Competition & Markets Authority

RETAIL BANKING MARKET INVESTIGATION

Summary of hearing with TSB Bank plc on 16 July 2015

Introduction

1. TSB Bank plc (TSB) told us that the creation of the bank was a highly complex and unique process successfully delivered by the Lloyds and TSB management teams which had provided TSB's management team with significant experience in creating and running a new entrant retail banking business in the UK, which also complements its past experience running a large-scale incumbent retail bank.

2. TSB informed us that it was acquired by Sabadell two weeks before the hearing date. It said that this was a huge vote of confidence in its capabilities as a new entrant and in its growth strategy. Sabadell's expertise in IT infrastructure and small and medium-sized enterprise (SME) banking would enable TSB, over time, to accelerate its plans and redouble its efforts to challenge the big banks.

3. TSB did not believe that there was intense competition in the retail market. Specifically, heavy concentration of current account back books in a few providers, very low switching rates and barriers to entry created by IT infrastructure and other requirements meant that the market was not working effectively for consumers. It said that all three of these issues were linked and that one problem could not be effectively addressed without also tackling the others. It said that it had been argued that the large banks controlling 85% of the personal and current account market had no bearing on competition. It said that if that was the case there would have been evidence of customers shopping around for the best deal and a healthy flow of customers between different banks. It pointed out that only 2% of consumers switched using the Current Account Switch Service (CASS) in the previous year. Including switchers that did not go through the CASS, TSB estimated that only around 4% of customers had switched accounts last year.

4. TSB noted that large banks had argued that the current account market was less important than it used to be for assessing how competitive the market was and that there was fierce competition in savings, credit cards and loans. It disagreed with this argument. It said that current accounts remained a gateway product for retail banking customers. Over three-quarters of

customers with savings accounts with the main banking players held those accounts with their current account provider. It said that four out of five customers who had a loan with the main banking players, held that loan with their current account provider, and around 70% of credit card customers with the main banking players held that credit card with their current account provider.

5. TSB argued that there was a fundamental lack of customer awareness and understanding of the CASS switching service. There were no prompts for customers to shop around and more importantly a lack of transparency around what a customer was actually paying for in relation to their current account, making true price comparison difficult for most customers. It said that back book customers gave the big banks a significant financial advantage which they used to full effect by maintaining control of both the current account and wider product markets.

6. TSB noted that the big banks owned and controlled the industry's IT infrastructure. For a new bank entering the market, the cost of creating a system that provided multi-channel and multi-product offering was prohibitive. Current account customers that switched took several years to become profitable so many new entrants focused first on a single channel or a single non-current account product business model. It said that the interaction of the concentration, lack of switching and barriers to entry in retail banking all reinforced the dominance of the large banks and helped maintain the status quo. It said that the market lacked transparency and choice.

Profitability and financial performance

7. TSB told us that it conducted net present value analysis of a value of a customer over time, and the value of each product over time, alongside a return on equity impact. The pricing decisions it made about its products were done by looking at a product's current value over that product's life plus cross sale value.

8. [✀]

9. Savings, personal loans and credit cards were contributors to cross sales to current account customers. TSB said that mortgages had less of an impact. Product profitability was typically dependent on the position of the economic cycle. It found that the asset margin and liability margin typically behaved in contrasting ways. It noted that savings were less important at this point of the cycle in terms of creating value, but remained important for liquidity. It argued that any increase in base rates would typically lead to an increase in the liability margin whereas the asset margin would fall. Therefore having a

balanced liability and asset position in terms of retail assets and liabilities was extremely important for banks. Banks that grew quickly in an unbalanced way were exposed to cyclical effects unlike mature banks.

10. TSB said that, when deciding which products it offered, it was driven not just by profitability but also by fit with brand positioning. The credit card market had long interest free periods of up to 36 months. [✄]

11. TSB said that personal current account (PCA) customers who went into overdraft tended to be some of the most profitable. Even when taking account of impairments it was still a minority of customers that provided the majority of profits of PCA providers in the market.

12. TSB told us that its SME business was small, being made up of about 100,000 customers. It had a large concentration of charities and clubs on its books. TSB wanted to compete more aggressively in the SME market but did not currently have the capability to do so.

13. TSB's aim was to grow its retail business by 40 to 50% over the next five years through three key strands. First it planned to grow its current account market share, by achieving greater than a 6% share of flow of all new, switching or moving current accounts. Second, it planned growth in the lending side of its business, increasing asset growth by [✄], amounting to between [✄] of lending. Third, it planned growth by differentiating the TSB brand and delivering a different service to its customers.

14. TSB said that PCA growth was mainly due to new acquisitions and those customers were generally in credit and valued credit interest. Those customers were probably some of the least profitable customers. It did not typically see customers with overdrafts switching and it did not therefore try to target that segment. The way the market was structured was very challenging.

