantly impeding entry or expansion and each barrier is diminishing.

1.17 There has been extensive new entry and expansion in both the PCA and SME banking markets over the past five years.

(a) A number of providers have successfully entered the PCA and/or SME banking markets recently and have experienced rapid growth and high levels of investor confidence. These include:

(i) For PCAs, BCAs and SME lending: Metro Bank and TSB.

(ii) For PCAs: Virgin Money, Tesco Bank and the Post Office.

(iii) For SME lending: Aldermore Bank, Shawbrook Bank, Paragon Bank and OneSavings Bank.

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[13] See paragraph 99(a) of the UIS.

(b) Established banks have also successfully grown market share and have not faced significant barriers to expansion. For example:

   (i) Nationwide has seen a significant increase in its share of new PCAs from 3.3% to 7.3% in the last five years.[14] Its strategic agenda is focused on increasing its share of the PCA market to 10%.[15]

   (ii) Santander has seen a significant increase in its share of BCAs[16] and is now considered one of the "Big Five" banks for both PCAs and SME banking.

(c) Further new entry into both the PCA and SME banking markets is imminent.[17] This includes:

   (i) For PCAs, BCAs and SME lending: Atom Bank and Williams & Glyn.

   (ii) For PCAs: Starling Bank and Fidor.

   (iii) For BCAs and SME lending: CivilisedBank.

   (iv) For SME lending: OakNorth.

Therefore, each provider within the PCA and SME banking markets is subject to a significant aggregate competitive constraint from larger banks, smaller banks, new entrants and non-traditional providers[18] – and – it is important that the CMA looks at this holistically.

1.18 When assessing barriers to expansion, the CMA should assess what level and speed of expansion would be realistic in well-functioning PCA and SME banking markets. Although none of the recent entrants (post financial-crisis) has yet attained the size of some of the larger providers, the growth rate of certain entrants has been rapid and it would not be reasonable to expect them to have attained the size of HSBC yet (one of the smallest of the larger

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[14] GFK Market Share data (6 months rolling data), April 2015. See further Annex 18(12) of HSBC's response to the off-the-shelf material for SME banking dated 25 November 2014, *Research Now/BoxClever <£2m competitor Benchmark Survey*, H2 2014: this indicates that Santander's BCA market share for SMEs with annual turnover below £2 million increased from 8% to 14% between 2013 and 2014.

[15] See paragraph 14 of the CMA's case study on Nationwide dated 5 June 2015.

[16] GFK Market Share data (6 months rolling data), April 2015.

[17] See HM Treasury, *Banking for the 21st Century: driving competition and choice*, March 2015. Paragraph 5.3 notes "*the pipeline of potential new banks is ... strong: around 10 are currently going through the regulators' pre-application process*".

[18] Non-traditional providers include (i) alternative finance providers (e.g. Funding Circle, Zopa, RateSetter and MarketInvoice) and (ii) payment service providers (e.g. PayPal, Apple Pay and Google Wallet). See further paragraphs 6.6 and 6.9 below.

providers in market share terms). None of the CMA's case studies reveal any insurmountable barriers to expansion. In these circumstances, the CMA should consider the rate at which a prudent new entrant or expanding provider adopting a sustainable strategy may be expected to expand. The CMA may therefore wish to explore such prudential constraints further with the PRA. A failure to do so will compromise the CMA's ability to rely on any alleged lack of expansion as the basis for any finding of an adverse effect on competition.

1.19 Barriers to entry and expansion that may previously have been a feature of the market are now declining. In particular:

(a) **Regulatory obligations:** the PRA and the FCA have introduced significant changes to the authorisation process and capital and liquidity requirements which reduce barriers in this area.

(b) **Funding**: the evidence indicates that new entrants and banks looking to expand are not experiencing any issues raising funds, either through capital raising or attracting deposits.

(c) **Branches**: as the UIS recognises, "*there are a number of different strategies available to potential entrants*".[19] Successful entry does not need to be premised on the offer of physical counter services or an extensive branch network. In particular:

(i) Due to technological advances and the growing usage of non-branch channels, it is no longer necessary to offer physical counter services to enter the PCA or SME banking markets. Given the most frequently cited reason for using counter services is to pay in cheques, technological developments (such as cheque imaging) will accelerate the decline in customer demand for these services. Several new and prospective entrants are only offering remote channels to access banking services, including Tesco Bank and Starling Bank for PCAs, and Atom Bank for PCAs and SME banking.

(ii) Even if a new provider wishes to provide counter services as part of its offering, it does not need to have its own premises. There are various alternatives, including: (i) agency banking relationships with sponsor banks; (ii) inter-bank agency agreements; (iii) use of the Post Office's network of 11,500 branches; and (iv) cash collection and delivery services agreements.

(iii) The evidence shows that it is not necessary to have an extensive branch network to enter or expand in either the PCA or SME banking markets. Larger banks are reducing the size of their branch networks to reflect changing customer preferences and usage patterns, while other providers such as Metro Bank

[19] See paragraph 118 of the UIS.

and Handelsbanken have grown their branch networks organically by initially focusing on particular regions or cities.

(d) **IT systems**: the CMA's case studies show that new entrants have the ability to utilise innovations in the provision of IT services at a faster rate than established providers with legacy IT systems, allowing them to benefit from lower fixed IT costs and giving them a significant competitive advantage. To the extent that any individual banks, particularly those formed from existing providers, face higher costs to adapt their IT systems, this is no different from the difficulties faced by established providers with their legacy systems. Efficient new entrants do not face any such issues.

(e) **Payment systems –** the UIS states that the CMA has not received any evidence that new entrants have been unable to access payment systems either directly or through a sponsor bank.[20] Furthermore, the Payment Systems Regulator (***PSR***) has already taken a number of steps to improve direct access and indirect access to payment systems, and has launched a market review[21] to consider whether further measures may be required in relation to indirect access.

(f) **Information asymmetry**:

(i) For PCAs, the availability of credit data through credit reference agencies ensures that new entrants have access to necessary information to make informed credit decisions. In addition, the Midata initiative will assist customers in making effective comparisons between providers.

(ii) For SME banking, the SBEE Act, together with the proposed Bank of England credit register, will assist providers in extending credit to new-to-bank customers by increasing access to credit data.

(g) **Cross-selling**: the CMA should expect cross-selling to occur in a well-functioning market: (i) there are significant customer benefits to cross-selling (including economies of scope and satisfying the preference of some customers to build a broad relationship with one provider); and (ii) all providers, whether large or small (other than monoline providers), attempt to maximise their "share of wallet" through cross-selling. In relation to the PCA/BCA link, the existence of strong price competition for start-up SMEs, together with results from the Phase 2 BDRC Survey, demonstrate that any PCA/BCA "gateway" effect is not as strong as the UIS suggests.

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20 See paragraph 142 of the UIS.

21 PSR, *Market review into the supply of indirect access to payment systems – terms of reference*, May 2015.

Next steps

1.20 As the CMA continues to explore its theories of harm, it must separately assess whether the evidence taken together supports each of these theories for each of the PCA and SME banking markets. Within the SME banking markets, the CMA must distinguish, where necessary, between BCAs and SME lending to reflect differences in the competitive dynamics for these product markets.

1.21 HSBC considers that Theory of Harm 1 should be the main focus for further exploration by the CMA. HSBC also recommends that the CMA should focus on the areas set out below to test its three theories of harm properly – further details are set out at the end of each theory of harm section (see paragraph 4.71 for Theory of Harm 1, paragraph 5.24 for Theory of Harm 2 and paragraph 6.60 for Theory of Harm 3).

Theory of Harm 1

(a) Given the limitations of relying on "hard" switching levels as a reliable indicator of customer engagement, the CMA should consider in detail the impact on customer engagement of multi-banking, new account opening, "try-before-you-buy" behaviour, soft-switching and, in relation to SME banking, individual (re-)negotiation of terms and conditions.

(b) The CMA should also consider how developments in the PCA and SME banking markets, such as the Midata initiative, the SBEE Act, the extension of CASS to cover a larger population of SMEs, the BBI survey and developments to digital banking (including an open API standard), will further enhance the ability of customers to assess and compare competing PCA and SME banking offerings.

(c) In relation to FIIC, the CMA should take a cautious approach that explores in detail whether there is a sound theoretical and evidential basis for thinking that any specific alternatives would have tangible benefits for customers and actually improve customer outcomes.

(d) Since the SME banking markets are characterised by a high rate of customer churn, which drives competition for start-ups, the CMA should take this into account when assessing the extent of overall competition in the market.

(e) Given that customer satisfaction levels are high and the key barriers to switching relate to customers' perceptions of the difficulty of the switching process, the CMA's focus should be on exploring whether any measures are required to stimulate the demand-side.

Theory of Harm 2

(f) The CMA should reconsider the usefulness of the "mechanisms" it is proposing to explore. It should also give commensurate weight to the fact that:

(i) concentration levels in both the PCA and SME banking markets are in fact moderate and decreasing;

(ii) there is significant evidence of increasing rivalry both (i) amongst the larger banks and (ii) between the larger banks and smaller providers (including non-traditional providers); and

(iii) the UIS has not identified any relationship between the size of the provider and worse customer outcomes.[22]

Theory of Harm 3

(g) The CMA should assess what level of expansion would be realistic in well-functioning PCA and SME banking markets. In particular, the CMA should consider the rate at which a prudent new entrant or expanding provider adopting a sustainable strategy may be expected to expand.

(h) Given the difficulties faced by established providers with their legacy systems and the faster rate at which new entrants can utilise new innovations in the provision of IT services, the CMA should assess whether established providers in fact face a competitive disadvantage in relation to IT costs.

(i) HSBC considers that the PSR is best placed – and can be relied upon - to deal with any remaining issues relating to access to payment services. The CMA should continue to coordinate with the PSR on any such issues.

1.22 The remainder of HSBC's response adopts the same structure as the UIS: HSBC first considers the CMA's evidence gathering to date and the key sector characteristics of the PCA and SME banking markets (Sections 2 and 3 below), before dealing with each of the CMA's three theories of harm in turn (Sections 4 to 6 below).

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[22] See paragraph 34 of the UIS.

2. THE CMA'S EVIDENCE GATHERING AND ANALYSIS

2.1 HSBC welcomes the CMA's fresh evidence gathering and analysis for PCAs, in particular the PCA survey research undertaken by GfK NOP (the ***GfK PCA Survey Report***). This will assist the CMA in properly testing its theories of harm. This contrasts with the position for SME banking, where HSBC continues to have concerns that the CMA is undertaking insufficient fresh evidence gathering and analysis.[23] There has been **limited development of the CMA's analysis for SME banking** since its Statement of Issues:

(a) The UIS reveals almost no new evidence for SME banking; and the list of planned working papers[24] suggests that little more is on the way (given the apparent disproportionate focus on the PCA market).

(b) The UIS focuses on the products which raised some basis for concern at Phase 1, namely BCAs and general purpose business loans. The terms of reference for the market investigation are wider and cover various other SME banking and lending products (including alternative forms of finance). However, the UIS adduces very little evidence that would enable the CMA to undertake a proper competition assessment of these products. In order to undertake a proper and robust assessment of competition in the general purpose business loans market, the CMA should explore how alternative forms of finance (such as commercial mortgages, invoice finance, asset finance – including subvention finance - and peer-to-peer lending) are acting as a significant competitive constraint on general purpose business loans.[25] Alternative forms of finance constitute a significant and growing proportion of the total debt finance market for SMEs.[26]

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[23] HSBC has previously raised these concerns with the CMA. See, for example, (i) paragraphs 2.19 to 2.22 of HSBC's response to the CMA's Statement of Issues dated 3 December 2014 (the ***Issues Statement Response***); (ii) HSBC's email to Min Lim of the CMA dated 17 December 2014 with the subject "*SME customer survey*"; (iii) HSBC's response to the CMA's notice of intention to conduct an SME survey dated 21 January 2015; (iv) HSBC's response to the CMA's draft SME survey questionnaires dated 5 February 2015; (v) HSBC's response to the CMA's notice of intention to conduct SME qualitative research dated 13 March 2015 (in particular, paragraph 1.1); and (vi) HSBC's email to Paul Jackson of the CMA dated 22 April 2015 with the subject "*CMA Notice of intention to conduct SME qualitative research*".

[24] See Appendix A to the UIS.

[25] The CMA should take into account the various changes that providers have made to their SME lending propositions in response to the growing competitive threat from other lenders and alternative finance providers. For example, HSBC has recently launched a new SME lending initiative, which includes: (i) setting aside an £8 billion SME fund to be allocated in 43 local tranches across the country and (ii) waiving (or refunding) arrangement fees and security fees on qualifying business loans between £1,000 and £300,000 until the end of July 2015.

[26] HSBC does not have comprehensive data showing the value of aggregate stocks of all forms of external debt finance to SMEs. However, data from a range of sources indicates: (i) the total stock

2.2 The lack of fresh SME-related evidence gathering and analysis presents the risk that there will be an insufficient base of information to undertake a proper competition assessment of the SME banking markets and, if required, to prescribe any remedies. As HSBC stated in its Issues Statement Response:[27]

(a) in the absence of a sufficient evidential base, the CMA's conclusions on whether competition is delivering positive customer outcomes will lack credibility; and

(b) having a sound understanding of what drives customer behaviour is essential if there is to be any properly informed discussion later in the market investigation of whether remedies are required and, if so, what form these should take.

2.3 Given the lack of new quantitative evidence, HSBC commissioned the Phase 2 BDRC Survey. This work builds on the Phase 1 BDRC Survey. The results from the Phase 2 BDRC Survey demonstrate that competition and customer engagement in the SME banking markets are significantly healthier than the CMA might assume. For example, the Phase 2 BDRC Survey found that take-up and usage of digital tools and digital banking channels is just as, if not more, prevalent amongst SMEs as amongst PCA customers.[28] This contradicts the suggestion in the UIS that innovation is less dynamic in the provision of BCAs than for PCAs.[29]

2.4 HSBC recommends that the CMA uses and builds upon the evidence from the Phase 2 BDRC Survey to explore the following key areas in the SME banking markets:

(a) In relation to **Theory of Harm 1**:

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of loans and overdrafts for SMEs was c.£170 billion at March 2015 (Bank of England data, 1 April 2015), (ii) asset finance provided to SMEs totalled c.£13 billion in 2014 (British Business Bank FLA data), which appears to constitute c.7% of the SME debt finance market, (iii) invoice finance provided to SMEs totalled c.£18.9 billion in June 2014 (British Business Bank – Small Business Finance Markets 2014), which appears to constitute c.11% of the SME debt finance market, (iv) the total stock of peer-to-peer lending was c.£1 billion between June 2014 and June 2015 (AltFi Volume Index) and (v) overdraft finance provided to SMEs was c.£12.5 billion in April 2015 (Bank of England data). Lending flow of alternative finance is also significant: while HSBC advanced [***Redacted***] of general purpose business loans in 2014 (HSBC internal data), gross financing flows to businesses from alternative finance totalled £749 million in 2014 (see Nesta, *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*, page 12). In addition, the BDRC SME Finance Monitor Q4 2014 found that 7% of respondents were using a bank loan or commercial mortgage and 6% were using leasing, hire purchase or vehicle finance (page 56).

27 See paragraphs 2.14 to 2.15 of HSBC's Issues Statement Response.

28 Figure 8 of the GfK PCA Survey Report shows that 66% of all PCA customers use internet banking and 37% use a tablet/smartphone app. This compares to the Phase 2 BDRC Survey results, which show that 95% of SMEs use internet banking and 41% use mobile banking.

29 See paragraph 44 of the UIS.

(i) levels of switching and shopping around over a two to five year timeframe (see paragraphs 4.57 and 4.61(b) below);

(ii) customers' motivations for considering whether or not to switch, including any link between customer satisfaction and customers not considering switching (see paragraph 4.58 below);

(iii) the ability of customers to assess and compare different SME banking offerings (see paragraph 4.58(d) below);

(iv) the prevalence of, and reasons for, multi-banking, new account opening, "try-before-you buy" behaviour, soft-switching and individual (re-)negotiation of terms and conditions (see paragraph 4.61 below); and

(v) any barriers to switching, in particular whether customers perceive any difficulties with the switching process (see paragraphs 4.64 to 4.65 below).

(b) In relation to **Theory of Harm 3**:

(i) the extent to which branch usage is declining, the reasons why customers visit branches, and how future developments are likely to affect branch usage (see paragraph 6.33 below);

(ii) the extent to which online and mobile banking usage is increasing and the reasons why customers use digital banking channels (see paragraph 6.33 below);

(iii) customer awareness of the Post Office network for counter services (see paragraph 6.36(c) below);

(iv) willingness of customers to consider using (i) a bank with a small branch network, (ii) a digital-only provider, and / or (iii) an alternative finance provider (see paragraph 6.41 below); and

(v) the extent to which there is any "gateway" effect between (i) PCAs and BCAs and (ii) BCAs and SME lending (see paragraphs 4.62 and 6.56 to 6.57 below).

3. CUMULATIVE IMPACT OF PRO-COMPETITIVE MARKET, REGULATORY AND TECHNOLOGICAL DEVELOPMENTS ON THE PCA AND SME BANKING MARKETS

3.1 It is important that the CMA's analysis gives due consideration as to whether the significant ongoing and forthcoming market, regulatory and technological developments (which are set out at paragraphs 3.3 to 3.17 below) undermine the usefulness of any "static" finding on an "adverse effect on competition" based on *current market conditions*. HSBC is therefore encouraged to see signs in the UIS that the CMA is taking a forward-looking approach to its assessment of the PCA and SME banking markets.

3.2 The following developments are relevant to all three theories of harm set out in the UIS.

Macro-economic developments

3.3 HSBC agrees with the UIS's recognition that the CMA must take into account the macro-economic conditions following the 2007/08 global financial crisis and the subsequent economic downturn.[30]

3.4 These macro-economic conditions identified by the CMA will continue to sharpen competition in the PCA and SME banking markets. In particular:

(a) **Current low interest rates** reduce the opportunity cost of holding balances in accounts, which pay no or little interest.[31] As interest rates return to more normal levels, customer engagement and shopping around will increase.

(b) The **financial crisis and subsequent regulatory intervention** has increased the importance of current account balances to providers, as new liquidity regulations demand that banks hold higher levels of customer deposits.[32] This will be a persistent feature of the banking sector over the coming years (given regulatory requirements that increase the demand for stable funding and the collateral that supports such funding) and increase providers' incentives to compete for PCAs and BCAs (as these are primary sources of stable funding). The regulatory developments related to this are discussed further at paragraphs 3.7 to 3.10 below.

(c) As **banks have sought to rebuild their balance sheets**, this has led to some reduction in lending by some of the larger banks (though not HSBC).[33] This has to some extent offset the impact of suppressed demand for credit in the aftermath of the financial crisis and has

[30] See paragraphs 15 to 16 of the UIS.

[31] See paragraph 16(a) of the UIS.

[32] See paragraph 16(b) of the UIS.

[33] See paragraph 16(c) of the UIS.

facilitated the entry and expansion of new banks and alternative finance providers (even in a difficult macro-economic climate). For example, between 2013 and 2014, Metro Bank increased its stock of lending to personal and business customers by c.112%,[34] Aldermore Bank increased its stock of SME lending by c.33%,[35] and Shawbrook Bank increased its stock of SME lending by c.46%.[36]

Regulatory developments

3.5 Regulatory developments are a principal determinant of competitive dynamics in the banking sector. The interplay between financial regulation and competition is reflected in the duties and objectives of the FCA and the Bank of England. HSBC welcomes the CMA's acknowledgement in both the UIS[37] and the regulatory background working paper[38] that regulatory developments have had a significant impact on competition in the PCA and SME banking markets.

3.6 However, it is not yet apparent from the UIS how the CMA intends to factor these regulatory developments into its assessment. These developments will cumulatively continue to have a very significant impact on competition in the PCA and SME banking markets. If the CMA was to overlook the full extent of these developments, this would be likely to undermine materially the robustness of its conclusions on whether there is an adverse effect on competition and whether any regulatory intervention is required.

Changes to the regulatory framework for capital, liquidity and funding

3.7 Developments to the regulatory framework for liquidity and funding[39] will have pro-competitive effects in the PCA and SME banking markets, as they will increase providers' incentives to compete for PCA and BCA deposits (as these are sources of stable funding).

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[34] See: https://www.metrobankonline.co.uk/News-Events/PressReleases/2015/January/Metro-Bank-grows-118-in-2014/article/.

[35] See Bank of England Funding for Lending data, Q1 2015.

[36] See Bank of England Funding for Lending data, Q1 2015.

[37] See paragraphs 13, 119, 122, 148 and 156 to 157 of the UIS.

[38] See the CMA's working paper on the *Regulatory framework applicable to the retail banking industry in the UK* dated 1 May 2015 (the ***Regulatory Background Working Paper***).

[39] As the CMA notes in its Regulatory Background Working Paper (see paragraphs 45 to 75): (i) recent changes to the Basel Accord and the introduction of EU Capital Requirements Directive IV will require banks to hold both higher and better quality capital than was the case historically (these standards will be tightened further as definitional changes are adopted during the transition phase to 2019); and (ii) banks will also be expected to meet mandatory requirements for increased capital buffers, including additional buffers for systemically important global banks (such as HSBC), local systemic risk buffers, and requirements for loss absorbency.

3.8 In addition, developments in the regulatory capital framework are levelling the playing field between larger banks and new entrants. During the recent financial crisis, many banks benefited directly or indirectly from government support. However, any remaining advantage is more than offset by the additional capital buffers that systemically important banks will now be required to hold.[40]

3.9 In order to ensure an economically meaningful allocation of capital to the PCA and SME banking businesses, the CMA will need to consider the implications of alternative bases for allocation, in particular the **risk-weighted assets and leverage ratio approaches**.

3.10 The CMA will also need to take account of other regulatory developments which increase the strategic importance of sources of stable funding. More stringent regulation relating to liquid assets and stable funding will increase providers' incentives to compete for sources of stable funding (including PCAs and BCAs). These developments include:

(a) The introduction of the **Liquidity Coverage Ratio**, which requires the maintenance of minimum levels of high quality liquid assets to support banks through prescribed stress events. These liquid assets cannot be pledged as collateral to support wider funding requirements.

(b) The introduction of the **Net Stable Funding Ratio**, which is particularly relevant to the longer-term funding model of banks. The ratio is designed to test whether sources of stable funding are sufficient to fund the more illiquid assets of a bank. The application of this ratio will result in differences in banks' demand for deposits and approach to funds transfer pricing.

Ring-fencing of retail banking functions

3.11 The UIS and the Regulatory Background Working Paper note that the Financial Services Banking Reform Act 2013 will require banks to restructure their operations to allow the "ring-fencing of retail banking functions". These structural changes will alter the competitive dynamics within the banking sector by increasing the costs that "universal" banks face in operating within the PCA and SME banking markets.[41]

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[40] For example, HSBC Bank Plc has a strong credit rating and receives no benefit from sovereign support under Moody's methodology (see Moody's, *Key Analytic Considerations in our Rating Actions on Global Investment Banks*, 28 May 2015). The cost of maintaining the systemic capital buffer that HSBC Bank Plc holds at a global level, and will be required to hold at the ring-fenced bank level, is not offset by any sovereign support benefit.

[41] See paragraph 13 of the UIS and paragraphs 233 to 258 of the Regulatory Background Working Paper.

3.12 As explained in previous submissions to the CMA,[42] the requirement to put in place a ring-fence around UK retail and SME banking activities will affect the funding position of those business areas. The use of deposits held within the ring-fence will likely be restricted to lending to retail and corporate customers who are also within the ring-fence (as opposed to more broadly across the operations of the wider group).

3.13 The CMA must assess properly the impact of ring-fencing reform on providers' competitive strategies and incentives to compete in the PCA and SME banking markets to ensure it reaches robust findings. These will be determined by the relative value of deposits in the ring-fenced bank, which in turn will be driven by the interplay between capital reforms,[43] the future interest rate environment and the composition of the ring-fenced bank.

Other important regulatory developments

3.14 The CMA should also take into account the following regulatory developments, which will have a significant positive impact on competition:

(a) The UK government expects to set out a detailed framework for an open API standard by the end of 2015. As stated by HM Treasury: "*This will further increase consumer engagement by making it even easier for customers to see where they could get a better deal, meaning banks will have to work harder to win and retain customers. It will also increase competitive intensity by supporting the growth of technology that can be adopted by banks and non-bank providers to compete to offer new products*".[44] An open API standard has the potential to improve customer engagement significantly.[45] In particular, it will enable customers to access transactional (and other banking) data and connect this data with financial management and comparison tools. Customers will then be able to make more informed

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[42] See paragraphs 8.126 to 8.128 of HSBC's response to the CMA's SME banking market questionnaire dated 26 January 2015 (the ***SME MQ Response***); paragraphs 6.18 to 6.20 of the PCA MQ Response; and paragraph 2.10 to 2.11 of HSBC's Issues Statement Response.

