

RETAIL BANKING MARKET INVESTIGATION

Summary of challenger banks roundtable on 3 July 2015

The following attended outside the Competition and Markets Authority (CMA):

Aldermore Bank Plc
BBA (British Bankers' Association)
Svenska Handelsbanken AB
Metro Bank Plc
OneSavings Bank Plc
Paragon Bank Plc
Sainsbury's Bank Plc
Secure Trust Bank Plc
Shawbrook Bank Limited
Virgin Money Plc

Introduction

1. We were told that the larger banks had the most to lose from the CMA market investigation given their dominance of the current account market. The larger banks, therefore, had the incentive and resources to engage with the CMA, certainly more than the smaller and challenger banks. There was a danger that the bigger banks would drown out the voices of the smaller banks and it was vital for them to be heard. This roundtable should only be part of the opportunity for smaller/challenger banks to be heard by the inquiry Group.
2. The point was made that competition in banking had been an issue that had been investigated for years going all the way back to Cruickshank in the late 1990s. But a number of banks that had been around at that time had now disappeared or been subsumed within other banks, mainly within larger banks now making them 'too big to fail' banks.
3. There had been a period of consolidation in the past decade or so and that had led to the current concentration in the market. Against this background competition could not take place, as had been recognised by the Retail Banking Select Committee report in 2011. In 2011 the Independent Commission on Banking (ICB) had also recognised that in a well-functioning market there had to be competition between existing providers but also the threat of new entrants coming into the market.

4. The 2015 Financial Conduct Authority report into the cash savings market indicated that little had changed over the past years, noting that the bigger banks had considerable advantages.
5. Challenger banks faced difficulties in entering the market not least: funding; capital requirements; payment infrastructure access and regulatory disadvantages compared to the existing banks. Some challenger banks suffered all those disadvantages. Other challenger banks were more advanced so capital disadvantages were not so pronounced.
6. The point was made that previous market investigations had failed to foster competition because there needed to be a broader discussion about competition in banking and the focus should not just be on the current account market. There were broader inhibitors to growth.

Barriers to entry

7. Under the Basel 1, broadly, all banks regardless of size risk rated their assets on the same basis. Basel 2 introduced a significant change which had a further detrimental impact on smaller challenger banks. Examples were given of risk ratings for smaller banks compared to larger banks which meant that the bigger banks had a much lower capital requirement relative to challenger banks. In some cases according to the ICB report the bigger firms had a 700% capital advantage. This along with the 'too big to fail' culture and access to cheaper funding gave larger banks a significant advantage.
8. The big banks' significant advantage meant that, for instance, they dominated the UK mortgage market. But this was not just an issue of the UK mortgage market it went much wider. Similar issues arose in both the larger end of the small and medium-sized enterprises (SME) market and the large corporate market. An example was given of how a smaller bank using the standardised model for SMEs would have had to set aside twice as much capital than a larger incumbent bank on the internal risk weighting if it were to acquire the Williams & Glyn assets.
9. It was suggested that Basel 3 could make the standardised issue worse because of the discussions around the risk ratings going forward. The secured market seemed to be coming under particular pressure in Basel 3 and this would unlevel the playing field even further between small/challenger and incumbent banks.
10. Some SME lending would be risk rated at 300% under the new regime and that could completely close down lending to a huge number of SMEs by smaller/challenger banks and the incumbents would not deal with them.

11. In summary the playing field was not level as a result of capital requirements and was likely to worsen. It would be helpful for the government to give the Prudential Regulation Authority (PRA) discretion to dis-apply Basel 2. The ten biggest banks should continue to operate as they were now and all the other banks would get the average risk rating of those ten banks. In doing this it would negate the need for a huge amount of work by small, capital resourced limited banks.
12. The view was also expressed that the UK was more rigid in applying of Basel 2 than some other jurisdictions. The UK chose to apply the same standards to larger banks as it did the smallest banks and that was not necessarily the case in other jurisdictions. In addition the PRA needed to make the case that property related risk in the UK was very different to countries such as Spain, Portugal and Greece and they and the Treasury had to make that case in negotiations.
13. The PRA was aware of these issues and to some extent the feeling was that it was sympathetic to the issues that had been raised but its hands were tied.
14. If the UK government wanted to address the too big to fail problem, ring fencing would not work, the big banks had to be made smaller. That required a broad range of steps, not just in capital terms but also funding infrastructure and regulatory terms. The PRA was not empowered to make those decisions.
15. It was noted that in the USA the Basel 2 requirements were only applied to the systemic banks – smaller banks were governed by local regulators.
16. There was a lack of understanding in government of these issues and constant changes of ministerial responsibility did not help.
17. Bigger banks got cheaper funding for a number key reasons: an implicit UK government guarantee which had been estimated to be worth up to £100 billion by previous Bank of England and International Monetary Fund reports, low risk, high quality assets on their back book; high quality collateral against which they could borrow and the huge number of free-if-in-credit current account balances against which they could borrow. As the base rate began to rise again this advantage would be greatly extended.