TSB's position

15. TSB's main advantage over the larger banks was its brand and positioning in the market. It had realised at its launch that it would find it extremely difficult always to compete on price as it did not have the scale. It also realised that in some areas it may be difficult to compete on innovation because it was reliant on Lloyds for its IT infrastructure. To differentiate itself it had chosen to focus on its brand and service.

16. Branding and focus on service had also paid an important role in TSB's entry into the mortgage intermediary market. It had grown from a standing start to £1.9 billion worth of mortgage applications in the first half of 2015. The market

responded well to its service proposition and it had seen an annualised growth rate of £[✂] in its first months of operation.

17. [✂]

18. [✂]

19. TSB said that not having the full SME capability, eg the ability to operate multi-currency accounts, was a barrier to entry in relation to SME banking. Another obvious barrier to entry was not having the necessary underwriting skills in-house. It said that banks had to have deep sector specialists to lend across the board in SME banking. It said that there were fundamentally different risks between lending, for example, to a farmer, a small industrial manufacturer or to a services company, which had to be understood.

20. TSB said that some new entrants entered the SME market through different SME channels and niches. It said that, for instance, Aldermore had specifically provided asset-backed finance to SMEs. [✂]

Innovation in banking

21. TSB argued that there had been few real innovative game changers in banking – perhaps the last one was the introduction of credit cards. The nature of the business, which was essentially IT based, meant that new products could be copied within a fairly short space of time. There had been some innovation around the periphery of the core banking market. The difficulties in product innovation was one of the reasons it had decided to innovate on service provision, where possible.

22. TSB questioned whether new technology, such as apps, was really innovation in the market. However, it said that the proportion of overdraft requests and overdraft sales sold through mobile devices had increased significantly and it had seen that as extending its service offering.

23. TSB said that Apple Pay was seen as an innovation [✂]. It argued that this kind of innovation investment was an additional burden on the smaller banks. [✂]

Theory of harm 1 – low levels of switching

24. TSB did not believe that the lack of switching was the fault of customers. It was very difficult for customers to understand how much they were really paying for their current account product. It wanted true transparency for consumers so that consumers could see what it cost them to buy the services

that they purchased from the bank. It said that this would allow consumers to make informed choices as to who was going to provide them with the best offer. It wanted customers to be provided with a bill rather than just a statement.

25. TSB argued that it was very difficult for a customer that did not know the product cost since the customer would not be able to make an informed choice as to which competitors' offers would be better or worse. It also said that it was difficult for the customer to understand the switching service. For an overdraft customer, it was extremely difficult, or perhaps even impossible, to move an overdraft as part of a switch. It was not surprising, therefore, that, in that context, customers found it very difficult to make a rational or even an emotional choice to switch.

26. TSB had spent a lot of time explaining to its customers how banks made money out of current accounts. Its website ran this level of information and called it 'Truth and Banking', which explained to customers how banks earned their income. It believed the primary problem in banking was that customers had no idea what they were being charged.

27. TSB argued that Midata as a tool could be very informative on how much a customer could earn from an account, although there were issues with how Midata currently worked. However, it said that there was no prompt for the customer to act on the information. It believed the way to address this was by providing customers with a bill letting the customer know what the benefits were and what the cost was of a particular account. It said that this would provide the prompt a customer needed to switch.

28. TSB argued that Midata, as it currently worked, was distorted by teaser rates. It argued that this issue would need to be resolved in order for Midata to allow customers to understand the true financial benefits of switching to a particular provider.

29. TSB was also concerned that Midata did not build up a good picture of the comparability of quality between providers, although there was some data available that could be used. Complaints data was published by all banks. It said that the Prudential Regulation Authority and Financial Conduct Authority standard measures were available but were not that visible for customers and the way they were calculated was open to interpretation.

30. TSB believed that the market was moving to multi-banking and as a bank it was happy to have customers that chose to bank elsewhere for some products. One of the problems with CASS was that, if a customer used it to switch, then CASS switched or closed the donating account, which was not

something all customers preferred. Part of the reason why it was more proactive in welcoming multi-banking customers was because of that issue with CASS. It said that customer feedback had indicated that many customers were nervous about closing an old account, and that was one reason why so many customers were not willing to switch. It would, however, much rather a customer switched their whole banking relationship as that would be more profitable for it.

31. TSB said that customers who were regular overdraft users were very valuable customers to both large incumbent banks and smaller banks. It was not easy for such customers to switch because banks, including TSB, took credit decisions based on the transaction data that they saw on the account. It said that banks took a credit decision every time a customer started using their overdraft. If that same customer tried to open an account with a different bank, that bank did not have the customer's historic transaction data. It only had the bureau data and, typically, that would be more inclined to indicate 'do not give an overdraft to this customer'. It argued that if the customer was able to take all of their transaction data, or some sort of 'credit passport' to the new bank, the new bank would be better able to understand the spending nature of that customer. A credit passport would contain the customer's transaction data from the last nine to 12 months.

32. TSB said that a new customer switching accounts could not offer a record of transaction data to the new bank and therefore would have to convince the new bank to give them a credit line. The customer would be less likely to get a credit line and therefore less likely to switch.