[43] This includes the introduction of Total Loss Absorbing Capacity and the Leverage Ratio (see paragraphs 68 to 73 and 151 to 153 of the Regulatory Background Working Paper).

[44] See paragraph 1.6 of HM Treasury's report *Banking for the 21st Century: driving competition and choice*, March 2015.

[45] There are numerous examples that show how the adoption of an open API standard can facilitate innovation and increase customer engagement. For example: (i) Fidor Bank has a partnership with Currency Cloud (a foreign exchange provider) to offer a current account product that can be viewed in seven currencies and provide foreign exchange transaction services (see: http://www.ft.com/cms/s/0/4eea4798-81c6-11e3-87d5-00144feab7de.html#axzz3cfumCV1Z); (ii) Credit Agricole launched an open API in 2012 and now has a range of apps providing expense management, payments and finance analysis tools to customers; and (iii) online accounting software providers, such as Kashflow and Xero, have used APIs to build suites of third party 'add-ons' that enable SMEs to interact with their data (e.g. when filing quarterly VAT returns).

choices about what financial products and services best suit their needs based on their actual account usage (and banking data).

(b) The UK government's Midata initiative enables customers to obtain detailed comparisons of their account usage. Gocompare.com has recently launched a PCA comparison service that utilises the Midata initiative. This will enhance customers' ability to compare different PCA offerings and determine which offerings are best suited to them based on their account usage (see paragraph 4.15(c) below for further detail).

(c) The UK government also plans to introduce new legislation in 2015 in relation to peer-to-peer lending. Under this proposal, individuals will be able to offset bad debts arising from their loans to peer-to-peer lenders against the interest they receive from such loans for tax purposes.[46] This initiative aims to encourage individuals to invest in peer-to-peer lending platforms, which is expected to drive further growth of alternative finance.

Developments in digital banking and technological innovation

3.15 HSBC welcomes the recognition in the UIS that developments in digital banking and technological innovation are (i) facilitating new entry and expansion in the PCA and SME banking markets by reducing barriers to entry and/or expansion; (ii) enabling the use of different business models; and (iii) improving customer outcomes through new product and service innovation.[47]

3.16 However, HSBC considers that there should be greater recognition of how digital banking and technological innovation are not only facilitating new entry and expansion but also fundamentally changing customer behaviour and substantially increasing the dimensions and intensity of competition both amongst banks, and between banks and non-traditional providers:

(a) As explained in previous submissions[48] and demonstrated by recent survey evidence, these developments are **improving customer engagement** by transforming the nature and frequency of interactions between customers and banks. Customers are ever more able to engage with their banking services, access and assess information about other providers' offerings and subsequently act on this information (by switching or otherwise).[49] SMS alerts for balances and overdrafts are

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[46] See HM Treasury's 2014 Autumn Statement: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/382327/44695_Accessible.pdf.

[47] See paragraphs 14, 39 to 45 and 128 of the UIS.

[48] See paragraphs 2.5 to 2.9 of HSBC's Issues Statement Response; Questions 39 and 60 of HSBC's SME MQ Response; and paragraphs 6.69 to 6.97 and Question 36 of HSBC's PCA MQ Response.

[49] For example, the GfK PCA Survey Report provides an indication of increased engagement measured by frequency of use of services at paragraphs 27 and 78 that (i) 66% of PCA customers

increasing customers' ability to control their finances.[50] This positive trend is only set to continue as customers' use of digital banking channels and digital tools increases.

(b) Technological innovation and the rapid increase in customers' use of digital banking channels have **significantly reduced the need for a branch network**. There is now a significant proportion of PCA customers and SMEs for whom digital banking channels are the principal form of interaction with their banks. [***Redacted***].[51] As explained in previous submissions[52] and at paragraphs 6.24 to 6.35 below, this proportion is increasing, as customers continue to migrate away from branch-based channels and towards digital banking.

(c) In addition to increasing customers' engagement with their existing providers, these developments in digital banking channels have also:

(i) enabled the **emergence of digital-only players** (such as Atom Bank and Starling Bank); and

(ii) **facilitated the entry and expansion of new entrants** who have chosen to offer branch access as part of their commercial strategy (such as Metro Bank and Virgin Money). These entrants can serve a high number of customers spread over a relatively wide geographic area with only a limited, local branch network that can be expanded organically over time, augmented by digital capabilities.

(d) New entrants are also able to utilise innovations in the provision of IT services at a faster rate, without being burdened by legacy IT systems. This allows them to benefit from lower fixed IT costs and gives them a

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use internet banking and 37% use mobile banking (with the figures rising to 84% and 59% for 18 to 44 year olds) and (ii) at least two thirds of all those who either used tablets or smartphone apps (74%) or internet banking (66%) used it at least once a week or more. Strikingly, a third of mobile users access mobile banking services every day. For SME banking, the Phase 2 BDRC Survey found that (i) 95% of SMEs use internet banking and 41% use a mobile banking app on a tablet or mobile and (ii) 37% of SMEs use internet banking at least once a day and 79% of SMEs use internet banking at least once a week or more (see Questions 12(b) and 12(c) of the Phase 2 BDRC Survey).

50 For example, the FCA found that mobile banking and SMS alerts have had a significant impact on the reduction of overdraft fees (a cumulative total reduction of 24%). See page 5 of FCA Occasional Paper (No.10), *The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour*, March 2015.

51 [***Redacted***].

52 See paragraphs 2.5 to 2.9 of HSBC's Issues Statement Response; Questions 39 and 60 of HSBC's SME MQ Response; and paragraphs 6.69 to 6.97 and Question 36 of HSBC's PCA MQ Response.

significant competitive advantage. The CMA recognises this in its Metro Bank case study.[53]

3.17 Developments in digital banking and technological innovation have both materially improved levels of customer engagement and significantly reduced barriers to entry and expansion. Given the rapid pace of these developments, it is imperative that the CMA adopts a forward-looking approach to reflect fully the positive and ongoing impact of digital banking and technological developments on competition in the PCA and SME banking markets.

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[53] See paragraph 57 of the CMA's Metro Bank case study dated 21 May 2015 (the ***Metro Bank Case Study***).

4. THEORY OF HARM 1: HIGH CUSTOMER SATISFACTION AND INCREASING CUSTOMER ENGAGEMENT

4.1 The UIS correctly recognises that the three theories of harm are necessarily connected. That said, in HSBC's view, this does not mean that the CMA should devote equal resources to all three theories of harm. Rather, HSBC considers that Theory of Harm 1 should be the main focus for further exploration by the CMA. As explained in Sections 4 and 5 below:

(a) In relation to Theory of Harm 2, concentration levels are modest and decreasing, and there is strong rivalry both: (i) amongst larger banks and (ii) between larger banks and smaller providers (including non-traditional providers). Moreover, the UIS adduces no persuasive evidence isolating concentration levels in the PCA and SME banking markets as an independently verifiable (and verified) driver of adverse customer outcomes.

(b) In relation to Theory of Harm 3, the evidence before the CMA indicates that there are limited barriers to entry and points to a downwards trend in barriers to expansion.

4.2 As such, the key to well-functioning PCA and SME banking markets is an effective demand-side and this should be the focus of the CMA's work over the remainder of the market investigation.

Customer outcomes: service levels and customer satisfaction are high

4.3 The UIS acknowledges that quality of service is an "*important dimension of competition in banking markets*" and states that the CMA is comparing quality and levels of service between larger banks and smaller banks.[54] HSBC agrees that an overall understanding of quality of service is relevant to any assessment of competition. A failure to account for differences in quality risks undermining the robustness of any conclusions the CMA may reach from its pricing analysis.

4.4 HSBC uses the following sources of information to assess its quality of service:

(a) For PCAs: (i) the Customer Recommendation Index, (ii) GfK FRS satisfaction data, (iii) the Brand Engagement Index, (iv) eBenchmarkers market research reports, (v) satisfaction data for different channels (vi) internal data on the reliability of HSBC's payment services, ATM functionality, internet banking and mobile banking and (vii) complaints data from the FCA.[55]

(b) For SME banking: (i) market research, (ii) "dashboards" that provide a holistic view of customer service levels, (iii) competitor benchmarking,

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54 See paragraph 38 of the UIS.

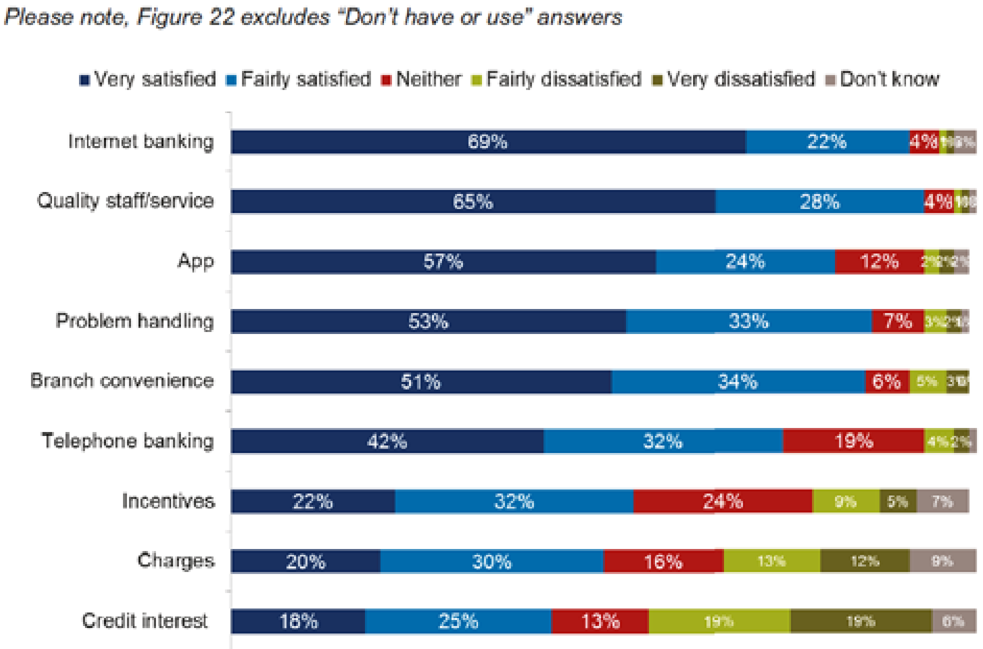
55 See Question 13 of HSBC's PCA MQ Response.

(iv) complaints data, (v) post sales feedback from customers, (vi) reviews when customers indicate they want to switch to another provider and (vii) performance reviews of "back office" operations.[56]

4.5 These sources of information indicate that HSBC provides a high quality of service to its PCA and SME customers. HSBC continues to take measures to improve its service proposition for PCAs and SME banking.[57] This is consistent with recent survey evidence:

(a) For PCAs, the GfK PCA Survey Report indicates that the vast majority of customers are "very satisfied" or "fairly satisfied" with the quality of customer service (93%) and problem-handling (86%) (see **Chart 1** below).[58]

Chart 1: PCA customer satisfaction with aspects of main bank account



Source: GfK PCA Survey Report (Figure 22)

(b) For SME banking, [***Redacted***][59]

4.6 HSBC also welcomes the recognition in the UIS that there are high levels of customer satisfaction across the PCA and SME banking markets.[60] Recent survey research supports these high levels of customer satisfaction:

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[56] See paragraph 18.5 of HSBC's SME MQ Response.

[57] See the covering submission and Questions 5 to 8 of HSBC's SME MQ Response, and the covering submission and Questions 4 to 6 of HSBC's PCA MQ Response.

[58] See paragraph 14 of the GfK PCA Survey Report.

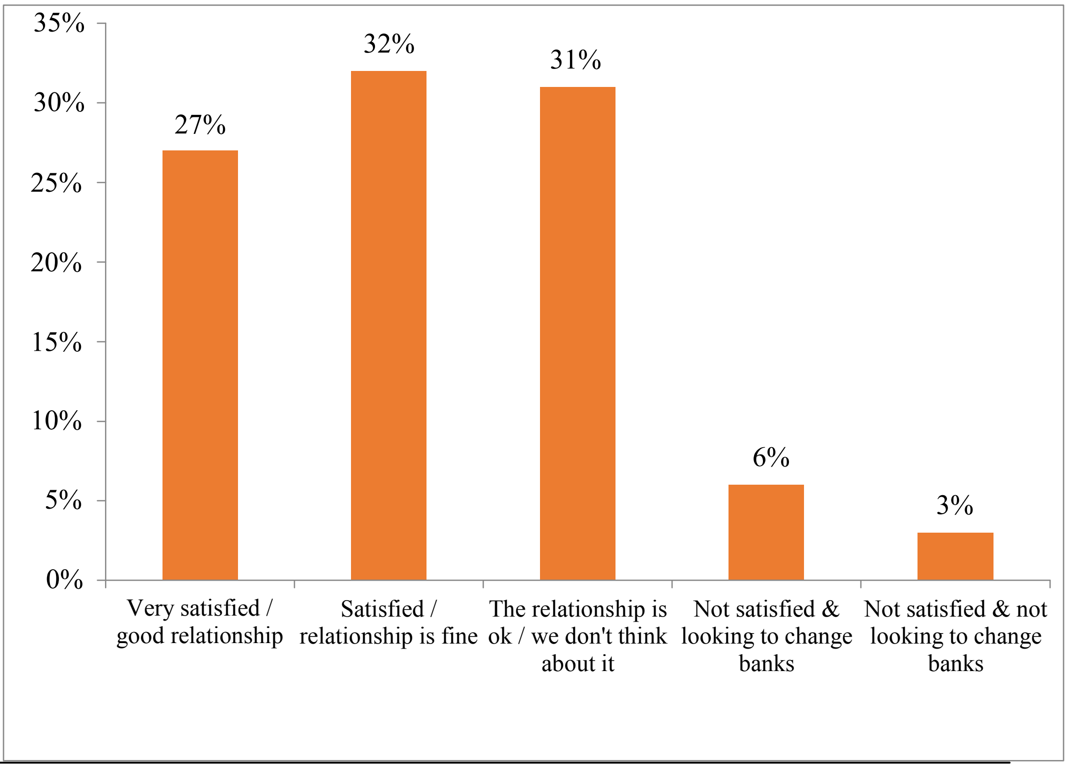
[59] See Charterhouse Competitor Benchmark survey Q1 2015 (£5m - £250m turnover data).

(a) FCA-commissioned research showed that 82% of PCA customers are very or fairly satisfied with the service they receive from their PCA provider and 81% with their PCA product.[61]

(b) GfK Financial Research Survey found that 91% of PCA customers are extremely, very or fairly satisfied with the service they receive from their PCA provider, with only 3% expressing dissatisfaction.[62]

(c) The Phase 2 BDRC Survey which found that only a small minority (9%) of SMEs are dissatisfied with their bank (see **Chart 2** below).[63]

Chart 2: SME customer satisfaction



[60] See paragraphs 58 to 59 and 79 of the UIS. [***Redacted***]. As explained at HSBC's site visit on 24 February 2015 and in the covering submission to HSBC's SME MQ Response, HSBC has made changes to its customer segmentation and adopted a strategy to improve customer experience in the areas of (i) relationship management, (ii) product proposition, (iii) client support and (iv) digital/channels. In any case, HSBC's position relative to its competitors does not undermine the fact that market-wide customer satisfaction levels are high.

[61] See paragraph 5.15 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[62] See paragraph 5.16 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[63] The customer satisfaction findings from the Phase 2 BDRC Survey are similar to the findings in the Charterhouse survey referred to in the UIS.

Source: Phase 2 BDRC Survey (Question 44)

4.7 The evidence therefore indicates that many customers may be choosing actively not to switch providers as they are satisfied with their current provider.

4.8 The UIS speculates that high customer satisfaction levels "*are potentially driven by customers' reasonable expectations, which may themselves be influenced by the alternatives currently available in the market*".[64] However, the UIS provides no evidence to support this. In contrast, the GfK PCA Survey Report shows that aspects of a PCA offering which were judged as "essential" or "very important" by customers were those aspects that respondents were most satisfied with. High levels of customer satisfaction therefore reflect customers' considered views based on what is most important to them.[65]

Customer engagement

4.9 For each of the PCA and SME banking markets, HSBC has considered below each element of the "access, assess and act" framework adopted in the UIS.

PCA

Access

4.10 HSBC is pleased that the UIS recognises that customers generally have access to necessary information.[66] The GfK PCA Survey Report illustrates that there are limited issues, if any, with access to relevant information:

(a) Around two thirds of all customers, including both those who had looked around and those who had not looked around, <u>expected</u> that it would be "very easy" or "fairly easy" to find out about features and charges of different accounts, understand the different current account options available and make comparisons between current accounts (see **Chart 3** below). The GfK PCA Survey Report concludes that "*this suggests concerns about the difficulty of looking around and comparing providers are not a significant barrier to engagement.*"[67]

(b) Of those who had looked around, 74% found it "very easy" or "fairly easy" to find out about features of different accounts, 73% found it "very easy" or "fairly easy" to understand the different current account

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[64] See paragraph 59 of the UIS.

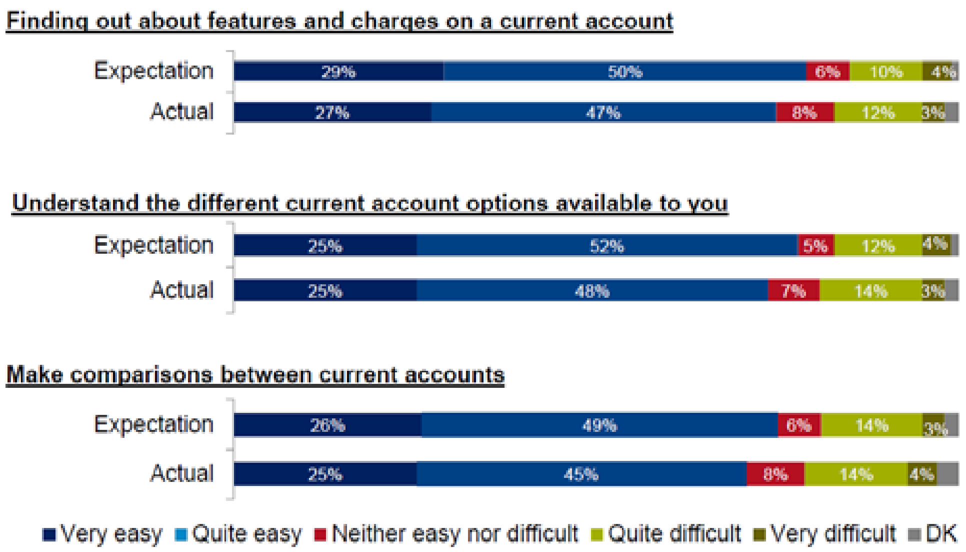
[65] See paragraph 143 and Figure 24 of the GfK PCA Survey Report. Customers placed most importance on and expressed highest levels of satisfaction with service metrics, such as quality of staff and customer service and problem handling.

[66] See paragraph 63(a) of the UIS.

[67] See paragraph 184 of the GfK PCA Survey Report.

options available and 70% found it "very easy" or "fairly easy" to make comparisons between current accounts (see **Chart 3** below).[68]

Chart 3: Ease of comparing PCAs (expectations vs. actual for those who looked around)



Source: GfK PCA Survey Report (Figure 46)

4.11 HSBC has also already taken steps proactively to improve customers' ability to access data, for example through the simplification of its charging structure for overdrafts and increasing customer communication through text alerts.[69]

4.12 This is consistent with HSBC's previous submissions to the CMA that identified a number of factors that had already increased the transparency and availability of information in the PCA market (such as the Midata initiative). Moreover, a number of forthcoming developments will further improve the transparency and availability of information in the PCA market (such as an open API standard, increasing awareness of the Midata initiative, and developments to digital banking tools).[70]

4.13 Therefore, PCA customers do not appear to have any difficulties in accessing the information required to make an informed decision about their PCA provider.

Assess

4.14 The UIS notes a number of concerns in relation to customers' ability to "assess" the relevant information: (i) "*complexity and comparability of information varies across account features*", particularly in relation to

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68 See Figure 46 of the GfK PCA Survey Report.

69 See, for example, paragraphs 3.9 to 3.13 of the HSBC May 2014 Submission and paragraph 6.41 of HSBC's PCA MQ Response.

70 See paragraph 3.2 of HSBC's Issues Statement Response, and paragraphs 3.5 to 3.8 and 3.24 to 3.29 of the HSBC May 2014 Submission.

overdraft charges; (ii) "*a lack of comparative information on banks' service quality*"; and (iii) "*price comparison websites are not used as much as in other industries*".[71]

4.15 However, recent and forthcoming developments in the PCA market will address the CMA's concerns with the ability of customers to assess and compare PCA offerings.[72] In particular:

(a) **Digital banking and technological innovation** are improving customer engagement by enhancing the ability of customers to access information, manage and control their finances, compare offerings across competing providers and actually undertake the switching process (see paragraph 3.16 above for further detail). As explained in previous submissions to the CMA, these developments include mobile banking apps, proactive text alerts, mobile payments services (such as Paym, Zapp and Weve), mobile personal financial management tools, quick balance views and digital wallets.[73]

(b) **Market-wide transparency initiatives implemented in recent years**, such as the OFT's transparency initiatives identified in its 2013 review of the PCA market,[74] have already increased transparency and control, leading to increased customer engagement and reduced costs.[75]

(c) **Recent and forthcoming initiatives** - such as the Midata initiative, an open API standard, the implementation of the EU Payments Account Directive and further digital developments - will enhance transparency and further improve the ease of comparing accounts. In particular, HSBC expects the Midata initiative to go a significant way towards addressing the CMA's remaining concerns about the ease of comparing different PCA offerings: Midata will enable customers to obtain detailed comparisons of which PCA products are best suited to them based on their account usage. Gocompare.com launched a new PCA comparison service in March 2015 stemming from the Midata initiative.[76] This PCA comparison service both (i) helps customers properly understand the costs and direct monetary benefits of their existing PCA and (ii) provides an opportunity to compare their existing PCA with competing providers' PCAs and thereby assess different

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71 See paragraphs 63 to 64 of the UIS.

72 See paragraph 65 of the UIS.

73 See paragraphs 2.8 to 2.9 of HSBC's Issues Statement Response and paragraphs 3.14 to 3.23 of the HSBC May 2014 Submission.

74 See paragraph 11 of the OFT PCA Decision dated 14 May 2013.

75 See paragraphs 3.4 to 3.9 of the HSBC May 2014 Submission for further details on these initiatives.

76 [***Redacted***].

competitive offerings in the market and select the PCA best suited to their individual requirements.[77]

4.16 The UIS also considers the free-if-in-credit model (***FIIC***) under the "assess" element of its analytical framework. HSBC sets out its views on FIIC separately at paragraphs 4.34 to 4.39 below.

Act

4.17 In relation to the "act" limb of the UIS's framework:

(a) there are clear indications that customers are engaging with the PCA market; and

(b) any barriers to switching relate primarily to customers' perceptions of the difficulty in the switching process.

(a) *<u>There are clear indications that PCA customers are engaged</u>*

4.18 The UIS suggests that there are a number of indicators of low customer engagement, including low rates of switching and shopping around.[78]

4.19 However, the UIS understates the level of customer engagement in the PCA market for the following reasons:

(a) **High levels of satisfaction and trust in the PCA market** go a long way to explaining the relatively low levels of switching (as acknowledged in the UIS and demonstrated by the evidence in the GfK PCA Survey Report on customer motivations) (see paragraphs 4.21 to 4.24 below).[79]

(b) **Customer engagement cannot simply be judged by reference to absolute switching levels.** The CMA must also consider the impact of multi-banking, new account opening, "try-before-you buy" behaviour, soft-switching and "considerers" who may periodically decide not to switch accounts. These alternatives to switching also drive rivalry among PCA providers (see paragraphs 4.25 to 4.26 below).

(c) On a **closer and more complete reading of the evidence**, the UIS's inferences about a lack of customer engagement do not appear to stand up to scrutiny (see paragraphs 4.27 to 4.28 below).

4.20 These issues are developed further below.

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77 See further Question 37 of HSBC's PCA MQ Response.