Domination of market

18. Unless there was a major re-think, Lloyds would continue to dominate the current account and mortgage market and RBS the SME and corporate banking market.

19. The in-built back book of the systemic providers gave them a huge advantage. It was not just about teaser rates it was about the rates they offered existing customers on savings. Banks could change rates without informing their customers, unless the changes were significant, which seemed perverse. Local authority and government also deposited to the big banks because their rules prevented them from using smaller non-rated banks.
20. The big banks did not make it easy for their own customers to know what rates were available. One challenger bank had launched a product that allowed customers to compare interest rates on any account across the country in any other bank. Some customers had indicated that it was easier to find an interest rate on a NatWest account from the challenger bank's website than from NatWest itself.
21. While there had been some improvement in the treatment of existing customers compared to trying to recruit new customers by the bigger banks this was largely a self-preservation exercise to try and ameliorate any Financial Conduct Authority action on this front.
22. The 2008 crash had meant that big banks had been hurt badly and this had led them to withdraw from some of their core markets. This had enabled challenger banks to take advantage of the gaps in the market and grow balance sheets fairly substantially since 2008. However, as the big banks started to gear up again they would seek to re-enter these abandoned markets and that could have an impact on the ability of challenger/smaller banks to compete.

Access as a barrier to entry

23. Challenger banks would not be around if the bigger banks had not allowed them to bank through them for some payments facilities. But it was not an easy process getting the big banks to do so.
24. It was perverse that challenger banks had to seek the cooperation of incumbent banks in order to enter the market. There could not be a truly competitive market where a potential competitor had to ask permission from its competitors to use its payment systems. It was anti-competitive that challenger banks did not have direct access to payment systems. It was noted that the Payment Systems Regulator was looking at this area.
25. It was also noted that faster payments was built by the bigger banks and challenger banks needed to have proper access.

26. However the environment was changing and the onset of new payments systems such as Paypal and Apple Pay would be helpful.
27. It was mentioned that one of the newer banks had said that it had only been able to get one bank to even engage with it about providing agency banking services. That was a logjam to new entrants. Because there was not a competitive environment in which to negotiate agency banking that increased the costs and was a further barrier to entry.
28. One clearing bank charged a challenger bank 40p per transaction for faster payments – and that, it was contended, represented a huge profit over and above the cost of providing the service by the incumbent bank.
29. While changes were coming it was still a relatively less competitive environment compared to, for instance, the USA where there would be three or four bureaus competing for the business.
30. Ownership of large numbers of transaction accounts meant that larger banks had huge advantages in the context of cross sales, which meant they were better able to cross-subsidise much more effectively than smaller banks with limited product suites.
31. Because the challenger banks were having to use incumbent banks for some of their transactions it meant no matter how good their own systems were they were to some extent hampered by the legacy issues affecting the incumbent banks. Ultimately because of the clearing/agency bank relationship, the payments service offered by the challenger bank could be no better than the clearing banks and when the clearing bank suffered an outage it remediated services to its own customers before the challenger bank's customers.

Customer acquisition

32. It was noted only two representatives at the meeting offered business bank accounts (BCAs) and personal current accounts (PCAs).
33. PCA customers starting up businesses often went to their PCA provider in the first instance for their BCA as well as for loans and other products.
34. Having transactional data on a customer was core to understanding and building a relationship. In the BCA world a core network of locally based SME relationship manager was also key. But that was costly and the business case needed to stack up before moving into that area.
35. It was also noted that banks with the deepest pockets could offer the best switching deals and it was no coincidence that Halifax as part of the Lloyds

group was doing so well in the CASS system because it was offering the highest cash incentive for people to open PCAs with Halifax.

36. It was further noted that those offering the biggest cash incentives to switch also had the most expensive overdraft facilities. However, there were other ways to win customers than on price, for instance by great service and by creating a different atmosphere in and around the bank.
37. While CASS operated effectively it probably was not as well advertised as it should be and could not in itself overcome customer inertia. There was still a job to persuade customers that the CASS system worked. People needed confidence in CASS. It might also be the case that customers were not sufficiently dissatisfied by the big banks that they were driven to switch. A perception that they were 'all the same' also prevailed. Differentiation in banks' offering was key to attracting new customers.