33. TSB said that, if a bill was sent to a customer every month or quarter telling them how much they were actually paying for their banking relationship that would be an incentive to consider switching. Customers could use their transaction data to find a better deal. It said that that would lead to more valuable customers switching to new entrants in the market and more competition between banks.

34. TSB stated that CASS would be much more useful for customers if it was marketed. There was a lack of awareness of CASS which was followed by a lack of understanding of how to switch. CASS would only be effective if customers were actually in a frame of mind where they realised switching was of benefit to them. It said that the level of switching seen, whether at 2 or 4%, was driven as much by the fact that customers could not easily compare and figure out whether they could get a better deal, as it was by the shortcomings of CASS itself.

Free-if-in-credit

35. TSB stated its view that there was no such thing as a free-if-in-credit account; it was a misnomer. TSB had developed an animation on its website to show this and to explain the four key sources of income that a bank received from current account customers. Free-if-in-credit was a misleading term that created the wrong perceptions and therefore affected behaviour.

36. TSB argued that in a world where customers could make informed choices on a regular basis based on the amount they were paying for each of the services they received, there could be an increase in the number of different propositions and different products targeted at different types of customers. For example, there could be a proposition targeted at customers who rarely use cheques or ATMs, with an appropriate pricing model to reflect those customer preferences.

37. TSB did not agree with the view that the banking business model was outdated and would not survive. It said that Oliver Wyman had published research in late 2014 that showed that retail banks in the UK had a typical return on equity of about 25%, excluding the conduct fines and redress.

38. TSB estimated that 90% of banks' PCA income came from PCAs that had been with banks for about three years or more . The vast majority of the income was in their mature back books, and that was driving their return on equity position which was very healthy. It said that there was a lack of incentive for the big banks to change pricing models. It was very difficult for the new smaller players to bring sufficient competition to unlock that model because of their lack of scale.

39. TSB said that the whole market was essentially competing on one aspect: credit interest. It estimated that the back book of customers was generating £7 billion to £8 billion of income for the industry, predominantly through the large incumbents. It said that it was very expensive to acquire individual new customers. However, for the larger banks the relatively small number of customers that were in the market for switching meant the total cost to acquire them was relatively small when compared to the back book income being generated.

40. TSB said that higher base rates and market swap rates made current account customers materially more profitable. It said that banks paid higher credit interest rates to the 2 to 4% of those switching but across the whole business banks typically paid low rates that tended not to increase as base rates or market swap rates increased.

Theory of harm 2 – concentration

41. TSB did see some geographical variation in the market but argued that there was little evidence to show that market and consumer behaviour fundamentally differed across geographical locations. It noted that history mattered in the banking industry. Its data showed that 60% of consumers had been with the same bank for more than ten years. If a bank acquired a regional bank, that bank would then acquire a relatively large branch network in the relevant region. It said that many of the banks were regionalised in the way they were constructed through acquisition/mergers over time.

42. TSB noted that focusing on market share alone would not change the fundamental competitive dynamics of the market. [✂]

43. TSB argued that it brought more competition to the market, as it was taking market share. [✂]

44. TSB was looking at the market share that had been taken by new entrants to the PCA marketplace. Including the increase in its market share since when it was divested as TSB, it said the total was less than 1% of the stock of PCAs across Marks & Spencer, Metro, Tesco, Virgin and TSB. [✂]

45. TSB fundamentally believed that more choice did not equal more effective competition. [✂]

46. [✂]

Theory of harm 3 – barriers to entry/expansion

47. TSB noted that there was a significant difference between Internal Ratings Based (IRB) risk weightings and standardised risk weightings and that a bank using the IRB approach had capital advantages over those that used the standardised approach. It was an IRB bank because it had sufficient scale and analytical capability to be able to produce better estimates of the losses in the capital requirements against its loans. A new bank, with a small number of customers, small infrastructure and small capability, would not have enough data to do the analysis and would therefore use the standard approach.

48. TSB said that larger banks were more profit-resilient and tended to have better credit ratings, allowing them to raise wholesale money cheaper than smaller banks. Typically the ability to manage the risks in a business are easier the larger the institution.

49. TSB had benefited from using Lloyds' IT infrastructure. [✂]

50. TSB said that access to payment systems was an important issue for new entrants. Banks that accessed payment systems through an agency relationship with one of the large established banks delivered a worse service than the service delivered by banks that had direct access.

51. TSB argued that a ‘bank in a box’ model did not work for banks that wished to operate a multi-channel, multi-product offering at scale. While external IT provision may be sufficient and economic for a niche player, it was not aware of any current provider that could meet all of the needs of such a full scale bank.

52. TSB said that the majority of customers opening current accounts would do so through branches. Its research showed customers valued branches and liked branches. TSB data further showed that customers who opened a current account online still had a need or a requirement for a branch. In the 12 months after people opened an account online, 50 to 70% of them used a branch within the next 12 months.

53. [✂]

54. [✂]

55. [✂]