78 See paragraph 57 of the UIS.

79 See paragraphs 58 and 88 of the UIS.

(i) Rates of switching and shopping around must be read in the context of evidence on customer satisfaction and customers' motivations for not switching or shopping around

4.21 The UIS places undue emphasis on certain selective statistics from the GfK PCA Survey Report and treats them as "*indicators of lack of customer engagement*". In particular, the UIS emphasises that: (i) only 3% of customers switched their main PCA in the last year; and (ii) 73% of customers did not shop around in the last three years.[80]

4.22 Given the evidence also before the CMA on high levels of customer satisfaction and trust in the PCA market and the reasons given by customers behind their decisions on whether or not to switch, that observed rates of "switching" and "shopping around" are alone a reliable basis for conclusions on levels of competition or customer engagement:[81]

(a) The same report provides clear evidence of high customer satisfaction and trust across the PCA market:

(i) An overwhelming majority of PCA customers (91%) were satisfied with their main PCA provider, whereas only 4% were dissatisfied.[82] Customer satisfaction was broadly uniform between customers of large banks (90%) and small banks (92%).[83] In relation to the qualitative aspects of a PCA provider's proposition, the vast majority of customers were also "very satisfied" or "fairly satisfied" with the quality of customer service (93%) and problem-handling (86%).[84]

(ii) High reported levels of satisfaction are also corroborated by the qualitative evidence: "[*m*]*any qualitative participants were satisfied with their PCA, because they felt their PCA functioned efficiently and effectively, thus enabling them to organise, protect and access their money*".[85]

(b) For those customers who have neither switched nor shopped around in the past three years, existing positive features relating to their current PCA provider are much more prominent as reasons for not doing so than inertia or the perceived difficulty of switching (see **Chart 4** below):[86]

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80 See paragraph 57 of the UIS.

81 See paragraph 3.6(a) of HSBC's Issues Statement Response.

82 See paragraph 128 of the GfK PCA Survey Report.

83 See paragraph 129 of the GfK PCA Survey Report.

84 See paragraph 132 of the GfK PCA Survey Report.

85 See paragraph 135 of the GfK PCA Survey Report.

86 See Figure 43 of the GfK PCA Survey Report.

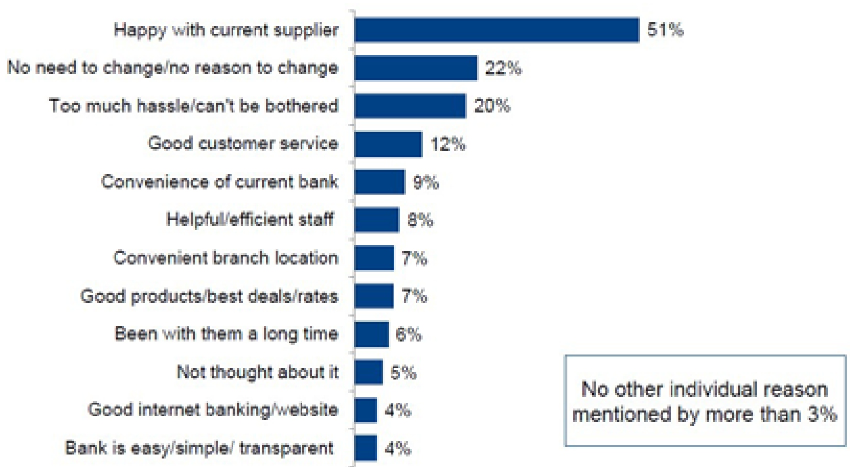
(i) The majority of survey respondents explicitly identified satisfaction as the main reason for not shopping around or switching (51% of those who had not shopped around or switched in the past three years said it was because they were happy with their current supplier and a further 22% said they had no need or reason to change).[87]

(ii) Several other positive factors were highlighted as reasons for customers staying with their current provider: 12% pointed to good customer service; 9% to the convenience of their current bank; 8% to helpful staff; and 7% to a "good deal".[88]

(iii) Customer inertia appears to be a much less relevant factor for customers not switching or shopping around: only 6% said they had been with their current bank for a long time, only 5% had not thought about it and only 20% said it was too much "hassle" or they could not be bothered.[89]

(iv) This is supported by the conclusion from the qualitative survey that "*many participants experienced low levels of dissatisfaction with their PCA, which meant they felt they had little incentive to search and switch PCAs*".[90]

Chart 4: PCA customers' reasons for not shopping or switching (in last three years)



Source: GfK PCA Survey Report (Figure 43)

4.23 In addition, the UIS notes that initial evidence suggests switching rates in the PCA market are lower than in other UK retail markets, such as car insurance

[87] See Figure 43 of the GfK PCA Survey Report.

[88] See Figure 43 of the GfK PCA Survey Report.

[89] See Figure 43 of the GfK PCA Survey Report.

[90] See paragraph 191 of the GfK PCA Survey Report.

and energy.[91] Such inter-market comparisons of switching rates are of limited value, as switching rates will invariably depend on the particular characteristics of the market. For example, levels of trust are significantly higher in the PCA market compared to the energy market: 85% of PCA customers stated that they strongly trust or tended to trust their own bank, in comparison to only 62% for energy companies.[92] This may be one factor explaining the differences in switching rates between the two markets.

4.24 HSBC therefore welcomes the UIS's acknowledgement that "*low rates of engagement*" may not be a concern if customers are already obtaining good outcomes.[93]

(ii) Customer engagement cannot be simply judged by reference to absolute switching levels

4.25 As HSBC has explained in its previous submissions,[94] switching rates alone, and "hard" switching rates in particular, are not a good determinant of competition in the PCA market, as they significantly underestimate the true competitive constraint that customers exert on PCA providers. HSBC is encouraged to see that the UIS recognises the relevance of other aspects of switching, such as internal switching and multi-banking.[95]

4.26 The CMA should take due account of the following factors before reaching any conclusions:

(a) **Multi-banking and partial switching**: multi-banking is also an alternative to switching, an important indicator of customer engagement and a key feature of the PCA market:[96]

(i) The GfK PCA Survey Report found that: (i) just under half of customers holds multiple PCAs with more than one provider (see **Chart 5** below);[97] and (ii) one third of customers who switched their main PCA in the past year left their old account open (with the figure increasing to almost 40% over three years).[98] The increasing importance of these 'multi-banking'

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[91] See paragraph 57(c) of the UIS.

[92] See Figure 5 of the GfK PCA Survey Report.

[93] See paragraphs 58 and 88 of the UIS.

[94] See paragraph 3.6 of HSBC's Issues Statement Response; paragraph 7 of HSBC's response to the CMA consultation on provisional findings dated 16 September 2014 (the ***HSBC September 2014 Submission***); and paragraphs 5.9 to 5.11 of the HSBC May 2014 Submission.

[95] See paragraph 75 of the UIS.

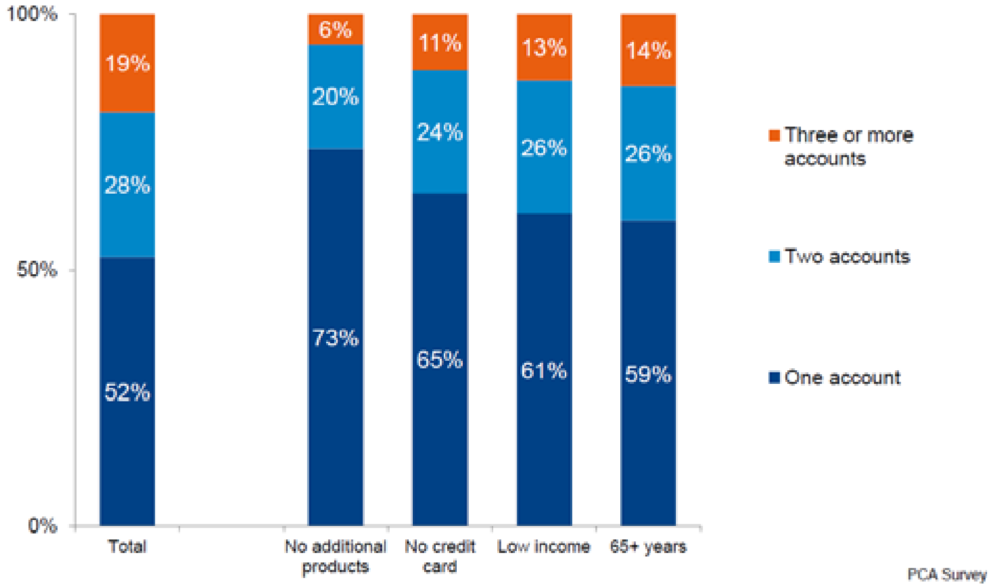
[96] See further Question 35 of HSBC's PCA MQ Response and paragraphs 5.9 to 5.15 of the HSBC May 2014 Submission.

[97] See Figure 25 of the GfK PCA Survey Report.

[98] See Figure 33 of the GfK PCA Survey Report.

PCA customers is reflected in the fact that while 22% of PCA holders reported that they "nowadays" used multiple current accounts with different banks, this incidence was higher among those who had switched their current account between banks in the past year (30%).[99]

Chart 5: Number of current accounts held by PCA customers



Source: GfK PCA Survey Report (Figure 25)

(ii) While the CMA's statistics on switching rightly capture those who switched their main PCA and left another account open,[100] they fail to take into account other soft switchers who may have opened an additional account but not yet used that account as a "main" account (e.g. those who switch on a "try-before-you-buy" basis).

(b) **Internal switching / new account opening**: banks compete intensely both (i) to retain customers and (ii) to acquire customers who are new to the PCA market:

(i) One way HSBC has sought to retain customers is through offering attractive upgrades and alternatives to internal switchers. HSBC considers that other banks have similar retention strategies, which drives rivalry between them.[101] Therefore, in addition to the 3% of customers who switched their main PCA provider last year, the CMA should take into

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[99] See Figure 26 of the GfK PCA Survey Report.

[100] See Figure 33 of the GfK PCA Survey Report.

[101] See, for example, paragraphs 6.161, 6.180, 6.194, 10.6 to 10.16 and 14.3 of HSBC's PCA MQ Response.

account the further 2% of customers who decided to switch PCAs internally (with this figure rising to 6% over a three year period).[102]

(ii) Approximately 6 million new PCAs are opened each year (approximately 7.5% of all PCAs).[103] Even accounting for the fact that a proportion of these accounts may be opened by switching or multi-banking customers, this leaves a sizeable pool of new customers for providers (including new entrants) to compete for on an ongoing basis, who are not captured by switching rates.

(c) **Considering:** as HSBC has previously submitted, the CMA cannot assume a perfect correlation between those who are looking around and those who are considering switching (as the GfK PCA Survey Report does).[104] Some customers who may have considered switching may not have identified themselves as having "looked around" (e.g. a customer talking to a friend about a bank or paying attention to advertisements). These customers, however, have actively engaged with the market by remaining with their current provider.[105]

(d) As noted at paragraphs 3.16 to 3.17 above, the CMA should expect customer engagement to continue increasing over time, as competitors continue to introduce attractive new or improved propositions and service offerings, and as use of online and mobile banking continues to grow and further simplify customers' use of their PCAs and control over their finances. This is evident from the GfK PCA Survey Report – the frequency in which PCA customers use digital banking services indicates a high level of engagement. Strikingly, a third of mobile users accessed mobile banking services every day and a significant majority of PCA customers who either used tablets or smartphone apps (74%) or internet banking (66%) did so at least once a week or more.[106]

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102 See Figure 32 of the GfK PCA Survey Report.

103 See paragraph 18(a) of the UIS.

104 For example, question F9 asked all those who did not switch or <u>look</u> around in the last three years: "*Why have you not <u>considered</u> changing your current account in the last three years?*".

105 HSBC has raised this concern in its previous submissions to the CMA: see HSBC's comments of 22 January 2015 on the draft PCA Survey Questionnaire published on 16 January 2015 and HSBC's comments of 20 March 2015 on the CMA's proposed econometric analysis of the determinants of searching and switching for personal current accounts.

106 See paragraphs 27 and 78 of the GfK PCA Survey Report.

(iii) A complete analysis of the evidence demonstrates already healthy levels of customer engagement

4.27 The CMA should exercise caution in drawing conclusions about lack of engagement from the finding that 73% of customers did not look around in the past three years:

(a) As the GfK PCA Survey Report shows, 35% of customers did search or switch in the last three years.[107]

(b) The CMA should not infer that the 65% of customers who neither switched nor looked around are disengaged: 52% of customers indicated they were highly satisfied with their current PCA provider, so there is no reason to expect them to switch or look around.[108] This is supported by research carried out by GfK on behalf of HSBC, which showed that customers who were extremely or very satisfied reported a much lower likelihood of switching compared with dissatisfied customers.[109]

(c) This leaves just under half the market as having a potential willingness to switch. Compared to this, over one third of all customers switched or looked around in the past three years. This suggests that a relatively high proportion of customers with this potential willingness to switch or look around did switch or look around.[110]

4.28 In any case, as explained in HSBC's Issues Statement Response,[111] the CMA should appreciate that effective competition and positive customer outcomes do not require all (or even nearly all) customers to be actively considering switching or to be fully engaged: rivalry for marginal customers - and the relative value of those customers - can drive competition. Markets can function well even though not every customer is fully engaged (indeed, it is unlikely that any market can achieve 100% customer engagement). Where marginal customers are driving competition, it is important to have a certain level of differentiation in customer offerings to ensure that engaged customers have an incentive to shop around. This is evident in the PCA and SME banking markets where there is differentiation across both price and non-price features.

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[107] See Figure 32 of the GfK PCA Survey Report. This figure is higher than the 73% identified by the CMA because 8% of customers who did switch providers did not identify themselves as having "looked around" before doing so, demonstrating that failure to "look around" is not necessarily a proxy for lack of customer engagement. This discrepancy is also recognised in footnote 6 to Appendix D of the UIS.

[108] See Figure 21 of the GfK PCA Survey Report.

[109] GfK FRS, *Understanding non-switching behaviour*, January 2015, slide 3.

[110] See Figure 32 of the GfK PCA Survey Report.

[111] See paragraph 2.28 of HSBC's Issues Statement Response.

(b) *Any barri ers to sw it chin g relat e primari ly to cu stomers' p erceptions of the difficulty of the switching process*

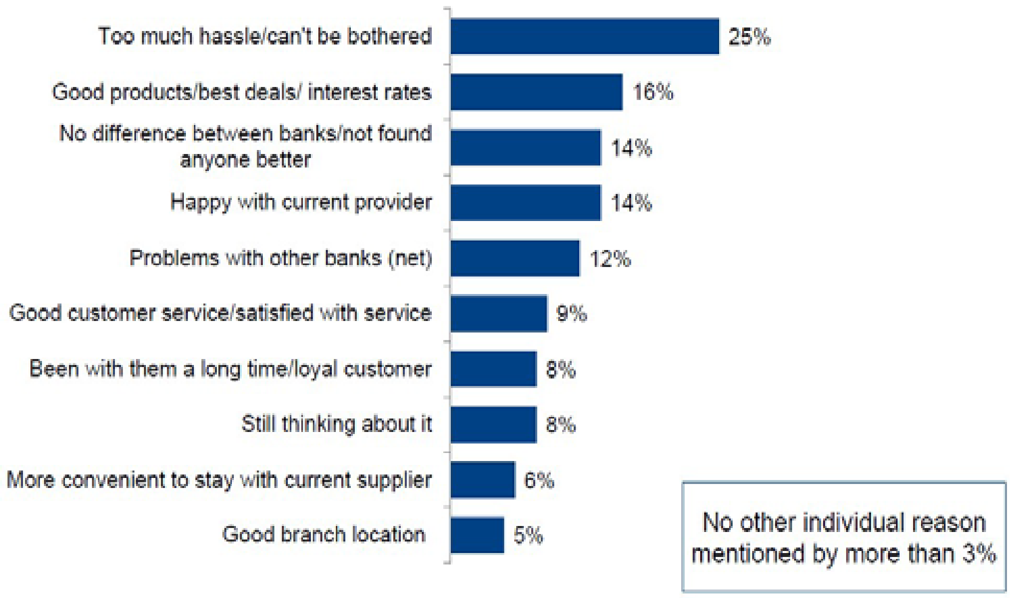
4.29 The UIS suggests that, even if customers have access to information, are willing to shop around and are willing to compare offers from different providers, there are barriers to switching relating to "*procedural switching costs (such as online account opening process and the switching process)*".[112]

4.30 Quantitative evidence from the GfK PCA Survey Report shows that, aside from high levels of customer satisfaction, current switching levels in the PCA market can be explained by customers' perceptions of the costs and "hassle" of the switching process rather than any lack of transparency (see **Chart 6** below):

(a) a third of all customers had expected the switching process to be "very difficult" or "fairly difficult";[113] and

(b) of the 16% of customers who had shopped around but not switched in the past year, 25% said they did not eventually switch because "it was too much hassle or they couldn't be bothered".[114]

Chart 6: Reasons for PCA customers not switching after searching (in last year)



Source: GfK PCA Survey Report (Figure 44)

4.31 However, the results of the GfK PCA Survey Report demonstrate a sizeable gap between customers' expectations of the difficulty of switching and the actual difficulty of switching: of those who had switched in the past year, 59% said they had expected the process to be easy, whereas a considerably higher

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[112] See paragraph 73 of the UIS.

[113] See paragraph 188 of the GfK PCA Survey Report.

[114] See Figure 44 of the GfK PCA Survey Report.

83% found it was easy in practice.[115] This is also supported by the findings of the CMA's qualitative survey, which found that "[t]*he concern that a problem could arise in the switching process* [led] *many participants to feel that switching was too much "hassle". This, combined with a lack of knowledge around what is involved with switching PCAs, low levels of dissatisfaction with PCAs, and the perception that there is little differentiation between PCAs meant many participants felt that switching PCAs was not worth the risk*".[116]

4.32 Any discrepancy between the perceived and actual cost of switching should be tackled through increasing awareness of, and confidence in, CASS. This is supported by the FCA's review of the effectiveness of CASS and evidence from the Payments Council:

(a) The FCA-commissioned quantitative research showed that "*awareness and confidence in CASS is low*" with only 41% of customers surveyed having heard of CASS. Of those customers that had heard of CASS, 41% stated that they had no understanding of the CASS guarantee.[117]

(b) The FCA also found that an error-free switch was the biggest concern for customers: the fact that fewer than 50% of customers were confident CASS would complete their switch without error suggests that confidence in the process is still relatively low.

(c) It is evident that there is a sizeable gap between perception and reality, as research published by the Payments Council reported that 89% of customers experienced an error-free switching process.[118]

4.33 As CASS has only been operational for less than two years, the CMA should not place undue weight on current levels of awareness, as its impact can be expected to increase over time (including through word of mouth). BACS also receives ongoing funding to raise awareness of, and confidence in, CASS.

FIIC

4.34 A particular focus of the analysis in the UIS is FIIC. The CMA acknowledges that it has not yet reached a view on whether FIIC: (i) reduces customer engagement by distorting customers' perceptions of the cost of banking (under Theory of Harm 1);[119] and/or (ii) acts as a barrier to entry and/or expansion

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[115] See Figure 48 of the GfK PCA Survey Report.

[116] See paragraph 198 of the GfK PCA Survey Report.

[117] See paragraphs 4.19 and 4.21 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[118] See paragraphs 4.6 and 4.26 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[119] See paragraph 68 of the UIS.

(under Theory of Harm 3). The UIS does not adduce any evidence that FIIC is a barrier to entry and/or expansion; it merely reports unsubstantiated assertions made by two of the CMA's case study participants.[120]

(a) <u>*The CMA should exercise caution in its assessment of FIIC and consider whether any specific alternatives would improve customer outcomes*</u>

4.35 Evidence to date on how customer outcomes might materially improve under alternatives to FIIC is limited.[121] However, recent survey evidence[122] suggests that UK customers do not expect to pay for a standard PCA, as they see this model as an implicit bargain in which they fund banks' activities through their deposits.

4.36 The GfK PCA Survey Report provides several important insights:

(a) Customers do not typically expect to pay for PCAs and only 22% of customers opt to pay a monthly fee for their main PCA for additional benefits.[123] This is reinforced by the fact that many customers see banking as an exchange: they do not pay upfront costs for the use of standard PCA facilities because PCA providers are remunerated by the "*banks receiving customers' funds to make more money*".[124]

(b) Given many customers are aware that PCA providers benefit from "*receiving customers' funds to make more money*", this suggests customers are aware of the implicit cost of FIIC in the form of foregone interest on credit balances. It seems likely that customer awareness will only increase as interest rates rise and customers become more sensitive to the opportunity cost of accounts that pay no or low interest on credit balances.

(c) Further, the qualitative research indicates that the introduction of fees without additional benefits may be "*felt to contribute to a product mystification*" (in particular, surrounding the amount of the fee) and could "*reinforce negativity around the banking sector*".[125] In this regard, the CMA must give due weight to the high levels of customer satisfaction in the current PCA market which predominantly operates on a FIIC model (see paragraphs 4.6 and 4.22 above).

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[120] This view is stated by Tesco Bank (see paragraph 70(c) of the CMA's Tesco Bank case study dated 21 May 2015 (the ***Tesco Bank Case Study***)) and Virgin Money (see paragraph 53 of the CMA's Virgin Money case study dated 5 June 2015 (the ***Virgin Money Case Study***).

[121] See the qualitative aspects of the GfK PCA Survey Report and unsupported assertions made by one of the CMA's case study participants (Tesco Bank).

[122] See the GfK PCA Survey Report and research conducted by M&S Bank in relation to the introduction of its fee-free PCA (see further Question 43 of HSBC's PCA MQ Response).

[123] See paragraph 206 of the GfK PCA Survey Report.

[124] See, for example, paragraphs 213 to 215 of the GfK PCA Survey Report.

[125] See paragraph 218 of the GfK PCA Survey Report.

(d) The CMA should be wary of drawing any conclusions on optimal customer outcomes from the finding that the introduction of a fee "*was highly likely to trigger searching and switching for many qualitative participants*".[126] This reflects the unsurprising conclusion that if customers previously on free banking start being charged, they would seek to find alternatives specifically (and potentially exclusively) to avoid or reduce such a fee. It does not indicate that changes to FIIC would stimulate further customer engagement across the full range of parameters of competition, including both price and non-price elements of PCA providers' offering. It also does not take account of the fact that multi-banking, an important driver of competition, stems in part from the availability of fee-free PCAs, as customers are more likely to open an additional account if it is free.[127]

4.37 In light of the above, if the CMA were to consider any regulatory intervention affecting FIIC, this would need to be underpinned by a well-balanced assessment of the merits of FIIC, relative to the possible alternative(s), on the basis of robust evidence. In doing so, it would be imperative that the CMA explores not only the alleged adverse effects of FIIC on customer engagement (on the basis of more robust evidence than qualitative research) but also:

(a) whether any specific alternatives would have tangible benefits for customers and improve customer outcomes, particularly in light of the high levels of customer satisfaction under the current FIIC model; and

(a) the extent to which the FIIC model fosters other pro-competitive market behaviour, such as (i) competition on the qualitative parameters of a PCA offering[128] and (ii) multi-banking and related "try-before-you-buy" behaviour.

(b) *The CMA's proposed evidence gathering and analysis on FIIC*

4.38 The CMA is proposing to assess FIIC on the basis of: (i) analyses of margins (including the relative profitability of particular customers (e.g. switchers) and comparisons with BCAs); (ii) its PCA survey research; and (iii) its analysis on the actual vs. perceived behaviour of PCA customers.[129] HSBC sets out below its views on the CMA's proposed evidence gathering and analysis:

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[126] See paragraph 217 of the GfK PCA Survey Report.

[127] For example, research conducted by Optimisa Research for M&S Bank in relation to the introduction of its fee-free PCA found that a fee-free PCA was likely to be opened by more than two times the number of customers who were likely to take out a fee-paying PCA (see paragraph 43.2 of HSBC's PCA MQ Response).

[128] Note that the GfK PCA Survey Report found that customers expressed high levels of satisfaction with non-price aspects of their PCA provider's offering: 93% were very or fairly satisfied with the quality of staff and customer service (paragraph 14).

[129] See paragraph 70 of the UIS.

(a) ***Margin and profitability analysis:*** HSBC has concerns about the degree of subjectivity associated with any margin and profitability analysis to inform the question of the impact of FIIC on customer engagement. Any meaningful comparison with other banking products (including BCAs)[130] would be very difficult given the same challenges of subjectivity that the CMA has recognised in assessing the profitability of individual products. It is also not clear how comparisons of the profitability of different customer groups will inform this question.

(b) ***GfK PCA survey research:*** the results of the qualitative s**u**rvey cannot provide a holistic view of the effect of FIIC on competition and customer outcomes. While the GfK PCA Survey Report notes that the introduction of a fee for PCAs (with no additional benefits provided) was "*highly likely to trigger searching and switching for many qualitative participants*", [131] this does not provide any basis on which to reach conclusions about the wider effects of a change in FIIC on the market. The scenario put to the qualitative respondents was one in which one bank in isolation introduced a fee for PCAs.[132] This means that any expectation of increased searching and switching cannot be generalised to a situation in which changes are made to FIIC at the industry level.

(c) ***Analysis on actual vs. perceived behaviour of PCA customers:*** as explained to the CMA in a prior submission, HSBC has concerns that this analysis may be prone to: (i) biases that reflect inconsistencies in the underlying data (including the GfK PCA Survey Report); and (ii) features of customer behaviour which may skew customers' perceptions disproportionately.[133] To the extent that the CMA has been unable to address such risks through adjustments to its approach, it should factor these risks into its assessment of the results of this analysis.