Branches

38. The number of SME businesses in the UK was stable at around 4.2 million. Most were consumer led rather than corporate led and the vast majority depended on cash flow. Having a branch network for cash transactions was crucial for some in this sector. However, it did vary by sector. It was considered that the majority of SMEs would bank with the branch closest to them.
39. The operational risk and cost of providing the infrastructure for personal or SME customers was noted as a significant barrier. That was why some challenger banks were focusing on specialist lending.
40. Some challenger banks had arrangements with bigger banks to provide counter services but this was problematic and expensive. Customers appeared generally content with the agency bank approach. Post Office counter services was another option that was being used.
41. However, more widely, banks had to be adaptable and proactive in meeting customers' needs and the multi-channel approach was crucial. For challenger banks 'branches' were not just about banking, they needed to be seen as 'stores' like John Lewis which provided a range of options and access to products.
42. Even if customers never, or hardly ever, used a branch they liked to know it was there if they needed it.
43. For the younger generation a solely digital banking experience was probably more attractive than for older people. However younger people got older and

their banking needs might become more complex and that could mean that their requirements changed as they got older.

Links between PCAs and lending to SMEs

44. SMEs would perhaps try out lending products and offers from a bank other than their PCA or BCA provider before moving their entire banking requirements. If the lending worked and a good relationship was built they might move their BCA.
45. Bank lending was a key area of profitability, just increasing numbers of PCAs and BCAs would not make a sufficient return on investment in isolation. The vast majority of SMEs would seek a general business loan from their current account provider that knew their business/turnover and could make risk assessments about loans/overdrafts more easily. For more occasional acquisitions like machinery or vehicles some might seek the input of brokers or other intermediaries who might be able to provide specialist advice.
46. Challenger banks should also be more reactive and not have multi-layer approval processes. An example was given of where a challenger bank confirmed lending support to a business – and the business's main bank approved the loan some ten months after the challenger bank. New banks needed to provide something different and better in order to gain new business. It was not accepted that the big banks could necessarily make quicker decisions because they had more information on existing PCA and BCA customers but the knowledge they had from analysing the current account activity gave them an advantage when making lending decisions.
47. Given the current uneven playing field, challenger banks could not generally offer cheaper loans than the big banks because they were paying significantly higher premiums for capital and liquidity and this was a key disadvantage that had to be tackled.
48. A number of new initiatives in relation to sharing SME data were noted, including the impact of the Small Business Enterprise and Employment Act, which would help inform lending decisions. However, it was noted that SMEs had to consent to participation and sharing of their data and it was not clear how helpful these initiatives would be. It was suggested that there should be an assumed opt-in of the sharing of data, as opposed to the big bank having to go and get the consent of its customer before it provided the data, because we all knew what would happen in that situation. Basic bank accounts were uneconomic and there had to be some proportionality according to a bank's size as to the number of basic bank accounts it had to take on.

Free-if-in-credit accounts

49. For many current accounts were not 'free' even if they were described as free-if-in-credit – lost interest, bundled accounts, foreign exchange charges etc all cost the customer. The point was made that overdraft charges were very difficult for customers to work out. A figure of around £3 billion was suggested as being charged in authorised and unauthorised overdraft fees annually. Fees were not wrong, but they had to be easily understood. Transparency was key to having an open competitive market so that customers could make informed decisions.

Switching if you have an overdraft

50. PCA customer concerns about a new bank matching the current overdraft facility was confirmed as an issue. But it might not be a competition issue but more of an individual credit risk assessment. While there were many similarities between PCAs and BCAs the issue of transferring an overdraft on switching was different for BCAs because of the way credit was scored.
51. Concerns were expressed that the same procedures were applied in terms of anti-money laundering checks to smaller SMEs as were applied to much larger enterprises. It was suggested that if a customer had a BCA or PCA at a large UK bank they should be deemed to have passed all 'know your customer' and 'customer due diligence' checks which would make it easier for these customers to open savings accounts elsewhere.

Regulation

52. Concern was expressed that a number of incoming regulatory requirements were a one size fits all – requiring smaller banks to have the same regulatory burdens as much larger banks. An example was the proposals arising from the Senior Managers Regime, which applied to a small bank in the same way as it applied to HSBC.
53. The consequence would be that in terms of percentage of turnover the smaller banks would bear a much heavier burden of the new regulations. The sheer level of this disproportionate burden on smaller/challenger banks could be argued to be anti-competitive in itself.

Conclusion

54. It was noted that the challenger banks had done well in recent year but the systemic banks were the weakest that they would ever be in a generation and

as they recovered, given their capital, funding and infrastructure benefits they would move back into the space now filled by challengers. The challengers did not seek any advantages but were looking for more positive intervention to create a level competitive playing field in capital, funding, infrastructure and regulatory terms.