Retail banking market investigation

Summary of provisional findings report

Notified: 22 October 2015

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Summary

1. On 6 November 2014, the Competition and Markets Authority (CMA) board launched a market investigation into the supply of retail banking services to personal current account (PCA) customers and to small and medium-sized enterprises (SMEs) in the United Kingdom (UK).[1] A group of five independent members[2] was then appointed on 10 November 2014 to conduct the investigation.

2. Our terms of reference for the investigation enable us to look at competition issues connected with the supply of PCAs including overdrafts. In relation to SMEs, our terms of reference are broader and enable us to look at competition issues covering a wide range of banking services to SMEs but excluding insurance, merchant acquiring, hedging and foreign exchange.

3. The group of independent members is required to decide whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom'. If we decide that there is such a feature or a combination of features, then there is an adverse effect on competition (AEC).[3] Should an AEC be found, we are also required to decide whether action should be taken by the CMA or a recommendation be made to others to take action for the purpose of remedying, mitigating or preventing the AEC or any detrimental effect on customers.[4]

4. This document summarises our provisional findings in relation to whether there is an AEC. Alongside this document we have prepared and published:

   (a) a Notice of provisional findings, in which we identify the features that we provisionally find give rise to AECs in the provision of retail banking services to PCA customers and SMEs; and

   (b) a Notice of possible remedies, in which we set out possible actions that may be taken to remedy, mitigate or prevent the AECs we have provisionally identified or any resulting detrimental effect on customers.

5. In parallel with this investigation, the CMA has also decided to conduct a review of the undertakings that were put in place following the 2002

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[1] Retail banking market investigation terms of reference.
[2] The members appointed are Alasdair Smith (Chair); Philip Marsden (Deputy Chair), Tom Hoehn, Jill May and Ed Smith.
[3] Enterprise Act 2002 (EA02), section 134(2).
[4] EA02, section 134(4).

Competition Commission (CC) investigation in SME banking (the 2002 SME Undertakings) and a review of the 2008 Northern Ireland PCA Order (the NI Order) that was put in place following the CC investigation into PCA banking in Northern Ireland (NI). The provisional decisions on the change of circumstances of these two reviews are due to be published in February 2016.

Background to the investigation

6. The UK banking industry has been subject to many reviews, several of which have raised concerns regarding competition in retail banking. These have included Sir Donald Cruickshank's review of retail banking in 2000 and the Independent Commission on Banking (ICB) chaired by Sir John Vickers in 2011. The Cruickshank review recommended in particular the launch of the 2002 CC investigation and the establishment of what became the Payment Systems Regulator (PSR). The ICB report made wide-ranging recommendations including the introduction of a switching service (the seven-day Current Account Switch Service (CASS) was launched in 2013), a primary objective to promote effective competition for the Financial Conduct Authority (FCA) and a secondary objective to facilitate effective competition for the Prudential Regulation Authority (PRA). Most notably the ICB proposed that the retail banking businesses of the banks be 'ring-fenced' from the riskier parts of banks' businesses (see further below).

7. The Parliamentary Commission on Banking Standards (PCBS) in 2013 also made a number of further recommendations including a review of account number portability and a voluntary code to provide free basic bank accounts (BBAs) and free use of automated teller machine (ATMs). Both the ICB and the PCBS recommended that consideration should be given to the CMA carrying out a market investigation by 2015 in light of the competition concerns they had identified.

8. The CMA's predecessor bodies, the Office of Fair Trading (OFT) and the CC, both also carried out a number of reviews of the retail banking sector in this period. These reviews include the CC's 2002 investigation into retail banking and its 2007 investigation into PCAs in NI which led to the 2002 SME Undertakings and NI Order respectively. During this time, the OFT also undertook several studies into PCAs, unarranged overdraft charges and barriers to entry, expansion and exit in retail banking. Several of these studies introduced a number of measures, mostly voluntary, to increase the information available to consumers on costs and charges. In addition to these reviews, the CC and OFT have considered a number of mergers in the sector including Lloyds Bank's attempted merger with Abbey National in

2001, Santander's acquisition of Abbey National in 2004 and Lloyds TSB's acquisition of Halifax Bank of Scotland (HBOS) to create Lloyds Banking Group (LBG) in 2008.

9. Consistent themes in these reviews have been the level of concentration in retail banking, the existence of high barriers to entry and expansion and difficulties for customers, both personal and business, in readily accessing, assessing and acting on information to make effective choices on providers and products. In light of the above reviews and the market studies undertaken by the CMA into PCAs and SME banking which led to this investigation, we identified in our issues statement and in our updated issues statement three hypotheses to focus our investigation. These three hypotheses were: (i) that there are impediments to customers' ability to shop around, choose and switch products and suppliers resulting in weak incentives on banks to compete; (ii) that the level of concentration is giving rise to market power leading to adverse outcomes for customers; and (iii) that there are barriers to entry and/or expansion leading to worse outcomes for customers.

10. As in the two market studies which led to this investigation, we have focused our analysis on PCAs, business current accounts (BCAs) and SME lending. The SME market study did not identify any concerns in relation to SME deposit accounts. Similarly, we have not seen evidence to suggest that further analysis should be undertaken of competition in relation to SME deposit accounts and we decided not to do so.