4.39 It will also be important for the CMA to consider customer outcomes against the background of an appropriate counterfactual. By definition, such a counterfactual will involve some form of payment for PCA services (e.g. annual or transaction fees). The CMA should consider how other parameters of competition (in-credit interest and overdraft fees) would change in response

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[130] The CMA also intends to use PCA and BCA profitability comparisons to inform its assessment of the impact of concentration (see paragraph 108 of the UIS). Even if either or both of these factors were a material influence on profitability, there would be no meaningful way for the CMA to separate the impact of these factors.

[131] See paragraph 217 of the GfK PCA Survey Report.

[132] See paragraph 216 of the GfK PCA Survey Report.

[133] See HSBC's comments of 20 March 2015 on the CMA's proposed approach for comparing the actual and perceived behaviour of personal current account customers.

to a move to an alternative structure to FIIC, and how customers would respond to these changes.

Conclusions for PCAs

4.40 HSBC welcomes the CMA's new evidence gathering and fresh analysis for PCAs, in particular the GfK PCA Survey Report. There are several positive indications in this research that demand-side fundamentals are strong and continue on a pro-competitive trajectory. HSBC is encouraged to see that the UIS recognises aspects of this, including that: (i) satisfaction levels in the PCA market are high (which may partly explain relatively low current switching rates);[134] and (ii) customers generally have access to necessary information about the offerings of different providers.[135]

4.41 The evidence demonstrates that there are high levels of customer satisfaction and, to the extent there are any barriers to switching, these appear to relate to customers' perceptions of the switching process. In these circumstances, the CMA's focus should be on taking stock of all the indicators that the demand-side is functioning effectively and balancing these against any indicators suggesting demand-side weaknesses.

SME banking

4.42 In relation to customer engagement in the SME banking markets, HSBC has again considered each element of the "access, assess and act" framework adopted in the UIS.

Access

4.43 HSBC is pleased that the UIS acknowledges that BCA prices are generally transparent.[136] Although the UIS does not consider the issue, loan prices are also transparent.[137] However, as discussed below, loan prices may not be readily and quickly comparable across a wide range of providers.

4.44 As explained at paragraph 1.6 above, HSBC commissioned the Phase 2 BDRC Survey to gather new evidence on customer behaviour and customer engagement, given the limitations of the existing research in these areas. The results from this survey indicate that there are limited issues with access to relevant information for BCAs:

(a) 79% of SMEs that had considered switching in the last five years stated that they "definitely" or "probably" had enough information to make a proper and informed decision about whether to make a change

[134] See paragraphs 58 and 88 of the UIS.

[135] See paragraph 63(a) of the UIS.

[136] See paragraph 84(a) of the UIS.

[137] See Question 17 of HSBC's response of 20 November 2013 to the OFT's request for information dated 15 October 2013.

to their BCA. Only a very small minority (6%) of SMEs stated they did not have enough information.

(b) Only a minority of SMEs stated that the time it took to assemble the information needed to search around for BCAs was "very time consuming" or "quite time consuming": 12% of those who searched for information online, 20% of those who searched for information via a branch and 24% of those who searched for information by telephone.[138]

4.45 In addition, as discussed in HSBC's previous submissions to the CMA:

(a) all finance providers are already required to meet extensive regulatory requirements on transparency, including those of the Consumer Credit Association, the FCA's Banking Conduct of Business, the Lending Code and the Payment Services regulations;[139]

(b) a number of recent and forthcoming measures will further increase the transparency and availability of information in the SME banking markets, including provisions in the SBEE Act relating to greater access to credit data;[140] and

(c) HSBC is proactively taking steps to improve customers' ability to access data on their BCA usage. In particular, HSBC issues customers with monthly "pre-notification advice statements" during their free banking period.[141] HSBC is also introducing text alerts to inform customers when they have entered into an unarranged overdraft.[142]

4.46 Therefore, SMEs do not appear to have any material difficulties in accessing the information required to make an informed decision about their BCA provider.

Assess

4.47 The UIS suggests that there "*may be an inability to easily compare and assess the benefits of switching*", as comparing prices between banks is "*unlikely to*

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[138] Question 30 of the Phase 2 BDRC Survey: "*How did you feel about the time it took to assemble the information you needed when you were searching by…*".

[139] See paragraph 8.19 of the HSBC May 2014 Submission.

[140] See paragraph 3.2 of HSBC's Issues Statement Response.

[141] This statement sets out the date on which the free banking period will end. It also details the customers' account usage and provides a breakdown of those transactions, as well as the price that they would have paid if the tariff that the customer would migrate to at the end of the free banking period were to apply. See further Question 5 of HSBC's response to the CMA's further information request of 3 April 2014.

[142] See paragraph 8.40(d) of HSBC's SME MQ Response. Implementation is targeted for Q4 2015 / Q1 2016.

be a quick and easy process" and there is "*a lack of independent indicators to compare quality of service and relationship management*".[143]

4.48 However, as explained at paragraph 4.15 above, recent and forthcoming developments – such as digital banking innovations and an open API standard – are improving customers' ability to assess and compare SME banking offerings, including for both BCAs and lending.

4.49 In addition, the BBI survey,[144] which was recently re-launched on 28 November 2014 with new data, provides objective and independent information on service attributes of different SME banking providers. The survey is repeated every six months and the findings reflect the responses of 15,000 SMEs.[145]

4.50 As stated by the National Chairman of the Federation of Small Businesses, the BBI survey "*provides businesses with somewhere to go to compare the full range of different bank and finance providers services based on the views of their own peers",* thereby *"enabling businesses to make more informed choices about which services are best suited to their needs*."[146] The survey is therefore a significant step towards improving customer engagement levels and helps facilitates competition between providers, particularly on the service element of their offerings.

4.51 As HSBC has previously stated,[147] the level of traffic to the BBI website has not been as high as desired. Certain banks (including HSBC, Barclays, Lloyds Banking Group and RBS), the British Chambers of Commerce and the Federation of Small Businesses are in the final stages of entering into an agreement regarding funding of the BBI survey in 2015. Given the low levels of customer awareness of the BBI survey to date, the key funding conditions are that more focus is placed on: (i) promotion and awareness; and (ii) making the interface a better customer experience and generally more 'fit for purpose'. HSBC considers that improving customer awareness of the BBI survey is likely to have a significant impact on the ability of customers to compare their SME banking offerings. The Phase 2 BDRC Survey research demonstrates that a significant proportion of SMEs (35%) are more likely to compare competing offerings and consider changing their BCA if there is an "independent website that provide[s] ratings on the quality of service from banks"; this is, in essence, what the BBI survey does.

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[143] See paragraphs 82 and 84 of the UIS.

[144] See: http://www.businessbankinginsight.co.uk/. This survey covers the full range of SME banking services, including BCAs, business deposit accounts and lending.

[145] See Question 58 and paragraph 59.28 of HSBC's SME MQ Response and paragraph 8.26 of the HSBC May 2014 Submission.

[146] See: http://www.fsb.org.uk/business-banking-insight.

[147] See paragraph 58.4 of HSBC's SME MQ Response.

Act

4.52 In relation to the "act" limb of the UIS's framework:

(a) there are clear indications that customers are engaging with the SME banking markets; and

(b) any barriers to switching relate primarily to customers' perceptions (i) of the difficulty in the switching process and (ii) that switching BCA provider may have implications for their ability to access future finance.

(a) <u>There are clear indications that SMEs are engaged</u>

4.53 The UIS notes that there are low levels of engagement among SMEs, including low levels of switching and shopping around.[148]

4.54 However, the UIS understates the level of customer engagement for the following reasons:

(a) The UIS's assessment of customer engagement relies on data from the Charterhouse Business Banking Survey 2014. However, evidence from HSBC's Phase 1 and Phase 2 BDRC Surveys, as well as Payments Council research,[149] demonstrates that **levels of customer engagement are significantly higher than the UIS suggests** (see paragraphs 4.56 to 4.59 below).

(b) **Customer engagement cannot be simply judged by reference to absolute switching levels**. The CMA must also consider the impact of customer churn, multi-banking, new account opening, "try-before-you buy" behaviour, soft-switching and individual (re-)negotiation of terms and conditions, as these factors are all strong indicators of customer engagement (see paragraphs 4.60 to 4.62 below).

4.55 These issues are developed further below.

(i) <u>Evidence from HSBC's Phase 2 BDRC Survey and other market research demonstrates relatively high levels of customer engagement</u>

4.56 The UIS notes that: (i) less than 20% of SMEs considered switching their main bank in the past year; and (ii) only approximately 4% of SMEs have switched in the past year.[150] However, this is based on data from the Charterhouse Business Banking Survey 2014, which does not present a full picture on customer engagement. As explained in AlixPartners' paper on the "*Analysis of likely gaps in customer research for SME banking*",[151] the

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[148] See paragraphs 78 to 79 of the UIS.

[149] See paragraph 51 of the HSBC September 2014 Submission.

[150] See paragraph 78 of the UIS.

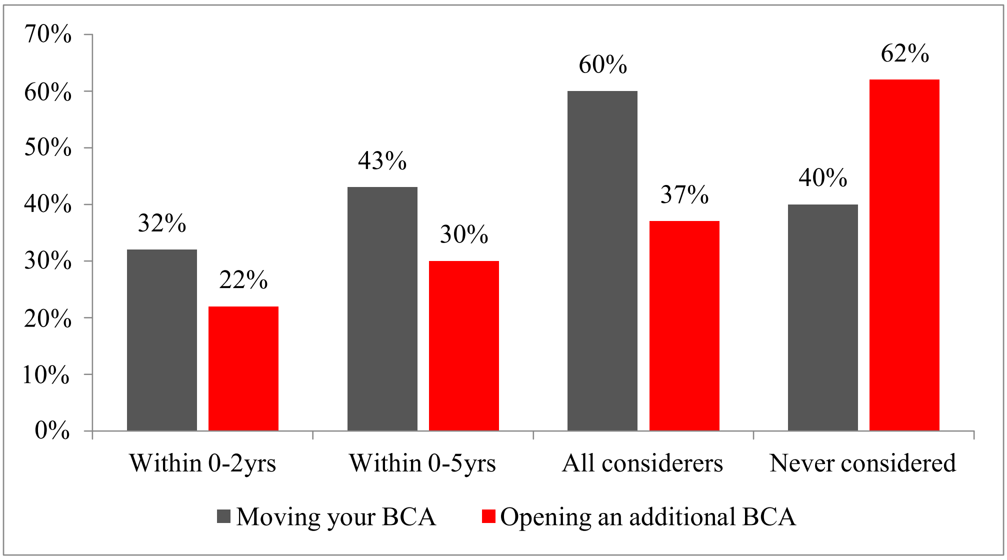
[151] This was submitted to the CMA on 3 December 2014. See, in particular, paragraphs 4.1 to 4.8.

Charterhouse survey provides limited evidence on the incidence of shopping around, the drivers of switching, why customers choose not to shop around, and how customer behaviour varies between different customer segments (e.g. SMEs that have considered switching and SME that have not considered switching). Without such an evidential base, it is not possible to draw robust conclusions about the level of customer engagement in the market.

4.57 As explained at paragraph 1.6 above, due to the limitations of the existing research (including the Charterhouse survey), HSBC commissioned the Phase 2 BDRC Survey to gather new evidence on customer behaviour and customer engagement. The results from the Phase 2 BDRC Survey indicate that levels of customer engagement are significantly higher than the UIS suggests:

(a) 32% of SMEs had considered switching their BCA provider in the last two years and 43% of SMEs had considered doing so in the last 5 years (see **Chart 7** below).[152]

Chart 7: SME rates of switching and multi-banking consideration



Source: Phase 2 BDRC Survey (Questions 24(a) and (b))

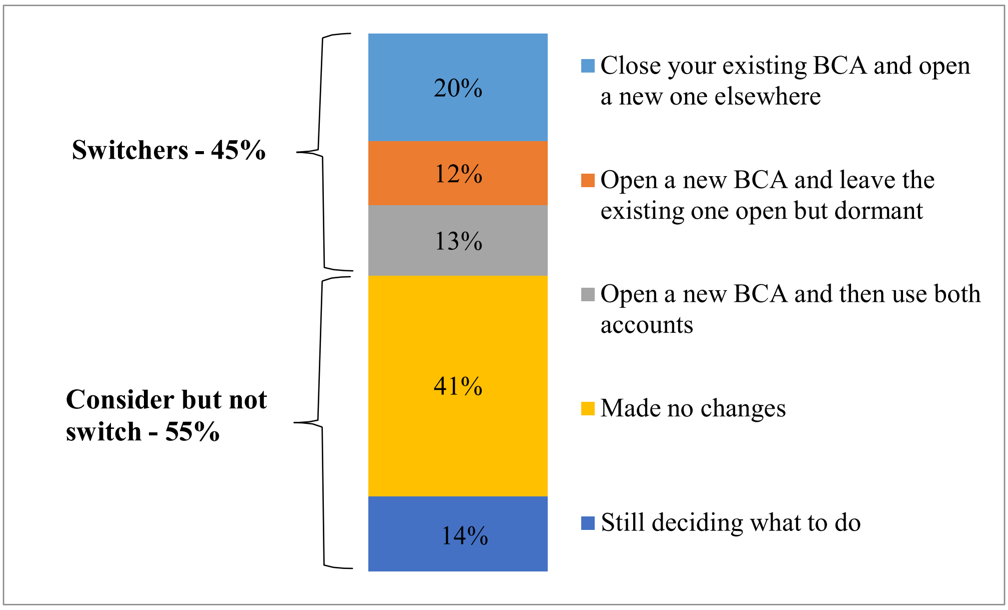
(b) 45% of "considerers" have actually switched their BCA in the last 5 years (see **Chart 8** below).[153] Given 43% of all SMEs are

[152] Larger SMEs are materially more likely to consider switching over the last two years (37% of SMEs with a turnover of £500,000 to £2 million and 40% of SMEs with a turnover of £2 million) and over the last five years (54% of SMEs with a turnover of £500,000 to £2 million and 58% of SMEs with a turnover of £2 million). See Question 24(a) of the Phase 2 BDRC Survey: "*How recently, if at all, have you considered doing either of the following? - Moving your business current account from one bank to another*".

[153] Question 33 of the Phase 2 BDRC Survey: "*What did you decide to do about your business current account in the end?*".

"considerers" (see **Chart 7** above), this means that 22% of all SMEs have switched their BCA in the last 5 years.[154]

Chart 8: SME decisions following consideration of switching



Source: Phase 2 BDRC Survey (Question 33)

(c) 22% of SMEs have considered opening an additional BCA at another provider in the last two years and 30% in the last five years (see **Chart 7** above).[155]

(d) 30% of SMEs stated it was likely they would consider changes to their BCA in the next 12 months. This figure rises to 52% for SMEs who had considered a change to their BCA in the last 5 years.[156]

4.58 As for customers' reasons for not considering switching, the Phase 2 BDRC Survey indicates that existing positive features relating to their current SME banking provider are much more prominent than difficulties in assessing and comparing offerings across providers (see **Chart 9** below):[157]

(a) The main reason provided by SMEs (45%) who had not considered switching in the last five years was that they were satisfied with the

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[154] 284 SMEs of our total sample of 1,311 SMEs had switched BCAs in the last 5 years.

[155] Question 24(b) of the Phase 2 BDRC Survey: "*How recently, if at all, have you considered doing either of the following? - Opening an additional business current account at another bank*".

[156] Question 46 of the Phase 2 BDRC Survey: "*How likely are you to at least consider making changes to your business current account (either moving it to another bank or opening an additional current account at another bank)?*".

[157] Question 37(c) of the Phase 2 BDRC Survey: "*And which of these would you say was the most important factor in your decision not to review your business current account provider?*".

service of their provider.[158] This is supported by the Phase 1 BDRC Survey, which found that those SMEs who had not considered switching in the past were the "happiest" with their current provider.[159] In addition, research undertaken by the Payments Council found that the most common reason for not switching by businesses (and charities) was that they were happy with their current provider.[160]

(b) Of the small minority of SMEs (9%) that were dissatisfied with their provider, approximately two-thirds of these SMEs were "looking to change banks".[161] This indicates that customers are engaged and dissatisfaction with their current provider triggers a decision to search for better offerings.

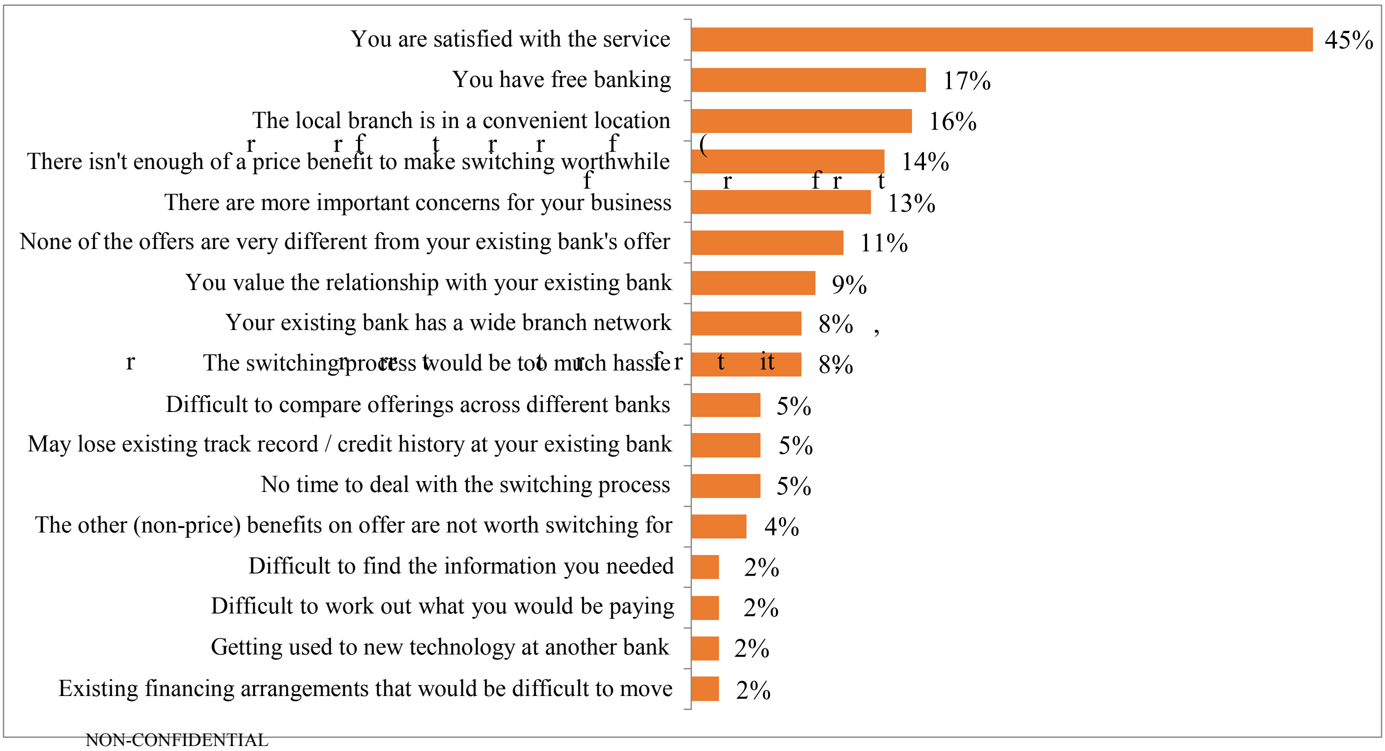
(c) Several other positive factors were highlighted as reasons for customers staying with their current provider: 17% pointed to free banking; 16% to a convenient branch location and 9% to relationship with provider.

(d) Difficulties in accessing information and comparing BCA offerings across different providers are less of a concern:

(i) For SMEs who had not considered switching, only 2% of SMEs stated they had concerns about the difficulty and time to obtain the relevant information; only 2% stated it would be difficult to determine charges based on their own usage and/or compare offerings across providers; and only 5% stated it would find it difficult and/or time consuming to compare offerings across different banks.

(ii) Only a minority (22%) of SMEs who had considered switching but decided not to switch stated it was difficult to compare offerings across different banks (see **Chart 10** below).[162]

Chart 9: Most important factor in the decision not to consider switching BCA



Source: Phase 2 BDRC Survey (Question 37(c))

4.59 In any case, as explained at paragraph 4.28 above, the CMA will appreciate that effective competition and positive customer outcomes do not require all (or even nearly all) customers to be actively considering switching or fully engaged; marginal customers - and the relative value of those customers - can drive competition.

(ii) <u>Customer engagement cannot be simply judged by reference to absolute switching levels</u>

4.60 As HSBC has explained in its previous submissions and at paragraphs 4.25 to 4.26 above,[163] switching rates alone, and "hard" switching rates in particular, are not a good determinant of competition in the SME banking markets, as they significantly underestimate the true competitive constraint that customers exert on SME banking providers.

4.61 The CMA must take full account of the following factors before reaching any conclusions:

(a) **High customer churn:** the SME banking markets are characterised by a high proportion of start-ups and exits. The UIS acknowledges that "*the churn rate for SMEs is high*": 12% of BCAs are opened and closed each year, only 60% of SMEs survive for three years and only 40% of SMEs survive for five years.[164] This means there is a deep pool of new customers on an ongoing basis and competition for start-ups is particularly intense. As such, switching rates are an inadequate indicator of the extent to which SMEs are engaged.

(b) **Switching and shopping around takes place over a longer timeframe than annually**: as explained at paragraph 4.57 above, the Phase 2 BDRC Survey shows that consideration of switching is significantly higher over a two to five year time period. This suggests that customers are engaged in the SME banking markets, but over a timeframe that is longer than one year. Since a significant proportion of the SME population is still within the first few years of their life (and likely benefitting from free banking), it is reasonable to expect that such SMEs would not consider switching within this period.[165] In addition, SMEs that have recently switched are likely to be on free

[163] See paragraph 3.6 of HSBC's Issues Statement Response; paragraphs 7 and 9 of the HSBC September 2014 Submission; paragraph 8.32 of the HSBC May 2014 Submission; and Question 16 of HSBC's response of 20 November 2013 to the OFT's request for information dated 15 October 2013.

[164] See paragraph 11 of Appendix B to the UIS and paragraph 21(b) of the UIS.

[165] See paragraph 11 of Appendix B to the UIS, which notes that only 60% of SMEs survive for three years and only 40% of SMEs survive for five years.

banking tariffs, which means they are less likely to consider switching providers in the short-term. The CMA should therefore consider rates of switching and shopping around over a longer timeframe than annually.

(c) **Multi-banking**: "hard" switching rates do not take into account SMEs that multi-bank. The Phase 2 BDRC Survey found that:

(i) 9% of SMEs have a BCA with more than one provider. This is higher for SMEs with annual turnover between £500,000 and £2 million (17%) and above £2 million (14%).[166]

(ii) 30% of SMEs have considered opening an additional BCA in the last five years.[167]

This demonstrates that simply focusing on "hard" switching is likely to underestimate the real competitive constraint of switching on SME banking providers.

(d) **Individual negotiation of charges and terms**: As the CMA acknowledges, "*[n]egotiation of charges is also more common for SMEs*".[168] Switching rates do not capture SMEs that negotiate more favourable terms with their SME banking provider over the course of the relationship; such customers are clearly engaged. This is a feature of both BCA and SME lending markets. As explained in HSBC's SME MQ Response. HSBC's relationship managers have a wide discretion to negotiate bespoke terms with certain cohorts of SMEs.[169]

4.62 In relation to lending, SMEs are increasingly sourcing their finance needs from providers other than their main bank, including alternative finance providers.[170] The Phase 2 BDRC Survey results indicate that 37% of SMEs who considered taking out a loan in the last 5 years considered a source other than their main bank.[171] Of SMEs that considered taking out a new loan and

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166 See Question 8(a) of the Phase 2 BDRC Survey: "*Which of these specific financial services do you currently use for your business, or have you used in the past? - Business current account*"; and Question 8(b) of the Phase 2 BDRC Survey: "*Which bank(s) or other provider does your business use for business current account?*".

167 See Question 24(b) of the Phase 2 BDRC Survey: "*How recently, if at all, have you considered doing either of the following? - Opening an additional business current account at another bank?*".

168 See paragraph 84(a) of the UIS.

169 See Questions 9 and 13 to 14 of HSBC's SME Response.

170 As noted at paragraph 2.1(b) above, gross financing flows to businesses from alternative finance totalled £749 million in 2014. Growth in alternative finance is expected to continue at a rapid pace (Nesta, *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*, page 13).

171 See Question 38 of the Phase 2 BDRC Survey: "*When you were last considering taking out a new loan, did you speak to any of the following about it?*".

obtained at least some finance, 33% obtained such finance from a source other than their main bank.[172] This demonstrates a high level of engagement with the SME lending market.

(b) *Any barriers to switching relate primarily to customers' perceptions (i) of the difficulty in the switching process and (ii) that switching BCA provider may have implications for their ability to access future finance*

4.63 The UIS suggests that the barriers to switching that exist in the SME banking markets primarily relate to customers' perceptions:

(a) of the costs, "hassle" and technical errors of the switching process (including the account opening process);[173] and

(b) that switching may have implications on their ability to access future finance.[174]

(i) Customers' perceptions of the difficulty of the switching process

4.64 The available evidence suggests that one of the main causes of low switching rates for SMEs who considered switching but decided not to switch is concerns with the switching process:[175]

(a) The Phase 2 BDRC Survey found that 32% of SMEs decided not to switch because they considered the switching process would be too much hassle, and 21% stated they did not have the time to deal with the switching process (see **Chart 10** below).[176]

(b) This is supported by results from the Phase 1 BDRC Survey, which demonstrate that many SMEs still perceive the switching process to be difficult or time-consuming:

(i) 30% of SMEs who were considering switching said that the switching process was too much "hassle" and required too much time to deal with; and

(ii) a significant proportion of SMEs who had switched found the switching process had taken either a very high degree of effort (9%) or a high degree of effort (24%), with only 26% of SMEs finding the process to involve low effort.[177]

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172 See Questions 40(a) and 40(b) of the Phase 2 BDRC Survey.

173 See paragraphs 85(a) to (d) of the UIS.

174 See paragraph 85(e) of the UIS.

175 See further paragraph 8.34 of the HSBC May 2014 Submission.

176 Question 36(a) of the Phase 2 BDRC Survey: "*Which of these (if any) are reasons why you decided not to make any changes to your business current account?*".

177 See paragraph 8.38 of the HSBC May 2014 Submission.

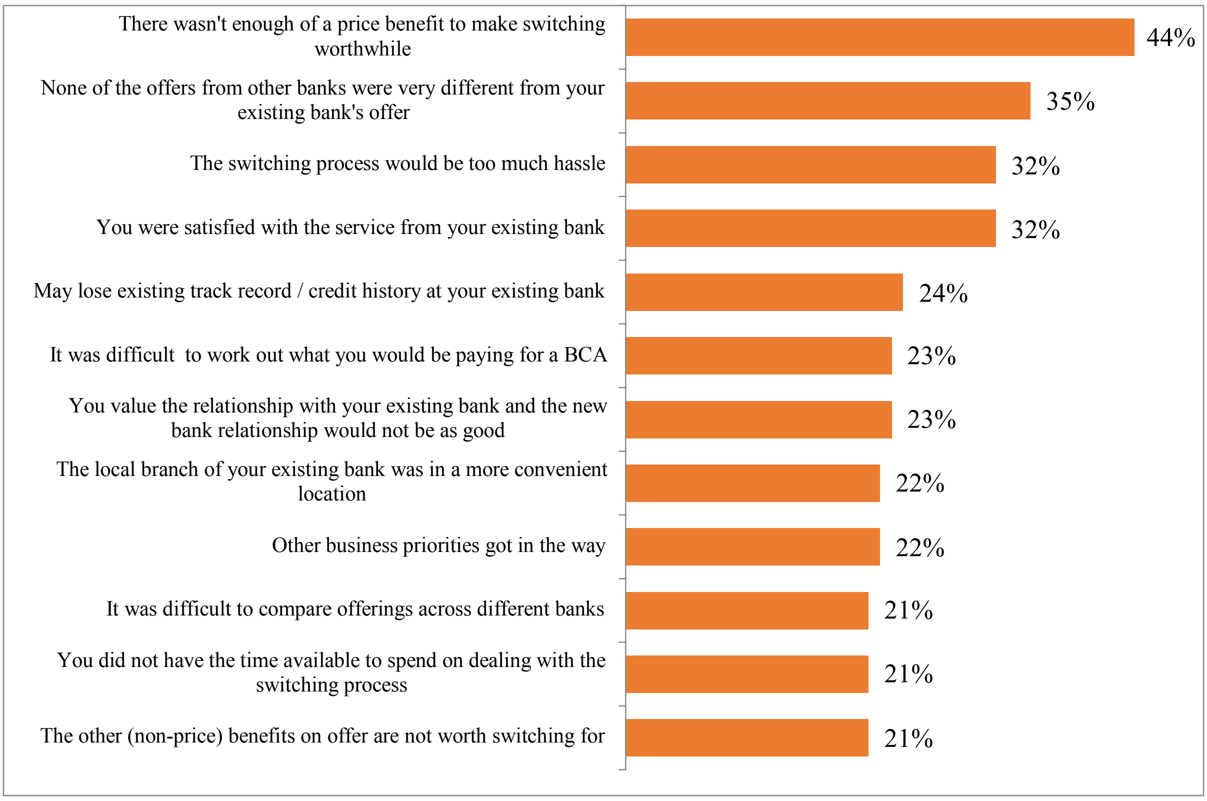
(c) Recent research by the FCA found that 58% of SMEs were not "very confident" or "fairly confident" that a switch would be error-free.[178]

(d) In addition, research by the Payments Council found that:[179]

(i) only 54% of non-switchers thought it would be easy to switch banks and only 46% thought it would be quick; and

(ii) 50% of respondents would not switch even if they knew that they would be better off if they did so, largely because of concerns about errors in the switching process (with only 33% of the total respondents thinking the process would be error free).

Chart 10: reasons for SMEs who considered switching deciding not to switch



Source: Phase 2 BDRC Survey (Question 36(a))

4.65 This perception that the switching process is difficult appears to stem from SMEs' general lack of awareness of or confidence in CASS, despite the recent extension of the switching service to cover all SMEs with annual turnover up

[178] See paragraph 4.26 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[179] See paragraph 8.35 of the HSBC May 2014 Submission.

to £6.5 million.[180] HSBC therefore considers that any discrepancy between the perceived and actual cost of switching may be resolved through increasing awareness and utilisation of CASS. This is supported by evidence from both the FCA and HSBC:

(a) As part of the FCA's review on the effectiveness of CASS, the FCA commissioned quantitative research that showed "*awareness and confidence in CASS is low*" with only 47% of SMEs having heard of CASS. Of those SMEs that had heard of CASS, 36% stated that they had no understanding of the CASS guarantee.[181]

(b) The Phase 1 BDRC Survey found that a significant majority of SMEs (namely 57% of switchers, 70% of those considering switching and 71% of those who had not considered switching) were unaware of the existence of CASS or that CASS applied to both BCAs and PCAs.[182] Furthermore, the existence of such a switching guarantee was the most important measure for all SMEs that could be undertaken to improve the likelihood that they would consider switching: 61% of those considering switching, 37% of those who had already switched and 28% of those who had never switched said it would make them more likely to consider changing their BCA.[183]

(c) This is supported by the results of the Phase 2 BDRC Survey which, once again, found the existence of a guarantee that switching would take place efficiently was the most important measure for all SMEs that could be undertaken to improve the likelihood that they would consider switching: 73% of those considering switching, 59% of those who had already switched and 48% of those who had not considered switching in the last five years said it would make them more likely to consider changing their BCA.[184] For SMEs who had not considered switching in the last five years, a switching guarantee was more

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[180] See: http://www.paymentscouncil.org.uk/media_centre/press_releases/-/page/3214/.

[181] See paragraphs 1.11 and 4.22 of the FCA's report, *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*, March 2015.

[182] See paragraph 3.7 of HSBC's Issues Statement Response and paragraph 8.29 of the HSBC May 2014 Submission.

[183] See paragraph 9.8 of HSBC's submission to the CMA Board dated June 2014.

[184] Question 47(b) of the Phase 2 BDRC Survey: "*To what extent might each of the following encourage you to find out more about what other banks could offer your business, and at least consider making a change to your business current account? - A guarantee that the switch to the new bank would take place efficiently with all the financial arrangements changed over for you and everything running smoothly*". SMEs were asked to rate the initiative on a scale of 1 ("not at all encouraged" to 5 ("very encouraging"). If SMEs responded with a "4" or "5", they were classed as "more likely to consider changing their BCA" because of the initiative.

significant than a recommendation from a trusted person, an introduction to a relationship manager and a price comparison website.

(ii) Customers' perceptions that switching BCA provider has implications for their ability to access future finance

4.66 In relation to the UIS's suggestion that a barrier to switching may be customers' perceptions that switching BCA provider has implications for their ability to access future finance, HSBC notes that the SBEE Act contains provisions:

(a) requiring banks to share credit data on their SME customers with credit reference agencies (which the credit reference agencies will then be required to provide to other lenders and alternative finance providers); and

(b) allowing HMRC to release non-financial VAT data to credit reference agencies for the purpose of assessing creditworthiness, fraud risk and compliance with financial services regulation.[185]

4.67 This increased access to credit data is likely to diminish customers' perceptions that they cannot access finance on similar terms from providers other than their BCA provider, provided the benefits are sufficiently publicised. This is discussed in further detail at paragraph 6.53 below.

Conclusions for SME banking

4.68 As explained at paragraph 4.6 above, there are high levels of customer satisfaction in the SME banking markets. The UIS caveats this finding by stating that: (i) low advocacy rates suggest some latent dissatisfaction; and (ii) qualitative research conducted by the FCA and the CMA suggests some SMEs are unhappy but "tolerating" their situation. This does not appear plausible for the following reasons:

(a) The Charterhouse survey research indicates that customers have expressed satisfaction with their SME provider with 77% stating that their satisfaction levels were "excellent", "very good" or "good".[186] If customers were merely "tolerating" their provider, it is unlikely that they would have responded in this way. The question was put in simple terms and did not invite customers to consider other options available in the market when responding to this question. It is therefore unlikely

[185] See further paragraph 8.120 and Question 59 of HSBC's SME MQ Response.

[186] Paragraph 78 of the UIS notes that the "*Charterhouse survey shows that the majority of businesses are satisfied with their main bank, with approximately 53% rating their satisfaction level as 'excellent' or 'very good', and an additional 38% rating their satisfaction level as 'good' or 'fair'*". The UIS does not specify (i) whether this survey data is for the full year period or a smaller time period and (ii) what size of SME is covered. HSBC has determined its 77% figure from the Charterhouse survey ending Q4 2014 for SMEs with annual turnover below £5 million.

that they have concluded that they are merely satisfied on a relative basis.

(b) The CMA should exercise caution in attempting to use its qualitative research as evidence that SMEs are dissatisfied and merely "tolerating" their providers, given the research comprised only a very small sample of 80 SMEs.

(c) The CMA should not infer a direct correlation between NPS and customer satisfaction, as there are a multitude of factors that influence whether someone is likely to recommend a product or service. In particular, there may be a number of reasons that influence SME business owners not to recommend their provider which are unrelated to customer satisfaction. For example, business owners may not wish to discuss their financial affairs with others or make recommendations that may not be appropriate.

Therefore, HSBC considers that there are high levels of customer satisfaction in the SME banking markets. This is supported by the results of the Phase 2 BDRC Survey, which found that only a small minority (9%) of SMEs were dissatisfied with their provider.[187]

4.69 Given that customer satisfactions levels are high and the key barriers to switching relate to customers' perceptions of the difficulty of the switching process, the CMA's focus should be on exploring whether any measures are required to stimulate the demand-side, in particular improving awareness of and confidence in CASS and the SBEE Act.

4.70 HSBC recognises that there remain limited tools for SMEs to compare the prices and services offered by different banks. Existing comparison websites are not as sophisticated as those used for other industries, although the introduction of the BBI survey appears to have addressed the concerns around the ability of SMEs to compare service levels. As any remaining demand-side issues are addressed, in particular improving transparency and the ability of customers to more readily compare offerings of different providers, competition can be expected to intensify further.

Next steps for Theory of Harm 1

4.71 HSBC recommends that the CMA explores the following areas:

(a) Given the very limited development of the CMA's analysis for SME banking since its Statement of Issues, the CMA should make full use of the new evidence from HSBC's Phase 2 BDRC Survey and undertake further fresh evidence gathering and analysis of customer engagement in the SME banking markets.

(b) Given the limitations of relying on "hard" switching levels as a reliable

[187] See Question 44 of the Phase 2 BDRC Survey: "*Which of these would you say best describes how you currently feel about your main bank in terms of the products and services they provide?*".

indicator of customer engagement, the CMA should consider in detail the impact of multi-banking, new account opening, "try-before-you-buy" behaviour, soft-switching and individual (re-)negotiation of terms and conditions on customer engagement. In this regard, HSBC looks forward to engaging with the CMA on its PCA switching model analysis.

(c) The CMA should also consider how recent and forthcoming developments in the PCA and SME banking markets, such as the Midata initiative, the extension of CASS to cover a larger population of SMEs (with annual turnover up to £6.5 million), the additional investment by certain banks in the BBI survey and developments to digital banking (including an open API standard), will improve the ability of customers to assess and compare competing PCA and SME banking offerings.

(d) Given that customer satisfaction levels are high and the key barriers to switching relate to customers' perceptions of the difficulty of the switching process, the CMA's focus should be on exploring whether any measures are required to stimulate the demand-side, in particular improving awareness of and confidence in CASS and the BBI survey.

(e) In relation to FIIC, the CMA should take a cautious approach that explores fully whether any specific alternatives would have tangible benefits for customers and actually improve customer outcomes.

(f) Since the SME banking markets are characterised by a high rate of customer churn, which drives competition for start-ups, the CMA should take this into account when assessing the extent of overall competition in the market.

5. THEORY OF HARM 2: DECREASING CONCENTRATION AND STRONG RIVALRY

5.1 There are two key weaknesses in the UIS's treatment of this theory of harm:

(a) A **lack of sound economic underpinning**. The UIS sets out two alternative mechanisms through which there might be a link between concentration and customer outcomes:

(i) **The impact of differentiation on market power:** this mechanism proposes that individual banks are highly differentiated, which may give banks market power. The UIS asserts that this effect is *necessarily* greater the more concentrated the market is. For the reasons explained at paragraphs 5.3 to 5.9 below, this theory is economically unsound, because it fails to capture properly the relationship between differentiation, market power and concentration.

(ii) **Differentiation between active and inactive customers:** this mechanism proposes that banks have difficulty in differentiating between active and inactive customers, which reduces their incentives to lower prices to attract and retain new customers.[188] HSBC views this second mechanism as primarily a repositioning of Theory of Harm 1. In any event, there are fundamental issues with this assertion, particularly given that banks (both large and small) do price differentiate between active and inactive customers (see further paragraphs 5.10 to 5.13).

(b) **No persuasive evidence** in the UIS linking the moderate levels of concentration in these markets to poor customer outcomes. Instead, there is substantial evidence which suggests that **concentration levels are declining and rivalry is increasing** both: (i) amongst the larger banks; and (ii) between the larger banks and smaller providers (including non-traditional providers).

5.2 Each of these points is further considered below. HSBC also considers the CMA's proposed workstreams for this theory of harm.

Deficient economic theory

5.3 There is no sound economic basis for this theory of harm under either mechanism outlined in the UIS for the reasons set out below.

Impact of differentiation on market power

5.4 The UIS's first mechanism is that larger banks have a greater ability to differentiate themselves and exercise market power. This rests on two key propositions that: (i) larger banks are more able to differentiate their products; and (ii) differentiation inherently conveys market power by allowing them to

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[188] See paragraph 99(b) of the UIS.

raise prices above marginal costs (and/or reduce quality) without suffering significant customer losses. According to the UIS, this is because product differentiation will reduce "*the degree to which each bank's products compete with other banks' products*".[189]

5.5 However, this theory is unsound as it fails to capture properly the relationship between differentiation and market power and concentration. In particular, as the UIS recognises,[190] differentiation is itself a dimension of competition. This is because differentiation reflects the need to meet diverse customer preferences for a multitude of price and non-price attributes (e.g. quality of service, multi-channel access, technological innovation, prudential strength, etc.).

5.6 As a result both of the key propositions underpinning the theory are undermined.

Size increases ability to differentiate

5.7 The UIS seeks to support the assertion that size increases ability to differentiate with the suggestion that there is a correlation between size and degree of differentiation. The CMA will need to set out compelling evidence in its working papers to support this. However, even if there is a correlation, this may not support the causality upon which this theory relies. The CMA cannot confidently conclude that size increases the ability to differentiate, as causality runs in the opposite direction: successful differentiation (i.e. meeting customer needs for non-price attributes) allows banks to grow.

5.8 The direction of causality that the UIS assumes therefore fails to capture the *dynamic* element of competition: firms that are most successful at meeting customer needs for non-price attributes will be rewarded with higher market shares at the expense of rivals. This may lead to higher concentration, with more differentiated firms having higher market shares. However, any implication that customer outcomes are harmed as a result of these banks being relatively more expensive (which reflects greater investment in providing relevant non-price attributes) would be fundamentally flawed, as customers benefit from the competition in relation to non-price attributes.

Differentiation inherently conveys market power

5.9 The UIS seeks to support the assertion that differentiation inherently conveys market power by observing that differentiation allows firms to raise price above marginal cost (and/or reduce quality) without suffering significant customer losses. This ability stems from product differentiation (i.e. the products are not perfect substitutes for each other).

(a) However, as each of these non-price attributes results in a further dimension of competition, the UIS is incorrect to assert that

[189] See paragraph 99 (a) of the UIS.

[190] See paragraph 99 (a) of the UIS.

differentiation reduces the "*degree to which each bank's products compete with other banks' products*".[191] Banks are competing on each of these individual price and non-price factors, and all banks, including smaller banks, can and do differentiate their PCA and SME offerings.

(b) Therefore, differentiation is a necessary outcome for a market that delivers on non-price elements, such as service and expertise. The fact that this differentiation results in banks pricing above marginal cost does not suggest poor customer outcomes. Pricing above marginal cost is necessary to invest in meeting customer needs with appropriate non-price attributes. Such investments are likely to constitute fixed and common costs, which require an ability to raise price above marginal cost in order to finance these costs. The fact that differentiation may allow banks to "price above marginal cost" is entirely consistent with a well-functioning market.

Differentiation between active and inactive customers

5.10 Under this mechanism: (i) banks have difficulty in differentiating between active and inactive customers; (ii) therefore, a price reduction to attract and retain new customers would be more costly for larger banks given their greater installed base of existing customers (the "installed base" theory); and (iii) this, in turn, produces weaker incentives for larger banks.

5.11 HSBC views this second mechanism as primarily a repositioning of Theory of Harm 1 (i.e. that low customer engagement leads to lower incentives to compete). To that extent, and given the fundamental difficulties to which this framework gives rise (as discussed below), the CMA should focus its assessment on Theory of Harm 1. Concentration is not the root of any problem: increasing customer engagement on the demand side drives evolution of the market structure.

5.12 For Theory of Harm 2, it would be necessary to demonstrate, on the basis of robust evidence, that concentration has an impact on individual banks' market power. However, the UIS seeks simply to assert that large banks may have weaker incentives to compete on the basis of its "installed base" theory. There are fundamental difficulties with this approach, as follows:

(a) First, as the CMA recognises,[192] the theory only holds if banks are unable to distinguish between new and existing customers. However, there is clear evidence that banks (large and small) can and do provide different offers to new and existing customers (see paragraph 5.15(b) below). Indeed, as the CMA has recognised, this ability to price discriminate undermines the installed base theory: "*The ability of banks to price discriminate between new and existing customers would imply that banks have similar incentives to charge relatively high*

[191] See paragraph 99(a) of the UIS.

[192] See paragraph 99(b) of the UIS.

prices to existing/back-book customers and lower prices to new customers, ***whatever their size. This could imply that concentration is not, in itself (or by itself), a source of concern in this market***"[193] (emphasis added).

Furthermore, banks are also able to differentiate between existing customers either: (i) in response to an approach from a customer indicating they are considering switching providers; (ii) through analysis of customer activity data; or (iii) through ongoing active contact with customers.[194]

(b) That is not to say that active customers do not benefit from many of the same advantages as inactive customers (including the same levels of service and channel usage, as well as the benefit of financial incentives when they first joined the bank). However, as in any well-functioning market, there must be a degree of differentiation between these two groups of customers in order for there to be an incentive for customers to switch. As explained in HSBC's response to the Issues Statement, well-functioning markets require a trade-off between the "incentive effect" of lower prices for active customers seeking out a better deal and the "transmission effect", which is the degree to which competition for active customers disciplines prices and the provision of services to inactive customers.[195]

5.13 In summary, the CMA is right to examine explicit mechanisms to explore the relationship between concentration and consumer outcomes. The assumption that a more concentrated market necessarily causes worse customer outcomes is inconsistent with both economic theory and regulatory practice.[196] However,

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[193] See paragraph 8.83 of the CMA's Phase 1 Report on the SME Banking Market.

[194] For details on actions that HSBC takes to differentiate between existing customers, see: (i) paragraphs 18.37 to 18.40 of the SME MQ Response; and (ii) Questions 4 to 6 and 10 of the PCA MQ Response.

[195] See footnote 40 of HSBC's Issues Statement Response.

[196] See, for example, (i) *Unilateral Competitive Effects of Horizontal Mergers,* Gregory J. Werden, Luke M. Froeb (2006) for a good summary of the restrictive circumstances in which an underlying positive relationship between concentration and price can be assumed; (ii) *Endogeneity in the concentration-price relationship: Causes, consequences, and curses.* Luke M. Froeb, William N. Evans (1993); (iii) *Competition, Concentration and Stability in the Banking Sector*, *OECD Policy Roundtables 2010,* http://www.oecd.org/competition/sectors/46040053.pdf: "*Market concentration does not in itself determine whether markets are competitive. Highly concentrated industries can be competitive and this may benefit consumers if larger companies are able to reduce production costs by achieving economies of scale. Measuring market concentration can be a useful initial indicator of competition, but it is by no means the sole indicator. Rather, there are a wide range of factors which determine the level of competitiveness in financial markets*" (page 203); and (iv) *Revised ERG Common Position on the approach to Appropriate remedies in the ECNS regulatory framework*, http://pfs.is/upload/files/erg_06_33_remedies_common_position_june_06.pdf , for a discussion of the trade-off between allocative/dynamic efficiency benefits and productive efficiency

for the reasons set out above, there are material conceptual flaws in the two mechanisms set out in the UIS. In the following section, we also explain the inconsistency of these mechanisms with the evidence.

There is no persuasive evidence to support this theory of harm

5.14 No persuasive evidence has been adduced linking the moderate levels of concentration in the PCA and SME banking markets to poor customer outcomes; claiming there is such a link would therefore be inconsistent with the evidence.

(a) The UIS accepts that there is competition to win new customers, including offers of one-off rewards to PCA switchers and free banking periods for SME start-ups and switchers.[197] This suggests there is no strong link between market share and the competitiveness of a bank's PCA or SME banking offering to new customers.

(b) The UIS also accepts that the evidence on pricing outcomes for PCA customers shows a wide variation in prices across the banks and "mixed evidence" on whether larger banks' prices are higher or lower than smaller banks' prices.[198]

(c) In terms of differences in quality of service, the UIS notes that some of the larger banks are innovating at least as much as smaller banks / new entrants.[199]

5.15 The evidence also indicates that neither of the two 'mechanisms' advanced in the UIS through which there might be a link between concentration and customer outcomes are present in the PCA and SME banking markets:

(a) In relation to the first mechanism, PCA and SME banking survey evidence does not support the suggestion that there are entrenched customer preferences for particular bank brands (particularly among the larger banks) that reduce the incentive to compete on price:

(i) For PCAs, there is no difference in overall satisfaction between those holding accounts with large (90%) or small banks (92%).[200] Furthermore, the evidence does not suggest that customers who had looked to compare different accounts in the last three years focus disproportionately on larger banks. In fact, only 30% of such customers looked only at the four major providers, while a similar proportion looked only at smaller

regarding optimal market structures in telecoms markets characterised by substantial economies of scale (in particular page 122).

[197] See paragraph 107 of the UIS.

[198] See paragraph 104 of the UIS.

[199] See paragraph 104 of the UIS.

[200] See paragraph 128 of the GfK PCA Survey Report.

providers and a larger percentage (40%) looked at both types of suppliers.[201]

(ii) For SME banking, price is the most important driver of SMEs' choice of BCA provider, rather than any factors linked to brand loyalty. Furthermore, when choosing their BCA provider, only 36% of SMEs considered their existing relationship with their PCA provider to be a "main reason" in their decision.[202]

In the absence of entrenched customer preferences for particular larger bank brands, larger providers do not have any market power in relation to their existing customers.

(b) In relation to the second mechanism, there is clear evidence that banks can and do provide different offers to new and existing customers. In particular, banks offer one-off rewards to PCA switchers and free banking periods for SME start-ups and switchers.[203] As noted at paragraph 5.12(b) above, this does not mean that existing customers do not benefit from many of the same advantages as new customers (including the same levels of service and channel usage). Since providers are able to distinguish between these groups, all providers are incentivised to compete to win new customers and retain existing customers.

Strong evidence that concentration levels are declining and rivalry is increasing

5.16 In any event, as explained in HSBC's Issues Statement Response, concentration levels in both the PCA and SME banking markets are moderate and decreasing.[204] This reduced concentration is the *result* of increased rivalry between all types of banks. The "established banks" are losing ground to other providers as competition in these markets increases:

(a) In the PCA market, six banking groups have market shares of 7% or more and the market share for the HSBC brand (c.9.8%) is currently smaller than Santander (c.10.9%).[205]

(b) In the SME banking markets, concentration levels are slightly higher but no individual bank has a market share which is above the level typically associated with market power.[206]

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[201] See paragraph 167 of the GfK PCA Survey Report.

[202] See Question 22 of the Phase 2 BDRC Survey: "*From the list below please select the three main reasons for choosing your business bank?*".

[203] See paragraph 107 of the UIS.

[204] See paragraphs 3.12 and 3.13 of HSBC's Issues Statement Response.

[205] GfK market share data, 6 months rolling data, April 2015.

[206] Annex 2 to Appendix B of the UIS notes that HHIs are around 1,700 in the UK BCA market (page B19).

5.17 The UIS provides evidence that concentration levels are declining:

(a) The PCA and BCA market shares of the four largest banks have fallen between 2012 and 2014.[207]

(b) HHIs have fallen for both PCAs and BCAs in each of England & Wales, Scotland and Northern Ireland over this period.[208] This is particularly noticeable in relation to new PCAs across England & Wales.[209]

(c) Revenues for PCAs and BCAs are declining over time.[210] This indicates that all banks are competing harder on price (as well as other parameters) in order to acquire and retain customers. The CMA notes that declining revenues are attributable in part to: (i) falling monthly account and overdraft fees and increasing interest payments for credit balances on PCAs; and (ii) declining transaction charges and arranged overdraft fees for BCAs, which is consistent with increased competition and improved customer outcomes.

5.18 Therefore, as HSBC has explained in its previous submissions, concentration, in and of itself, is not a concern.[211] What is more important is the degree of rivalry (for all key competitive dimensions, including price, service quality and innovation) and the aggregate competitive constraint provided by all players (both large and small), which cannot be captured by considering aggregate market shares of the four largest banks. As previously stated in HSBC's Issues Statement Response,[212] the CMA appears to have acknowledged this: it points to the UK retail mobile sector as "very competitive"[213] in spite of concentration levels (at the network level) that are significantly higher than the PCA and SME banking markets.[214]

5.19 In particular, aggregate market shares do not capture:

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[207] See paragraphs 18(a) and 22(d) of the UIS.

[208] See paragraphs 18(d) and 21(f) of the UIS.

[209] See Figure 12 on page B14 of Appendix B to the UIS.

[210] See paragraphs 35 and 36 of the UIS.

[211] See paragraphs 4.1 to 4.4 of the HSBC May 2014 Submission and paragraph 3.13 of HSBC's Issues Statement Response.

[212] See paragraph 3.13 of HSBC's Issues Statement Response.

[213] See paragraph 2.16 of the CMA's Market Investigation Reference decision.

[214] This is based on the European Commission's merger decision for T-Mobile/Orange (Case M.5650) on 1 March 2010. HSBC also notes Ofcom's estimation of a post-merger HHI of 2888 (see: http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr11/telecoms-networks/5.48), which compares to the CMA's estimates of current HHIs for PCAs and SME banking of c. 1,700 or less.

(a) **Rivalry amongst the larger banks** - the CMA would be wrong to disregard the importance of rivalry between larger banks (for example, the latest available CASS participant data shows that Barclays has the largest net losses and Santander has one of the largest net gains).[215]

(b) **The emergence of sizeable new providers -** it no longer makes sense for the CMA to consider that there is a "big four" in the PCA and SME banking markets, given the growth of Nationwide (in relation to PCAs) and Santander (in relation to PCAs and SME banking). Indeed, as noted above, the HSBC brand now has a lower share of the PCA market than Santander.[216]

(c) **Increasing rivalry between larger providers and smaller providers** - for example, the evidence appears to show that there is particularly intense rivalry from smaller providers for larger loans, given the larger providers have a lower market share by value of loan than by volume.[217]

5.20 Moreover, the larger banks have expended considerable efforts to try to retain and win customers through innovation (e.g. by providing a multi-channel offering), attractive switching and retention initiatives, and on-going efforts to offer improved products and services. This is reflected in HSBC's own initiatives to win and retain customers, including in response to attractive competitor offerings, which were outlined in its PCA MQ Response and SME MQ Response.[218] The UIS also acknowledges that "*some of the larger banks are innovating at least as much as smaller banks/new entrants.*"[219] This clearly indicates that large banks are incentivised to, and do in fact, compete intensely in both the PCA and SME banking markets.

HSBC has concerns about the CMA's proposed workstreams on this theory of harm

5.21 The UIS recognises the difficulties in making appropriate allocations of: (i) revenues; (ii) shared and common costs; and (iii) capital.[220] In light of this,

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[215] Payments Council data for Q3 2014.

[216] HSBC notes the finding in the UIS that Santander has a much larger share in relation to start-ups and SMEs with annual turnover below £2 million (see paragraph 21(e) of the UIS). However, given: (i) the high rates of entry/exit of SMEs each year (as acknowledged at paragraph 21(e) of the UIS); the growth in SME turnover over time; and (iii) Santander's own rapid pace of market share growth (see paragraph 8.106(b)(ii) of HSBC's SME MQ Response), this is likely to translate into a growing market share across all SMEs in the foreseeable future.

[217] See paragraph 21(g) to (h) of the UIS.

[218] See, in particular, Questions 6, 14 and 17 of HSBC's PCA MQ Response and Questions 11 and 20 to 23 of HSBC's SME MQ Response.

[219] See paragraph 104 of the UIS.

[220] See paragraph 26 of the UIS.

HSBC welcomes the CMA's decision not to undertake a market-wide profitability analysis.

5.22 However, the CMA's proposed next steps will not enable it to explore whether a link between concentration and poor customer outcomes exists:

(a) HSBC has previously noted its concerns with the **proposed customer and product profitability analysis**,[221] namely that if the CMA were to analyse contributions across products and/or customers, it would need to account for both subjective estimates of long-run incremental costs and a range of other factors that vary in the long-run.[222] In addition, customer profitability would also need to be measured over a customer's lifetime to capture changes in customer behaviour and definition.

(b) The CMA still intends to undertake further work on its **price dispersion analysis** (i.e. 'bottom-up' pricing comparisons).[223] As HSBC has previously explained, it has a number of concerns with the reliability of this type of analysis to the CMA's assessment of competition in the PCA and SME banking markets.[224] In particular:

(i) Although the UIS acknowledges that "*any pricing analysis needs to take into account differences in quality of service between banks*",[225] HSBC remains concerned that the proposed analysis fails adequately to capture the wide range of non-price factors on which banks compete, including:

(A) product differentiation (e.g. branding, marketing and service quality across distribution channels, including call centres, digital banking channels and branch-based services); and

(B) the financial strength / stability of the bank and the range of services offered.

(ii) Even in relation to price competition, list prices exclude negotiated discounts and incentives.

(iii) Further, the analysis fails to take account of value-added customer benefits which are particularly relevant to PCAs, such as bonus rates or preferential rates on savings accounts, higher

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221 See paragraph 7.4 of HSBC's response to the CMA's questionnaire on profitability of customers and products dated 30 March 2015.

222 For example, the impact of interest rates.

223 See Annex 2 to Appendix C of the UIS.

224 See HSBC's response to the proposed approach to the comparison of prices across PCA and SME banking providers dated 17 April 2014.

225 See paragraph 104 of the UIS.

rates on ISAs, and “free” products / services. HSBC continues to recommend that the CMA accounts for these additional value-added benefits in its price comparison analysis.

(iv) The CMA sets out a wide range of profiles and notes that a significant gap between the lowest and highest price is evident in each case.[226] However, this is not necessarily indicative of competition issues - it may simply reflect differences in banks' balance sheet positions and their strategies for the development of their funding profile. This can lead to banks seeking to target specific customer segments which, in turn, affects banks' customer mix. Further, the UIS acknowledges that there is mixed evidence on whether the prices of larger banks are higher or lower than smaller banks,[227] which indicates the absence of a linkage between concentration and worse customer outcomes.

5.23 In conclusion, there is no evidence to suggest that the moderate levels of concentration in the PCA and SME banking markets are leading to poor customer outcomes: neither of the 'mechanisms' that the UIS identifies may result in such outcomes are present in these markets.

Next steps for Theory of Harm 2

5.24 HSBC recommends that, in assessing its Theory of Harm 2, the CMA should reconsider the usefulness of the “mechanisms” it is proposing to explore. The CMA should also give commensurate weight to the fact that:

(a) concentration levels in both the PCA and SME banking markets are moderate and are decreasing; [228]

(b) there is significant evidence of increasing rivalry both (i) amongst the larger banks and (ii) between the larger banks and smaller providers (including non-traditional providers); and

(c) the UIS has not identified any relationship between the size of the provider and worse customer outcomes.

[226] See Appendix A and Appendix B of the CMA's proposed approach to its pricing analysis dated 31 May 2015.

[227] See paragraph 34 of the UIS.

[228] As noted at paragraph 3.13 of HSBC's Issues Statement Response, the UIS appears to acknowledge this, pointing to the UK retail mobile sector as “very competitive” in spite of concentration levels (at the network level) that are significantly higher than the PCA and SME banking markets.

6. THEORY OF HARM 3: LIMITED BARRIERS TO ENTRY AND DECREASING BARRIERS TO EXPANSION

6.1 As the UIS recognises, "*the existence of barriers to entry and expansion does not necessarily give rise to an adverse effect on competition*".[229] In a highly regulated and complex market such as banking, certain barriers will always be a feature of the market. However, such barriers are only a cause for concern if they enable incumbents to maintain their market position and prevent new entrants and expanding providers from stimulating competition.

Evidence of new entry and expansion

6.2 As HSBC has previously highlighted[230] – and as the UIS recognises[231] – there are limited barriers to entry and barriers to expansion are decreasing. As a result, there has been extensive new entry into both the PCA and SME banking markets over the past five years[232] and many more new providers will enter imminently.[233] HM Treasury recently recognised that various UK government initiatives represent "*the most significant, sustained programme to deliver lower barriers to entry and exit, level the playing field, and increase consumer engagement in banking for many years and, at the very least, since the mid-1980s*".[234]

6.3 When assessing barriers to expansion, the CMA should assess what level and speed of expansion would be realistic in well-functioning PCA and SME banking markets. Although none of the recent entrants (post financial-crisis) has yet attained the size of some of the larger providers, the growth rate of certain entrants has been rapid and it would not be reasonable to expect them to have attained the size of HSBC yet (one of the smallest of the larger providers in market share terms). None of the CMA's case studies reveal any insurmountable barriers to expansion. In particular, the CMA should consider the rate at which a prudent new entrant or expanding provider adopting a sustainable strategy may be expected to expand.[235]

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229 See paragraph 112 of the UIS.

230 See paragraph 3.21 of HSBC's Issues Statement Response and Question 61 of HSBC's SME MQ Response.

231 See paragraphs 110 to 159 of the UIS.

232 See paragraphs 115 and 116 of the UIS.

233 This includes Atom Bank, Starling Bank, OakNorth and CivilisedBank (which are all expecting to launch later in 2015), as well as Williams & Glyn (which is expecting to launch by the end of 2016).

234 See paragraph 1.4 of HM Treasury, *Banking for the 21st Century: driving competition and choice*, March 2015.

235 It is of note that Atom Bank, Starling Bank, OakNorth and CivilisedBank have no concerns about the extent of their geographic coverage acting as a barrier to entry or expansion in the PCA and

6.4 Furthermore, for those providers who have adopted a branch-based strategy (see further at paragraph 6.38 below), the organic development of a branch network can be expected to take a significant period of time. This is not an indication of a barrier to expansion, so long as a provider can profitably operate and grow its branch network over time. A failure to examine sustainable and prudent rates of expansion in well-functioning PCA and SME banking markets will compromise the CMA's ability to rely on any alleged lack of expansion as the basis for any finding of an adverse effect of competition in these markets. The CMA may wish to explore such prudential constraints further with the PRA.

6.5 New entrants to the PCA market have enjoyed rapid growth and high levels of investor confidence:

(a) Since launching its new, interest-bearing PCA in 2014, TSB has won roughly 9% of market flow (i.e. new PCAs), adding 200,000 PCAs to its stock.[236] TSB successfully floated on the London Stock Exchange in June 2014[237] and its share price has subsequently risen over 15%.[238] In March 2015, Banco Sabadell – Spain's fifth largest bank – made a takeover offer, which was accepted by TSB.[239]

(b) Between its launch in 2010 and the end of 2014, Metro Bank grew its total number of customer accounts to 447,000 at a compound annual growth rate (***CAGR***) of 166%.[240] It also attracted £2.9 billion worth of deposits over the same period at a CAGR of 256%.[241] Metro Bank has already successfully raised £641 million as equity capital from private investors[242] and has announced plans to float in 2016.[243]

SME banking markets (see page 7 of the CMA's case study on prospective entrants dated 5 June 2015 (***Prospective Entrants Case Study***)).

[236] See paragraphs 3 and 53 of the CMA's TSB case study dated 21 May 2015 (the ***TSB Case Study***).

[237] See: http://www.lloydsbankinggroup.com/globalassets/documents/investors/2014/2014jun20_lbg_tsb_ipo_offer_price.pdf.

[238] See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00BMQX2Q65GBGBXSTMM.html?lang=en.

[239] See: http://www.ft.com/fastft/295493/tsb-accepts-1.7bn-sabadell-takeover-offer.

[240] See paragraph 25 of the Metro Bank Case Study.

[241] See paragraph 26 of the Metro Bank Case Study.

[242] See paragraph 73 of the Metro Bank Case Study.

[243] See paragraph 22 of the Metro Bank Case Study.

(c) Virgin Money launched its first PCA product in 2014.[244] Virgin Money successfully floated on the London Stock Exchange in November 2014[245] and its share price has subsequently risen over 50%.[246]

(d) The Post Office started offering PCAs in May 2013.[247] The service is still in the trial phase but the Post Office has already expanded its offering to 110 of its branches[248] and will soon launch its current account mobile app.[249]

(e) Tesco Bank launched its current account in June 2014.[250] It has already started to grow its PCA customer base[251] and there are over 20 million Tesco customers that Tesco Bank can target.[252]

(f) Prospective entrants that also plan to offer PCAs include Williams & Glyn[253], Atom Bank,[254] Starling Bank[255] and Fidor.[256]

6.6 Non-traditional payment providers, which impose a competitive constraint on certain aspects of a PCA offering,[257] are also entering the UK market or rapidly expanding in the UK. For example:

(a) [***Redacted***].[258].

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[244] See: http://www.telegraph.co.uk/finance/personalfinance/bank-accounts/11390232/New-Virgin-Essential-Current-Account-is-it-worth-switching-to.html.

[245] See: https://otp.tools.investis.com/clients/uk/virgin_money/rns/regulatory-story.aspx?cid=962&newsid=456505.

[246] See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00BQ8P0644GBGBXSTMM.html. See further paragraph 14 of the Virgin Money Case Study.

[247] See: http://www.telegraph.co.uk/finance/personalfinance/bank-accounts/9985004/Post-Office-to-launch-current-account.html.

[248] See: http://www.ft.com/cms/s/0/c9437d76-7c43-11e3-b514-00144feabdc0.html#axzz3bioOz5rC.

[249] See: http://www.postoffice.co.uk/current-accounts.

[250] See paragraph 11 of the Tesco Bank Case Study.

[251] See paragraph 34 of the Tesco Bank Case Study.

[252] See paragraph 33 of the Tesco Bank Case Study.

[253] See: http://rbsbranchinformation.co.uk/.

[254] See: https://www.atombank.co.uk/.

[255] See: https://starlingbank.co.uk/.

[256] Fidor is a German-based bank that intends to enter the UK PCA market on an "EU passport" – Fidor notes that the "*FCA and PRA were very helpful with this*" (see page 6 of the Prospective Entrants Case Study). This entry strategy is also open to other EU financial institutions that want to enter the UK PCA and SME banking markets.

[257] See Questions 22 to 24 of HSBC's PCA MQ Response.

(b) From July 2015, Apple Pay will be available at more than 250,000 locations across the UK. It is intended to support more than 70% of debit and credit cards in the UK, with eight banks and several major retailers supporting the system at launch. Uptake of this service has been strong in the US; Auriema Consulting Group reported in April 2015 that: (i) more than half of iPhone 6 owners had used the service;[259] and (ii) there were high levels of repeat usage, with more than 63% of respondents stating they use Apple Pay at least weekly. Take up of this service is also expected to be swifter than in the US given the higher penetration of contactless payment systems in the UK.[260]

6.7 The UIS suggests that there has been "*less entry into SME banking*" than personal banking.[261] However, many of the new entrants and prospective entrants offer a full range of SME banking services alongside their PCA offerings:

(a) TSB already has a presence in SME banking[262] and is likely to focus on growing its SME banking business following its takeover by Banco Sabadell.[263]

(b) Metro Bank has noted that its SME business is "*key to its wider banking strategy*"[264] and is planning to almost double its number of BCAs in 2015.[265] It has also expanded its SME finance product range since its acquisition of SME Invoice Finance Limited in August 2013.[266]

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258 HSBC internal data.

259 See: http://www.acg.net/apple-pay-use-in-us-steadily-increasing-beyond-early-adopters/.

260 See, for example, http://www.theguardian.com/technology/2015/jun/08/apple-pay-launch-uk-europe-wwdc.

261 See paragraph 116 of the UIS.

262 TSB Case Study, footnote 2.

263 Commercial banking is the largest business line of the Banco Sabadell group: see https://www.grupbancsabadell.com/en/XTD/INDEX/?url=/en/SOCIEDAD/FUNDACION_BANCO_SABADELL/?menuid=72574&language=en. Banco Sabadell has already announced its intention to "*accelerate [TSB's] plans to enter small business banking*" and "*expand TSB's small business lending arm*": see http://www.ft.com/cms/s/0/1b852d96-ced7-11e4-893d-00144feab7de.html#axzz3bioOz5rC and http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11484514/TSB-sold-to-Spanish-bank-in-1.7bn-deal.html.

264 See paragraph 20 of the Metro Bank Case Study.

265 See paragraph 29 of the Metro Bank Case Study.

266 See paragraph 13 of the Metro Bank Case Study.

(c) Amongst the prospective entrants, Williams & Glyn[267] and Atom Bank[268] will offer a full range of SME banking services.

6.8 Additionally, as the UIS recognises[269], other new entrants and prospective entrants are specialised in SME banking services. Similarly to other new entrants, these SME banking providers have experienced rapid growth and high levels of investor confidence:

(a) Aldermore Bank launched in 2009 and offers a range of business deposit accounts[270] and finance products.[271] Aldermore Bank successfully floated on the London Stock Exchange in March 2015[272] and its share price has subsequently risen by nearly 20%.[273]

(b) Shawbrook Bank launched in 2011 and offers a range of SME finance products, including commercial mortgages, asset finance and invoice discounting.[274] Shawbrook Bank successfully floated on the London Stock Exchange in April 2015[275] and its share price has subsequently risen by nearly 25%.[276]

(c) OneSavings Bank launched in 2011 and provides SME lending products.[277] OneSavings Bank successfully floated on the London Stock Exchange in June 2014[278] and its share price has subsequently risen by over 85%.[279]

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267 See: http://www.rbs.com/news/2013/09/return-of-williams-glyns-moves-closer.html.

268 See: http://www.ft.com/cms/s/0/097b2f10-9b4c-11e4-b651-00144feabdc0.html#axzz3bioOz5rC.

269 See paragraph 116 of the UIS.

270 See: http://www.aldermore.co.uk/business/business-savings/.

271 See: http://www.aldermore.co.uk/business/business-finance/.

272 See: http://www.investors.aldermore.co.uk/sites/default/files/attachments/pdf/announcement-of-offer-price-100315.pdf.

273 See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00BQQMCJ47GBGBXSET3.html.

274 See: https://www.shawbrook.co.uk/.

275 See: https://investors.shawbrook.co.uk/news/rns/id/711.

276 See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00BWDPMF43GBGBXSET3.html.

277 See: http://www.osb.co.uk/.

278 See: http://www.osb.co.uk/documents/Medway-Pricing-notification.PDF.

279 See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00BM7S7K96GBGBXSSMM.html.

(d) Paragon Bank launched in early 2014 and provides vehicle finance.[280] Paragon Bank is part of the FTSE 250 Paragon Group of Companies whose market capitalisation has more than doubled over the last five years.[281]

(e) Several other SME banking specialists are also about to enter the market: CivilisedBank, a digital-only bank, will focus initially on small and medium-sized businesses and their owners,[282] while OakNorth will offer business deposit accounts and SME lending products.[283]

6.9 The UIS suggests that the alternative finance market "*remains a very small part of the SME lending market in the UK*".[284] However, similar to other new entrants, alternative finance providers have experienced rapid growth and high levels of investor confidence:

(a) Funding Circle's revenues grew by 122% in 2014[285] and it recently raised $150 million of investment in its latest round of fundraising.[286] Funding Circle has also formed partnerships with Santander and RBS, in which Santander and RBS will proactively refer certain SME customers in need of credit to Funding Circle.[287]

(b) Zopa's revenues grew by 69% in 2014.[288] Zopa has also recently formed a relationship with Metro Bank, in which Metro Bank will lend customer deposits through Zopa.[289] As noted at paragraph 6.5(b) above, Metro Bank has already attracted a significant amount of deposits.

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280 See: http://paragonbank.co.uk/file_source/Files/MAIN/pdf/Company%20Factsheet/PBK9689%20-%20September%202014%20Update%20to%20Paragon%20Bank%20Fact%20Sheet%20FINAL.pdf.

281 See: http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary-chart.html?fourWayKey=GB00B2NGPM57GBGBXSTMM.

282 See: http://beingcivilised.co.uk/application/files/4914/3282/4257/Civilised_Bank_press_release_09032015.pdf.

283 See: http://www.oaknorth.com/about.

284 See paragraph 44 of the UIS.

285 See: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11577827/Peer-to-peer-lender-Funding-Circle-doubles-sales-as-it-chases-growth.html.

286 See: http://www.ft.com/cms/s/0/a10fce2a-e832-11e4-894a-00144feab7de.html#axzz3bnJgavSh.

287 See paragraph 59.23 of HSBC's SME MQ Response.

288 See: http://www.altfi.com/charts/charts/uk-volume_chart.php.

289 See: http://www.ft.com/cms/s/0/efadf6fc-fd67-11e4-9e96-00144feabdc0.html.

(c) RateSetter's revenues grew by 144% in 2014.[290]

(d) MarketInvoice's revenues grew by 90% in 2014.[291]

6.10 The new entrants into the PCA and SME banking markets have adopted a wide range of strategies. Some providers (such as Metro Bank) have chosen to focus on their branch propositions, while a number of providers (such as Atom Bank, Starling Bank and many of the alterative finance providers) have opted for purely digital propositions. Other providers (such as Virgin Money) have focused on supplementing their targeted branch network with the use of digital banking channels. Successful entry through a variety of different strategies shows rigorous competition and the absence of any significant barriers to entry and expansion.

6.11 Together with the established challenger banks – such as Nationwide, the Cooperative Bank, Handelsbanken, Clydesdale Bank, Yorkshire Bank and Cambridge & Counties Bank – these new entrants are imposing a significant aggregate constraint on the larger banks.[292] Combined with the existing rivalry amongst the larger banks, a clear picture emerges of dynamic PCA and SME banking markets where new providers are able to overcome any barriers to entry or expansion.

6.12 The absence of any significant barriers to expansion is also apparent from the success of some of the established providers in growing their market share. In particular, Santander has seen a significant increase in its share of BCAs[293] and is now considered one of the "Big Five" banks for both PCAs and SME banking. New entrants such as Metro Bank and TSB have also seen rapid account growth (see paragraph 6.5 above).

6.13 We discuss below how various regulatory and technological developments are further reducing barriers to entry and expansion. Combined with the increasingly active demand-side (as discussed in Section 3 above), these developments are leading to increasingly competitive PCA and SME banking markets.

Reducing barriers to entry and expansion

6.14 Given the extent of the recent new entry and the rapid growth by new entrants and smaller providers, it is clear that none of the potential barriers identified in the UIS are preventing new entrants from stimulating competition. Barriers to entry and expansion have been reduced as a result of various factors, including

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[290] See: http://www.altfi.com/charts/charts/uk-volume_chart.php.

[291] See: http://www.altfi.com/charts/charts/uk-volume_chart.php.

[292] See further paragraph 2.30(a) of HSBC's Issues Statement Response; paragraphs 8.57 to 8.60 of HSBC's SME MQ Response; paragraphs 6.144 to 6.146 of HSBC's PCA MQ Response; and pages 30 to 37 of HSBC's response of 20 November 2013 to the OFT's request for information dated 15 October 2013.

[293] GFK Market Share data (6 months rolling data), April 2015.

regulatory and technological developments and evolving customer preferences.

6.15 According to a recent report by KPMG, "*in 2014, despite being significantly smaller [than the largest five banks], the Challengers reported only slightly higher costs, with an average cost to income (CTI) ratio of 64% ... compared to 63% for the Big Five… The Smaller Challengers [i.e. Aldermore, Handelsbanken, Metro Bank, OneSavings Bank, Shawbrook and Secure Trust Bank] produced a CTI ratio of just 53% in 2014, significantly better than the market*".[294] This suggests that, regardless of the impact of any individual barriers to entry and/or expansion, challenger banks may be better positioned to grow than larger banks.

Regulatory barriers

6.16 As HSBC has previously noted,[295] regulatory obligations (including the authorisation process and capital and liquidity requirements) pose a necessary barrier to entry in order to protect both customers and the banking system. However, HSBC agrees with the suggestion in the UIS that "*the authorisation process for becoming a bank* […] *is proportionate and efficient*" and that firms currently seeking authorisation "*are benefiting from changes in the authorisation procedure introduced in 2013 aimed at simplifying and speeding up the process*".[296]

6.17 Some of the banks in the CMA's case studies raised concerns that capital rules favour incumbents. HSBC agrees with the conclusion in the UIS that "*while the [internal ratings based (IRB)] approach and the costs of gaining IRB approval potentially give larger incumbent banks an advantage, there are a number of other requirements and policy measures that partially counterbalance this advantage, in addition to the cost of developing and maintaining the models required for IRB*".[297] The policy measures introduced by the PRA have been designed, in accordance with its competition objective, to reduce barriers to entry and expansion. These measures restrict the application of any capital planning buffer for new entrants to the costs of winding-up the business. In this respect, HSBC agrees that the PRA "*has taken a number of steps to level the playing field between new and incumbent banks*", including capital concessions for new entrants.[298] In July 2014, the PRA and FCA reviewed the revised approach to capital adequacy for new entrants, concluding that the reforms had delivered in line with the PRA's

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[294] KPMG, *The game changers – challenger banking results*, May 2015, page 3.

[295] See paragraph 3.21(a) of HSBC's Response to the Issues Statement.

[296] See paragraph 119 of the UIS. See further paragraph 4(b) and pages 5 to 6 of the Prospective Entrants Case Study.

[297] See paragraph 121 of the UIS.

[298] See paragraph 122 of the UIS.

projections.[299] HSBC suggests that the CMA continues to seek input from the PRA on the efficacy of these changes.

Funding

6.18 HSBC notes that the CMA's case studies and other evidence received "*do not suggest that potential entrants or banks wishing to expand have had significant difficulties in raising funds*".[300] As noted at paragraphs 6.5 and 6.8 to 6.9 above, new entrants have successfully accessed both private funding and the capital markets.

6.19 New entrants and smaller banks have also experienced rapid growth. According to a recent report by KPMG, challenger banks are outperforming the five largest banks in this regard, with a CAGR of 8.2% between 2012 and 2014 compared to a reduction of 2.9% for the five largest banks.[301]

6.20 Smaller banks are also generally experiencing net customer growth. As noted above, amongst the banks that took part in the CMA's case studies:

(a) Metro Bank has attracted £2.9 billion deposits since 2010 at a CAGR of 256%;[302]

(b) TSB has won roughly 9% of market flow, adding 200,000 PCAs to its stock in the last year;[303] and

(c) Tesco Bank has also grown its PCA book.[304]

6.21 The KPMG report also found that lending assets of challenger banks increased by 16% over the last year, compared to a decline of 2.1% for the five largest banks.[305]

6.22 Therefore, the evidence indicates that new entrants and banks looking to expand are not experiencing any issues raising funds, either through capital raising or attracting deposits. As acknowledged by the CMA in its Metro Bank case study: "*Metro has been able to rapidly grow its deposits to support its funding requirements. Metro has also been able to raise equity capital to fund its expansion, it appears, without any difficulties*".[306] Challenger banks and new entrants are competing for deposits as their primary source of funds, with

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[299] See paragraph 39 and graph 1a of the joint PRA and FCA report *A review of requirements for firms entering into or expanding in the banking sector: on year on*, July 2014.

[300] See paragraph 125 of the UIS.

[301] KPMG, *The game changers – challenger banking results*, May 2015, page 4.

[302] See paragraph 26 of the Metro Bank Case Study.

[303] See paragraphs 3 and 53 of the TSB Case Study.

[304] See paragraph 34 of the Tesco Bank Case Study.

[305] KPMG, *The game changers – challenger banking results*, May 2015, page 3.

[306] See paragraph 73 of the Metro Bank Case Study.

a limited customer funding gap, if any, that needs to be filled through wholesale funding. In any case, there is evidence that challenger banks and new entrants have been able to access wholesale funding markets: Aldermore Bank and Virgin Money have both issued residential mortgage-backed securities and Tesco Bank has securitised credit card receivables.[307]

Branches

6.23 Providers have adopted a range of different strategies to enter and expand in the PCA and SME banking markets. Some of these strategies focus on a physical branch presence, whilst others rely solely on digital offerings. Contrary to the position in the UIS:

(a) **providers do not need to offer counter services at all to enter and expand in the PCA and SME banking markets** – demand for counter services is falling as a result of technological developments and changing customer preferences;

(b) if the provider's strategy involves offering counter services, it **does not need to offer these services on its own premises** – there are several viable alternatives, including agency banking relationships and use of the Post Office network; and

(c) if the provider's strategy involves having a physical presence on the high street, **there is no need to have an extensive network** – providers can enter with a small number of branches and grow their network organically.

(i) There is no need for a provider to offer counter services

6.24 The UIS concludes that the case studies "*suggest that for some customers, counter services are crucial and the cost of providing such services… was an important factor in driving the banks' entry and/or expansion strategies*".[308] Even if this is true, it does not mean that providers need to offer counter services in order to enter or expand in the PCA or SME banking markets.

6.25 As noted at paragraph 3.16(c) above, new entrants have adopted a variety of different strategies. Some providers (such as Metro Bank), have focused on their branch proposition, while a number of providers (such as Tesco Bank, Atom Bank and Starling Bank) have opted for digital-only propositions. Other providers (such as Virgin Money) have focused on supplementing their

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[307] See for Aldermore Bank, page 7 of http://www.investors.aldermore.co.uk/sites/default/files/attachments/pdf/018459_aldermore_ar14_web.pdf; for Virgin Money, page 49 of http://uk.virginmoney.com/virgin/investor-relations/results/virgin-money-group-annual-report-and-accounts-2014.pdf; and for Tesco Bank, page 2 of http://corporate.tescobank.com/assets/files/cms/7657G__2014_5_9.pdf.

[308] See paragraph 128 of the UIS.

targeted branch network with the use of digital banking channels.[309] This shows that there is sufficient differentiation in customer preferences to support a range of different offerings. HSBC welcomes the recognition in the UIS that it will be important to consider how advances in technology will influence future branch use and importance.[310]

PCAs

6.26 The GfK PCA Survey Report provides evidence that a significant and growing proportion of PCA customers use non-branch channels:

(a) 66% of PCA customers use online banking, 37% use a mobile app and 32% use telephone banking (see **Chart 11** below).[311] Furthermore, 34% of customers only use bank branches once or twice a year or less.[312]

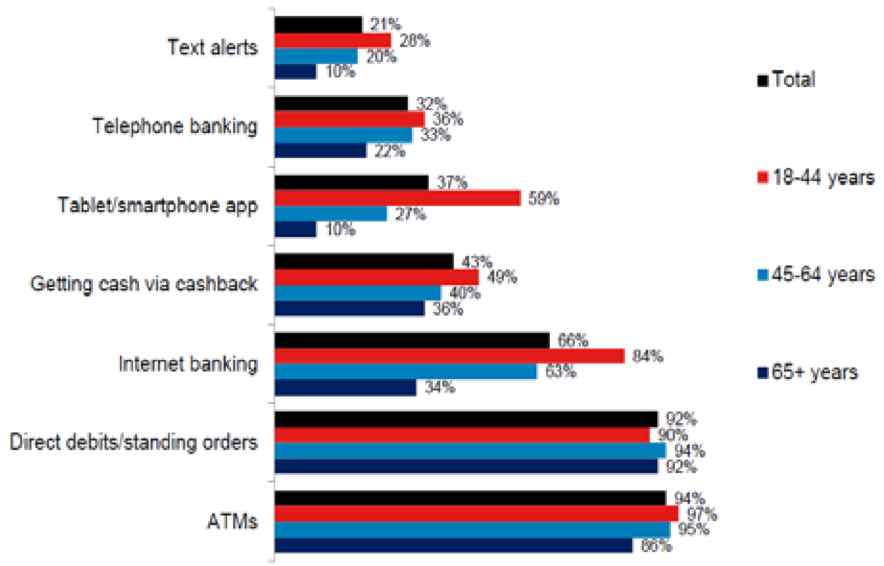

Chart 11: Account services used by PCA customers

Source: GfK PCA Survey Report (Figure 8)

(b) There are a wide range of drivers for customer engagement, including recommendation, reputation and pricing. For over two thirds of

[309] Other providers, such as first direct, have a digital / telephone "shop front" for customer acquisition, whilst still offering transaction services through a physical branch network (for first direct, this service is provided through HSBC's branches).

[310] See paragraph 128 of the UIS.

[311] See Figures 8 of the GfK PCA Survey Report.

[312] See Figure 17 of the GfK PCA Survey Report.

customers (69%), the convenience of a branch location was not a factor for choosing their main current account.[313]

(c) As noted at paragraph 4.26(b)(ii), 6 million new PCAs are opened each year, a sizeable proportion of which are opened by younger customers who are new to the PCA market and are more likely to be digitally engaged.

6.27 These factors indicate that the size of the contestable market for providers without any physical presence is growing.

6.28 In assessing the results of the GfK PCA Survey Report, the CMA should take account of the biases that exaggerate the importance of branches to customers. For example:

(a) The survey questions relating to branch usage were not complemented with similar questions for context on other aspects of customers' channel usage.[314] Such information would provide an important basis of comparison of the importance of different channels to customers. For example, the results could have provided additional insights if the survey had asked what reasons they had for visiting the branch as opposed to using non-branch channels (for example, lack of comfort with other channels, security, documentation requirements, etc.).

(b) The design of the questions does not enable the CMA to distinguish between activities that drive branch visits and activities that are undertaken incidentally while the customers are in the branch. As such, the results overstate customers' usage of branches to access certain services. For example, the PCA survey results suggest that 44% of PCA customers use branches to check balances.[315] However, given the availability of far more convenient means of checking an account balance (including through mobile, online and telephone channels), it seems likely that checking an account balance was not the driver of these customers' branch visits. It is more plausible that they visited a branch for another reason and checked an account balance while they were there.

(c) Customer aspirations or perceptions of what they think they want appear to diverge from their actual behaviour. For example, 48% of respondents stated they would switch if their most used branch

[313] Even Metro Bank, which has adopted a branch-based strategy that uses its branches for the account opening process in order to build customer relationships, will rely heavily on digital and telephone channels for day-to-day transactions.

[314] See HSBC's letter to the CMA dated 6 March 2015.

[315] See paragraph 129 of the UIS.

closed,[316] but only 15% cited the closure of a local branch as the reason for switching.[317] [***Redacted***].[318]

6.29 This accords with recent research by YouGov for the British Bankers' Association (the ***BBA***), which found that 32% of banking customers do not believe that access to a local branch is important and 65% of customers are confident they could do the vast majority of their banking either online or over the phone.[319] As the BBA stated, "*the trend away from branch usage is accelerating*".[320]

6.30 KPMG also recently concluded that "*there is clear evidence that for secondary savings the absence of a branch network is not a hindrance to customers. This is due to the growing willingness/preference to use online/mobile and, to a lesser extent, post and telephone*".[321] Amongst customers that use branches, the GfK PCA Survey Report showed that by far the most common reason (85%) was to deposit cash or cheques.[322] The introduction of cheque imaging (expected to launch in H2 2016) will allow cheques to be deposited remotely and will therefore further reduce the need for providers to offer physical counter services.[323]

6.31 New entrants offering a digital-only proposition, such as Tesco Bank, Atom Bank and Starling Bank, clearly consider that this market segment is large enough to support successful entry. In the CMA's case study, Tesco Bank emphasised its ability to enter the PCA market with a non-branch proposition, given the migration away from branches to digital channels.[324]

SME banking

6.32 The UIS suggests that the conclusions from the case studies on the importance of counter services "*[apply] equally for SMEs as well [as] for personal customers*".[325] However, HSBC notes that only two of the CMA's case studies

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[316] See paragraph 129 of the UIS.

[317] See Figure 39 of the GfK PCA Survey Report.

[318] See paragraph 4.36 of the HSBC May 2014 Submission.

[319] YouGov poll for the BBA. See page 32 and Figure 14 of the BBA's report, *Promoting competition in the UK banking industry*, June 2014.

[320] See page 23 of the BBA's report, *Promoting competition in the UK banking industry*, June 2014.

[321] KPMG, *The game changers – challenger banking results*, May 2015, page 15.

[322] See Figure 18 of the GfK PCA Survey Report.

[323] See: http://www.chequeandcredit.co.uk/cheque_and_credit_clearing/cheque_imaging/faqs/. It is anticipated that government regulations underpinning the introduction of cheque imaging will be drafted by July 2016 in time for the launch of this technology. The banking industry is also working to agree the necessary changes to the infrastructure and technological capabilities.

[324] See paragraphs 58 and 61 to 62 of the Tesco Bank Case Study.

[325] See paragraph 128 of the UIS.

relate specifically to SME banking (Aldermore Bank[326] and Nationwide)[327] and the CMA has only conducted very limited new quantitative research for SMEs. This is an insufficient evidential basis on which to draw any robust conclusions on the relevance of counter services to SMEs or the extent to which the absence of a counter service proposition may act as a barrier to entry and/or expansion.

6.33 The Phase 2 BDRC Survey found a clear trend of declining branch usage among SMEs:

(a) Before the use of digital technology, branches were visited once a week or more by 55% of SMEs.[328] Now, only 29% of SMEs use branches once a week or more[329] and SMEs' forecast of their branch usage indicates that in three years' time only 21% of them will use branches once a week or more (see **Chart 12** below).[330]

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[326] As at the date of this response, the Aldermore Bank case study has not yet been published.

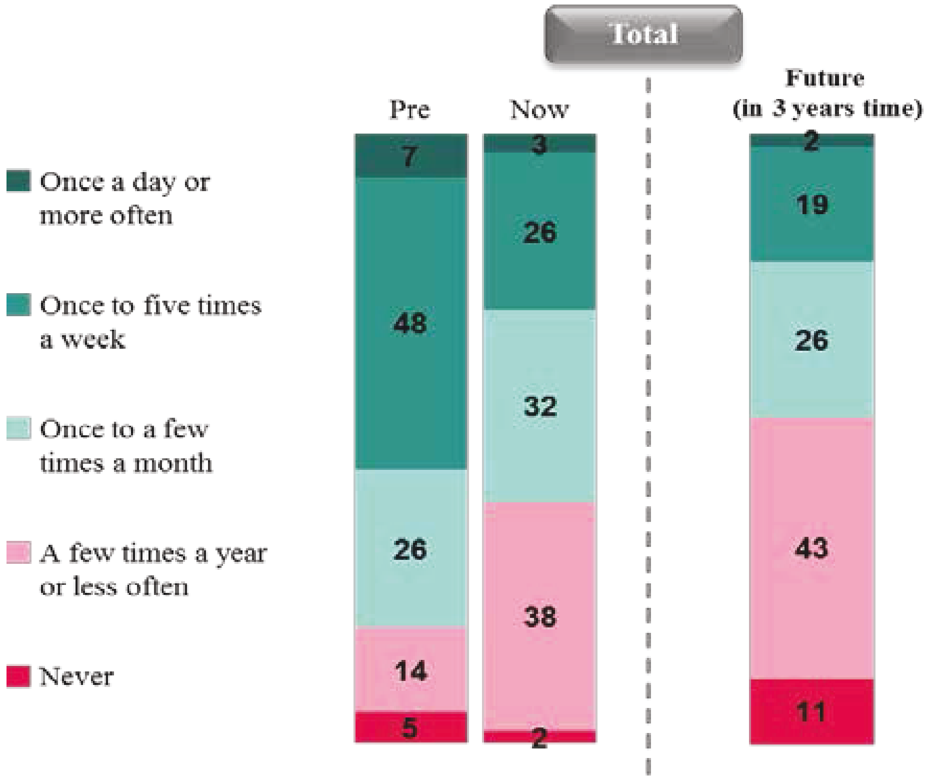
[327] TSB also provides SME banking services. However, the CMA did not consider any barriers that TSB faced in relation to its SME banking business: see paragraph 5 of the TSB Case Study.

[328] Question 14(a) of the Phase 2 BDRC Survey: "*Thinking back to before your business used internet banking and/or mobile banking, how often did you / someone in the business typically visit a branch of your bank for any reason?*".

[329] Question 14(b) of the Phase 2 BDRC Survey: "*And now that you use internet banking and/or mobile banking how often do you / someone in the business currently visit a branch of your bank for any reason?*".

[330] Question 19 of the Phase 2 BDRC Survey: "*Given the potential for wider use of technology like mobile and online banking how often do you think you or someone in your business will be visiting a branch of your bank in three years' time*?". The fall is even more acute among "high digital users", where branch visits once a week or more have fallen from 39% before their adoption of digital technology, to 5% now, and are predicted to be only 2% in three years' time. Given the trend towards higher digital usage, this suggests that the decline in branch usage may continue to accelerate.

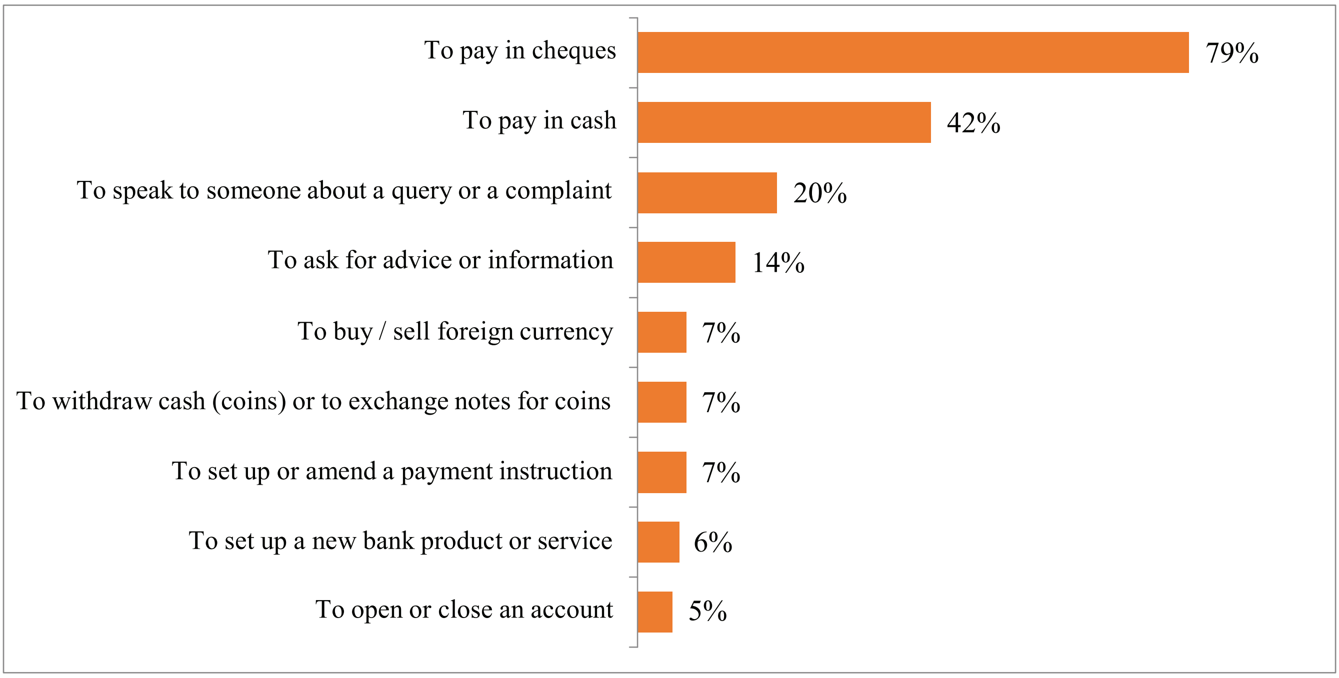
Chart 12: Expected frequency of branch visits over time



Source: Phase 2 BDRC Survey (Questions 14(a), 14(b) and 19)

(b) The most frequent reason given by respondents for visiting a branch was to pay in cheques (79%) (see **Chart 13** below). Cheque imaging will render this unnecessary.[331] The second most frequent reason given was to pay in cash (42%). Similarly, cash usage is in decline so the need to pay in cash will also diminish. There are also alternative ways of paying in cash instead of visiting a branch, as discussed at paragraph 6.36 below.

Chart 13: Reasons for visiting a branch



Source: Phase 2 BDRC Survey (Question 13)

(c) The Phase 2 BDRC Survey also asked SMEs how they would respond, if at all, to branch closures. This was aimed at exploring the importance of branch proximity to SMEs. The survey found that only 28% of SMEs would switch to a nearby different bank in response to a branch closure. The most common response (33%) was to increase their use of internet banking.

6.34 Furthermore, counter services are not relevant to the provision of SME finance. There are a number of providers offering or planning to offer financing propositions through digital-only channels, including Atom Bank, Funding Circle and MarketInvoice.

6.35 There is therefore a large part of both the PCA and SME banking markets that is contestable even for providers that offer no counter services at all. This is supported by the fact that several new and prospective entrants are only offering remote channels to access banking services:

(ii) There is no need for a provider to have its own premises to offer counter services

6.36 If a new provider does wish to provide counter services as part of its offering, it does not need to have its own premises to do so. Alternatives to providers having their own premises include:

(a) **Agency banking relationships** – these are relationships under which a bank (the sponsor bank) provides payment services to another provider, which includes the ability of this provider's customers to use the sponsor bank's branch network for counter services. By entering into agency banking relationships, providers can offer access to counter services to PCA and SME customers in areas where they do not themselves have a branch or if they do not have a branch network at all. This is a viable alternative to providing counter services both for banks without an extensive branch network and for digital-only providers (as evidenced in the CMA's case study on prospective entrants).[332] For example:

(i) Atom Bank, Starling Bank and CivilisedBank, all digital-only banks, appear to be adopting this solution to provide counter services to their customers.[333]

(ii) Handelsbanken's branches do not provide counter services. [***Redacted***].

(b) **Inter-Bank Agency Agreements (*IBAAs*)** – these are bilateral agreements under which one bank agrees to provide another bank's SME customers with access to its branch counters. Such agreements are not used in relation to PCA customers. IBAAs are generally managed locally on a branch-by-branch basis and used where providers do not have a branch within a certain local area.[334] By entering into IBAAs, providers can offer their SME customers access to counter services in areas where they do not themselves have a local branch. This is a viable alternative to providing counter services for banks without a large branch network.

(c) **Post Office network** – as recognised in the UIS,[335] providers can use the Post Office's network of c.11,500 branches to offer their PCA and SME customers counter services.[336] For example, Santander does not allow its SME customers to make cash deposits or withdrawals across its own branches but they are able to do so through the Post Office.[337] There are around c.4,000 "main" Post Office branches within its network that are able to handle large cash deposits. This provides a sufficient branch coverage for SMEs with larger cash needs. HSBC is currently working with the BBA and the Post Office to formulate an industry-agreed framework for the provision of counter services to PCA customers and SMEs, which is expected to be agreed in Q2

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[332] See paragraph 3(b) and page 5 of the Prospective Entrants Case Study.

[333] See page 5 of the Prospective Entrants Case Study.

[334] See further Questions 28 to 29 of HSBC's PCA MQ Response.

[335] See paragraph 131 of the UIS.

[336] The Phase 2 BDRC Survey found that 19% of SMEs would use a local Post Office if their nearest bank branch closed, which indicates that use of the Post Office network is a valid alternative to their usual branch (Question 16: *If your nearest bank branch closed, which of the following, if any, would you be prepared to do instead?*). This must be judged against the context that there has been limited promotion of the Post Office network to SMEs and SMEs' awareness of the ability to use counter services at a Post Office is relatively low.

[337] Santander's SME customers can only use automated teller machines for cash deposits or withdrawals at Santander branches.

2015.[338] Following this, HSBC anticipates offering the use of the Post Office network for its own SME customers in Q3 or Q4 2015.

(d) **Cash collection and delivery services agreements** – customers utilising these services will generally have an agreement with the bank for the processing of cash and a separate direct agreement with the carrier for the collection, transportation and delivery of cash. By using bilateral agreements such as these, new entrants can avoid having to develop their own counter services infrastructure.

6.37 There is therefore no need for a provider to have its own premises to offer counter services. This is supported by the CMA's case study on prospective entrants, as none of Atom Bank, Fidor, Starling Bank and CivilisedBank identified physical presence as a concern.[339]

(iii) There is no need for a provider to have an extensive branch network

6.38 Among providers with a branch-based or multi-channel strategy, it is not necessary, or desirable, to have an extensive network of branches.

(a) All of the larger banks are reducing the size of their branch network to reflect changing customer preferences and usage patterns. As noted in previous submissions, [***Redacted***].[340] The current size of the branch network, with high fixed costs and many branches generating little revenue, is unsustainable in a competitive environment.

(b) Providers such as Metro Bank[341] and Handelsbanken[342] have grown their branch networks organically by initially focusing on particular regions. The success of the banks adopting this model shows that it is possible to compete effectively with a small local network and to expand gradually over time. Metro Bank has specifically stated that it does not consider that a branch network should act as a barrier.[343]

(c) Other providers that have a branch-focused strategy, such as Virgin Money,[344] have expanded by supplementing their targeted branch

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338 Services that will be available through the Post Office network include: cash deposits; cheque deposits; notes for coins exchange; and carrier cash collection.

339 See page 5 of the Prospective Entrants Case Study.

340 See Question 39 of HSBC's SME MQ Response.

341 See paragraph 22 of the Metro Bank Case Study.

342 Handelsbanken's branches do not provide counter services (see paragraph 6.36(a)(ii) above).

343 See paragraph 49 of the Metro Bank Case Study.

344 Virgin Money acquired Northern Rock and its 75 branches in January 2012 – these 75 branches provide a "*good coverage of the major urban centres in the UK*". Its PCA product (the "Essential Current Account") can only be opened in a Virgin Money branch and is designed to be managed through Virgin Money branches, with some services provided online and by telephone. Virgin

network with the use of digital banking channels. In 2014, 81% of Virgin Money's customer interactions were via digital channels.[345] Virgin Money notes that it has "*no plans to expand its branch network in the near future*"[346] and "*does not consider its limited network of 75 branches to be an obstacle to its further expansion*".[347] Given the declining importance of branches and the fact that it "*expected the majority* [of its customers] *want to access* [their] *services through digital and online technologies*",[348] it is working to "*provide more advanced digital banking capabilities to its customers*".[349]

6.39 The size and nature of branches is also changing as technological developments allow for the automation of counter services. Many services, including cash and cheque deposits, balance transfers and payments, can now be done through electronic terminals. These require less floor space than manned counters and therefore reduce the size of the property (and therefore rent) needed to offer counter services. [***Redacted***].

6.40 The UIS notes the finding from the PCA survey that "*a national [branch] network was identified as essential or very important by 58% of respondents*".[350] However, HSBC does not consider that this accurately reflects the importance of a national branch network as a barrier to entry or expansion:

(a) The survey results show that only 21% of respondents considered access to a national branch network to be "essential"; the remaining 37% considered it "very important".[351] Customers in this latter group were provided with the option of stating that a national branch network was "essential" but decided it was not. This indicates that they may consider many aspects of a bank's offering to be very important and may be willing to compromise on certain elements (such as a national branch network) to gain access to other features. This would suggest that providers without a national branch network may be able to

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Money relies on its branches and word of mouth to acquire customers (see paragraphs 47 and 66 and footnote 27 of the Virgin Money Case Study).

345 See paragraph 65 of the Virgin Money Case Study.

346 See paragraph 67 of the Virgin Money Case Study.

347 See paragraph 5 of the Virgin Money Case Study.

348 See paragraph 65 of the Virgin Money Case Study.

349 See paragraph 66 of the Virgin Money Case Study.

350 See paragraph 129 of the UIS.

351 See Figure 19 of the GfK PCA Survey Report.

compete for such customers on the basis of other aspects of the offering.[352]

(b) Even if 58% of PCA customers do consider a national branch network to be important this would mean that a national branch network is not considered particularly important by 42% of customers – this suggests that there is a large contestable market for providers without a national branch network.

6.41 The Phase 2 BDRC Survey explored the extent to which SMEs considered a national branch network to be important. The survey found the following:

(a) Only 8% of SMEs that had not considered switching stated that their existing bank's wide branch network was a main reason for not doing so (see **Chart 9** above).[353]

(b) When choosing a BCA provider, 71% of SMEs would consider a traditional bank with a wide branch network, 46% would consider a newer challenger bank with few branches and a significant online offering, and 30% would consider an internet only bank (see **Chart 14** below).[354] This again shows a large contestable market for providers offering digital-only channels or a small local network.

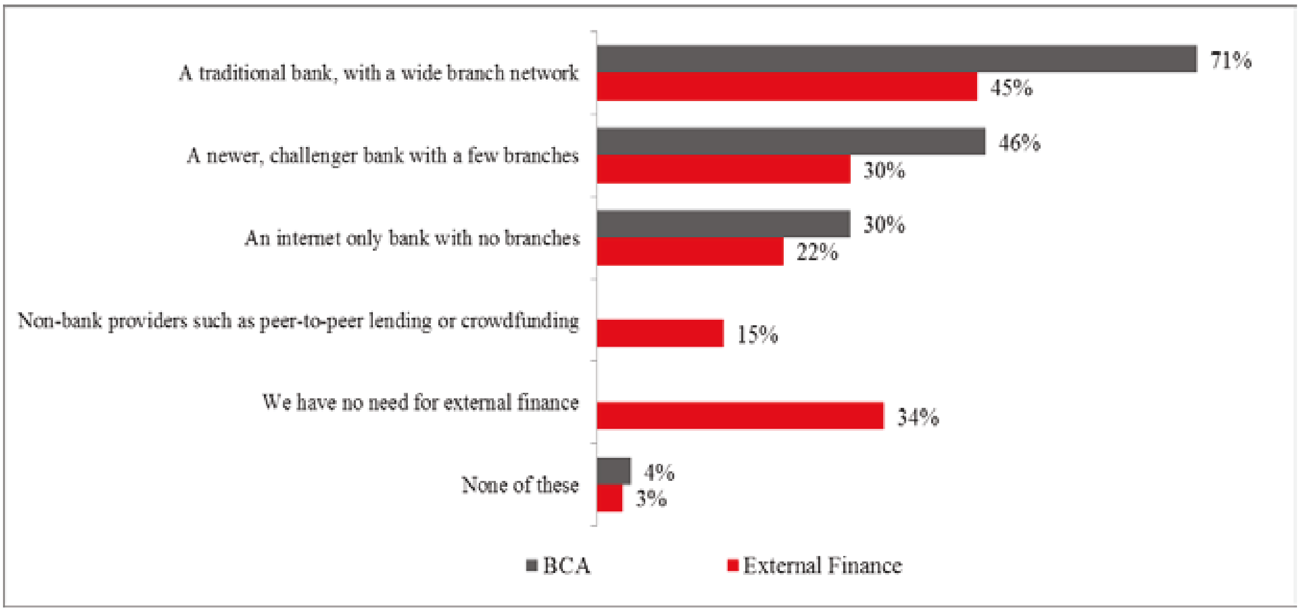
(c) When seeking finance, 45% of SMEs are willing to try a challenger bank and 33% an internet-only bank. Furthermore, 15% of SMEs were willing to consider non-bank providers, such as peer-to-peer lending or crowdfunding (see **Chart 14** below).

[352] For example, more people indicated that a provider's internet banking was "essential" (24%) than they did the convenience and opening times of branches (16%): see Figure 23 of the GfK PCA Survey Report.

[353] Question 36(a) of the Phase 2 BDRC Survey: "*Which of these (if any) are reasons why you decided not to make any changes to your business current account?*".

[354] These statistics were even higher for "high digital users": 57% would be willing to consider using a newer challenger bank with few branches and 47% would consider an internet only bank. Given the trend towards higher digital usage, this suggests that in the future the size of the contestable market for digital only banks is likely to continue to grow.

Chart 14: Types of provider SMEs would consider



Source: Phase 2 BDRC Survey (Questions 20(a) and 20(b))

6.42 Therefore, this new evidence shows that it is not necessary to have an extensive branch network to enter and expand in either the PCA or SME banking markets. Indeed, due to technological advances, it is no longer necessary to offer physical counter services at all to enter these markets.

IT systems

6.43 HSBC welcomes the recognition in the UIS that "*firms providing banking products for the first time may not face significant entry barriers in relation to IT systems*".[355] The CMA's case studies show that new entrants have the ability to utilise new innovations in the provision of IT services, allowing them to benefit from lower fixed IT costs and giving them a significant competitive advantage.[356]

6.44 To the extent that any individual banks, particularly those formed from existing providers, face higher costs to adapt their IT systems, this is no different from the difficulties faced by established providers with their legacy systems. Efficient new entrants do not face any such issues.[357]

6.45 Given the difficulties faced by established providers with their legacy systems and the faster rate at which new entrants can utilise new innovations in the

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[355] See paragraph 137 of the UIS.

[356] See paragraph 57 of the Metro Bank Case Study and paragraph 55 of the Tesco Bank Case Study.

[357] See paragraph 207 of the CC Guidelines for market investigations (CC3 (revised), April 2013), which notes: "*Barriers to entry and expansion give at least some incumbent firms an advantage over **efficient** potential firms or rival incumbent firms…*" (emphasis added). See further paragraph 54 of the Tesco Bank Case Study.

provision of IT services, the CMA should assess whether established providers in fact face a competitive disadvantage in relation to IT costs. In particular:

(a) As stated in the case study on prospective entrants: "*IT costs for start-ups are substantially lower than they are for existing banks due to the latter's high costs of maintaining legacy systems. In addition to this, the introduction of off-the-shelf SaaS IT solutions has resulted in a lower proportion of fixed costs and higher levels of scalability. This results in relatively low barriers to entry for new start-up entrants*".[358]

(b) As stated in the Metro Bank case study: "*A recent report by Temenos concluded that in the UK, computer systems may put larger banks at a disadvantage. Another report by Deloitte and Temenos has found that over the past five years, banks using third party banking applications have enjoyed on average a 19% higher return on assets, a 28% higher return on equity and a 6.5 percentage point lower cost-to-income ratio than banks running legacy applications*".[359]

Payment systems

6.46 HSBC welcomes the recognition in the UIS that the CMA has "*not received evidence that new entrants have been unable to access payment systems either directly or through a sponsor bank*".[360] As acknowledged by Virgin Money in its case study, it is "*probably quicker, cheaper, easier and more practical to interface through a sponsor bank (agency banking) rather than building and maintaining costly infrastructure for lower volumes*".[361]

6.47 The PSR has already taken a number of steps to improve direct access and indirect access to payment systems.[362]

6.48 For **direct access**:

(a) The PSR has implemented an "Access Rule". This will require operators who are not already subject to access obligations (i.e. BACS,

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[358] See paragraph 4(c) of the Prospective Entrants Case Study. In addition, CivilisedBank notes that it intends to spend significantly less for its IT systems than existing banks would need to spend (see page 6 of the Prospective Entrants Case Study).

[359] See paragraph 56 of the Metro Bank Case Study. See also paragraphs 4.16 to 4.18 of the HSBC May 2014 Submission.

[360] See paragraph 142 of the UIS. See further paragraph 60 of the Virgin Money Case Study: "*in practice* [Virgin Money] *did not appear to have any major concerns regarding the cost and quality of service of its indirect membership of payment systems*".

[361] See paragraph 57 of the Virgin Money Case Study.

[362] See the PSR's Policy Statement (PSR PS15/1), *A new regulatory framework for payment systems in the UK*, March 2015. See further page 5 of the Prospective Entrants Case Study: Starling Bank notes that recent changes by the PSR should address its previous concerns on accessing payment systems through an agency agreement.

C&C, CHAPS and FPS) to have objective, risk-based and publicly-disclosed access requirements which permit fair and open access. The PSR notes that this will help ensure that access requirements do not unnecessarily or disproportionately restrict direct participation in payment systems and do not act as a barrier to entry and expansion for new and emerging payment service providers.

(b) The PSR has also decided to apply a “Reporting Rule”, which will require operators of payment systems to: (i) keep under review their access requirements and provide the PSR with an annual compliance report; and (ii) publish their access requirements.

6.49 For **indirect access**:

(a) As acknowledged by the CMA,[363] the PSR has introduced an information direction that will require the four sponsor banks (Barclays, HSBC, Lloyds Banking Group and RBS) to publish clear and up-to-date access-related information. The publication of this information should enable indirect payment service providers to assess and compare the different offers by these sponsor banks, which the PSR expects will increase competitive pressure on the sponsor banks and the ability of indirect payment service providers to negotiate with them.

(b) Also, as noted by the CMA,[364] the PSR will work with the industry to develop a Code of Conduct, which is to be approved by the PSR and with which (at least) the four sponsor banks are expected to comply. The purpose of the Code is to address concerns regarding the continuity and security of supply, contractual arrangements, reliance on downstream competitors and the communication of information to payment service providers on indirect access to payment systems. The PSR expects the Code to be in place by 30 June 2015 and the sponsor banks to comply with the Code from 30 September 2015.

(c) The PSR anticipates that technical access solutions will be developed as commercial propositions funded by those that use the service. The PSR will actively monitor and evaluate the ongoing development of alternative access mechanisms. For example, the CMA’s case study on prospective entrants notes that Faster Payment Scheme Limited intends to develop an independent technical direct access solution, which would address any issues relating to access to the Faster Payments service by enabling direct access for all market participants.[365]

[363] See paragraph 148 of the UIS.

[364] See paragraph 148 of the UIS.

[365] See paragraph 4(a) of the Prospective Entrants Case Study.

6.50 As recognised by the CMA, the PSR is conducting a market review into the supply of indirect access to payment systems.[366] The PSR has published its final terms of reference, which state that the PSR expects to publish its final report in April or May 2016.[367] HSBC considers that the PSR is best placed to deal with any remaining issues relating to access to payment services as a barrier to entry and/or expansion in the PCA and SME banking markets.

Information asymmetry

6.51 HSBC notes the concerns raised in the UIS that there may be asymmetry of information between established banks and new entrants, such that established banks can use their customer data to make faster and better financing decisions.[368] This issue only arises in relation to lending, rather than deposit-taking.

6.52 As explained at paragraph 4.15(c) above, the Midata initiative will assist PCA customers in making effective comparisons between providers and will enable providers to make decisions based on actual customer data. Together with the existing credit information available through credit reference agencies, new entrants should not be at a significant disadvantage to existing banks in relation to the information available to them to make credit decisions.

6.53 For SME banking, HSBC agrees that the SBEE Act will assist providers in extending credit to new-to-bank customers by increasing access to credit data. HSBC also notes that the Bank of England is consulting on the establishment of a National Credit Register and is looking to create a pilot. HSBC agrees with HM Treasury's assessment of the potential transformative benefits of a credit register in the longer term: "*The greater availability of information established by a credit register might, for example, support the emergence of new lenders with business models that make greater use of borrower information and rely less heavily on collateral. A credit register could also deliver benefits to the securitisation of SME loans by making a large statistical dataset on the performance of this asset class available to investors*."[369]

[366] See paragraph 148 of the UIS.

[367] PSR, *Market review into the supply of indirect access to payment systems – terms of reference*, May 2015, Appendix 1.

[368] See paragraph 155 of the UIS.

[369] See HM Treasury Consultation on *Competition in banking: improving access to SME credit data*, update of 15 December 2014 (https://www.gov.uk/government/consultations/competition-in-banking-improving-access-to-sme-credit-data/competition-in-banking-improving-access-to-sme-credit-data).

Cross-selling

6.54 The UIS notes that the CMA will assess "*whether larger banks use BCAs and PCAs as gateway products to cross-sell other retail banking products and whether… cross-selling acts as a barrier to entry or expansion*".[370]

6.55 HSBC does not consider cross-selling to be a barrier to entry or expansion in the PCA and SME banking markets. In particular, the CMA should expect cross-selling to occur in a well-functioning market:

(a) As explained in HSBC's Issues Statement Response,[371] there are significant customer benefits to cross-selling: (i) there are economies of scope in providing multiple products, which allow providers to offer additional products at a lower cost to the same customers and (ii) customers often prefer to use a single bank to meet the majority of their banking needs.

(b) It is not only larger banks that adopt a relationship banking model and attempt to maximise their "share of wallet" through cross-selling products to PCA customers and SMEs. This strategy is also used by many smaller providers and new entrants. For example, as illustrated in the Tesco Bank, Virgin Money and TSB case studies, smaller providers and new entrants in the PCA market are not seeking to offer PCAs as a monoline product. This is because PCAs are viewed as a "relationship product" that allow providers to develop a deeper understanding of their customers' needs and suitability for other financial products.[372]

6.56 In relation to any "gateway" between PCAs and BCAs, the UIS notes that "*approximately half (51%) of SMEs set up their BCA with their main PCA provider*".[373] HSBC considers that any "gateway" between PCAs and BCAs does not act as a barrier to entry and expansion in the BCA market. This is supported by the results of the Phase 2 BDRC Survey (see **Chart 15** below):[374]

(a) When opening a BCA, 30% of SMEs did not consider their PCA provider at all when considering where to open their BCA. Of this cohort, the main reasons for customers choosing their BCA included

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[370] See paragraph 28 of the UIS.

[371] See paragraph 3.21(f) of HSBC's Issues Statement Response.

[372] See paragraphs 14 and 19 of the Tesco Bank Case Study; paragraphs 32 and 43(d) of the Virgin Money Case Study; and paragraph 26 of the TSB Case Study.

[373] See paragraph 78 of the UIS.

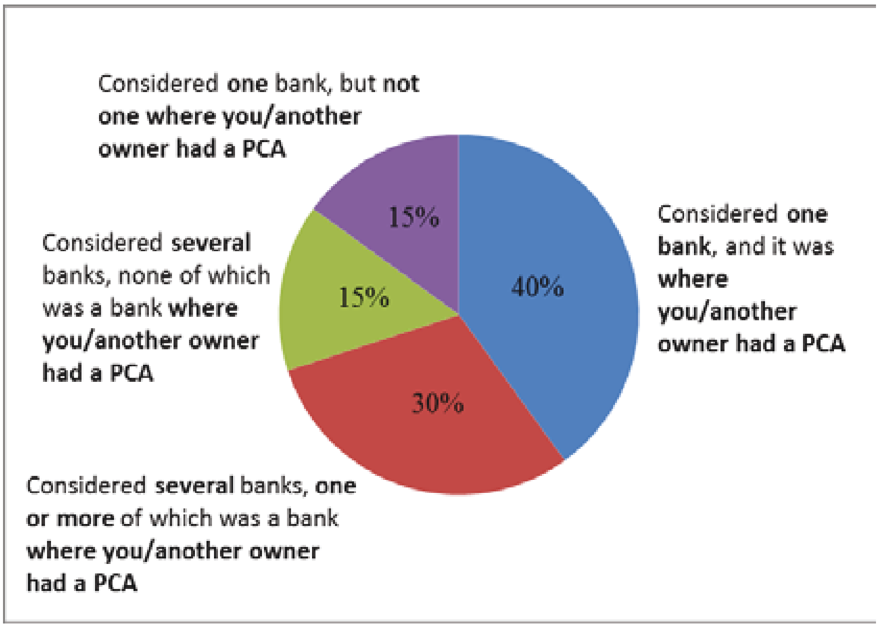
[374] Question 23 of the Phase 2 BDRC Survey: "*Which of the following best describes what happened when you opened your first business bank account for this business?*".

free banking / pricing (51%), a good reputation (32%) and a good online / mobile banking service (31%).[375]

(b) A further 30% of SMEs considered several BCA providers, including the provider where they held a PCA. Such SMEs are clearly shopping around and engaged. To the extent that these SMEs decide to open a BCA with their PCA provider, this does not suggest that there is a "gateway" between PCAs and BCAs that acts as a barrier to entry and expansion in the BCA market. Instead, it is likely that these customers have assessed competing BCA offerings and chosen the offering that they consider to be most suitable for their needs.

(c) Only 40% of SMEs considered only the provider where they held a PCA. Of this cohort, only 65% cited the PCA link as one of the main reasons for choosing their BCA, which suggests that prior experience with a PCA provider is not a key driver of BCA provider choice for almost three quarters of SMEs. Those SMEs were also interested in free banking / pricing (41%), a good reputation (34%), and a good online / mobile banking service (33%).[376] This indicates that the link between PCAs and BCAs is not automatic for these customers.

Chart 15: Link between PCA provider and BCA provider



Source: Phase 2 BDRC Survey (Question 23)

[375] Question 22 of the Phase 2 BDRC Survey: "*From the list below, please select the three main reasons for choosing your business bank*".

[376] Question 22 of the Phase 2 BDRC Survey: "*From the list below, please select the three main reasons for choosing your business bank*".

6.57 The Phase 2 BDRC Survey results therefore demonstrate that any "gateway" between PCAs and BCAs is not significant. Even if 40% of SMEs looking to open a BCA only consider their PCA provider, this leaves a contestable market of 60%. Since a significant proportion (30%) of SMEs do not consider their PCA provider when selecting their BCA, PCA providers may only be able to contest 70% of the BCA market. The contestable market size for BCAs is therefore nearly the same for both PCA providers (70%) and non-PCA providers (60%).

6.58 HSBC notes that any suggestion that a "gateway" between PCAs and BCAs reduces competition in the BCA market does not reconcile with the fact that price competition is particularly aggressive for SME start-ups (with many providers offering periods of free banking).

6.59 In any case, the CMA should not overstate any potential negative impact of cross-selling. The GfK PCA Survey Report indicates that while over 80% of PCA customers hold other financial products as well as a PCA, almost all of these customers obtain some or all of these products from a different bank to their PCA provider. Only 12% hold all of their other products with the same bank as their PCA.[377]

Next steps for Theory of Harm 3

6.60 HSBC recommends that the CMA explores the following areas:

(a) The CMA should assess what level of expansion would be realistic in well-functioning PCA and SME banking markets. In particular, the CMA should consider the rate at which a prudent new entrant or expanding provider adopting a sustainable strategy may be expected to expand.

(b) Given the difficulties faced by established providers with their legacy systems and the faster rate at which new entrants can utilise new innovations in the provision of IT services, the CMA should assess whether established providers in fact face a competitive disadvantage in relation to IT costs.

(c) HSBC considers that the PSR is best placed to deal with any remaining issues relating to access to payment services. The CMA should continue to coordinate with the PSR on any such issues.

[377] See paragraph 22 of the GfK PCA Survey Report.

7. CONCLUSION

New evidence and analysis show competition is continuing to intensify

7.1 New evidence presented in the UIS, together with HSBC's Phase 2 BDRC Survey, reveals that competition in the PCA and SME banking markets is significantly healthier than the UIS suggests. Recent and forthcoming market, regulatory and technological developments are continuing to drive this healthy competition and significantly improve customer outcomes.

7.2 Whilst HSBC welcomes the new evidence gathering and analysis to date, HSBC continues to have serious concerns in relation to:

(a) the CMA's approach to Theory of Harm 2, where there continue to be theoretical and evidential shortcomings; and

(b) the limited development of the CMA's analysis of the SME banking markets.

7.3 These issues present the risk that there will be an insufficient evidential base to undertake a proper competition assessment of each of the PCA and SME banking markets and to determine if any remedies may be necessary and proportionate.

The CMA should take certain steps to ensure it reaches robust conclusions

7.4 The CMA should assess each of the three theories of harm set out in the UIS fully and separately for each of the PCA and SME banking markets.

(a) HSBC has set out, at paragraph 4.71 (Theory of Harm 1), paragraph 5.24 (Theory of Harm 2) and paragraph 6.60 (Theory of Harm 3), its recommendations for the evidence gathering and key analyses required to test each of these theories of harm. Theory of Harm 1 should be the main focus for exploration by the CMA as an effective demand-side will underpin well-functioning PCA and SME banking markets.

(b) The CMA must ensure that its findings take full account of the wide range of recent and forthcoming market, regulatory and technological developments, which are increasing customer engagement and reducing barriers to entry and expansion.

(c) Given the increasing rivalry among established banks and extensive entry and expansion in recent years, the CMA must assess the aggregate competitive constraint imposed on all providers across each of the PCA and SME banking markets.

(d) As part of its assessment of the SME banking markets, the CMA should consider the findings from HSBC's Phase 2 BDRC Survey.

7.5 These steps are necessary to allow the CMA to reach robust conclusions on the state of competition in the PCA and SME banking markets and, consequently, whether any regulatory intervention may be required.