11. Our website contains full details of the progress of the investigation to date including submissions made by parties, summaries of hearings and roundtables held as well as the results of several significant workstreams. These include the results of our consumer survey of 4,500 PCA customers undertaken by GfK, our qualitative research on personal and SME customers undertaken by GfK and Research Works respectively, three surveys undertaken by Charterhouse Research (Charterhouse) into SME banking to supplement the Charterhouse British Banking Survey which we acquired, case studies into barriers to entry and expansion and a report by Deloitte on the impact of innovation in the UK. We also undertook quantitative analysis of customer transactional data and survey data to understand searching and switching behaviour and actual behaviour versus perceived behaviour of personal customers to which we refer in this summary.

Industry background

12. Retail banking is of fundamental importance to consumers and businesses and to the UK economy as a whole. There are more than 68 million active PCAs in the UK and 97% of adults in the UK have a PCA. PCAs generated revenues of approximately £8.7 billion in 2014.

13. In the period since the 2008 financial crisis there has been a steady rise in the number of SMEs. In 2014 there were over 5 million SMEs accounting for 99.9% of all UK businesses. There are approximately 5.5 million BCAs which generated approximately £2.7 billion in revenues in 2014. The total stock of outstanding general-purpose business loan balances at the end of 2014 was £90 billion with a further £9 billion of invoice finance loans and £25 billion of new asset finance loans.

14. The five largest banks are LBG, Royal Bank of Scotland Group (RBSG), HSBC Group (HSBCG), Barclays and Santander UK plc (Santander) (part of the Spanish banking group Santander). These banks operate throughout the UK and provide the full range of retail banking services. The leading banks in NI are Ulster Bank (Ulster) (part of RBSG), Santander, Allied Irish Bank (AIB) and Bank of Ireland (BoI) which are both based in the Republic of Ireland and Danske Bank (Danske), whose parent bank is Danish.

15. In addition to these larger banks, there are a number of smaller banks and over 40 building societies including several new entrants. Some of these banks and building societies are regionally based, some only provide personal or SME banking services, some are part of large retail groups and/or focus on digital-only distribution channels. They include Clydesdale and Yorkshire Banks (part of National Australia Bank (NAB), TSB (recently acquired by the Spanish bank Sabadell), Nationwide Building Society (Nationwide), Handelsbanken (part of a Swedish banking group), the Co-operative Bank (Co-op), Metro Bank (Metro), Aldermore, the Post Office, and Tesco Bank. In addition to banks and building societies, a number of other providers provide elements of retail banking services such as credit unions, alternative finance providers offering, for example, crowd-funding and peer-to-peer lending and new payment providers offering digital wallets and other services, such as PayPal, Amazon, Google and Apple.

16. The four largest banks (LBG, HSBCG, RBSG and Barclays) in Great Britain (GB) accounted for approximately 70% of active PCAs and 80% of active BCAs in 2014. The four largest banks (RBSG/Ulster, Danske, Santander and AIB) in NI similarly account for approximately 70% of active PCAs while RBSG/Ulster, Danske, BoI and AIB account for over 80% of active BCAs in NI in 2014.

17. SME lending encompasses a range of different products. In relation to general-purpose loans excluding peer-to-peer lending, the combined share of the four largest banks (LBG, HSBCG, RBSG and Barclays) in the UK of the value of outstanding loans was 80% in 2014. Their UK share in 2014 of invoice finance was also 80% and of asset finance was 65%. The same four providers also had a combined share of 87% of business credit cards in GB and RBSG/Ulster, Danske, BoI and AIB accounted for 75% of business credit cards in NI in 2014.

18. We did not find significant variations in market shares between Wales, Scotland and England if looked at separately or within England.

Regulation of banks

19. Banks and building societies are highly regulated under both UK and EU legislation. The Financial Services Act 2012 introduced a new regulatory framework for financial services in the UK. Under the new framework, the Bank of England (BoE) is responsible for financial and monetary policy and the safety and soundness of banks and other financial institutions. The PRA, which is part of the BoE, is responsible for the prudential regulation of banks including the authorisation of deposit-taking activities. The Financial Conduct Authority (FCA) regulates the conduct of banks and building societies. As already noted, the PSR is the regulator for payment systems and became fully operational in April 2015. Both the FCA and the PSR have a duty to promote competition and concurrent competition powers with the CMA and, as recommended by the ICB, the PRA has a secondary duty to facilitate competition.

20. In addition to these bodies, a number of European and international bodies also regulate UK banks and building societies. These include the European Banking Authority which ensures effective and consistent prudential regulation and supervision across the EU banking sector and the Basel Committee on Banking Supervision which issues the Basel Accords setting out the prudential capital requirements for banks globally.

New entry

21. There has been new entry into retail banking in recent years. Metro Bank (PCA and SME) was the first organic entrant to the UK banking market in more than 100 years when it received its banking licence in March 2010. Aldermore Bank (primarily SME but not BCA) entered in 2009. Several other new entrants have their roots in ancillary financial/retail services such as Tesco Bank (PCA 2014), the Post Office (PCA 2013/14), Virgin Money (PCA 2014), and Marks & Spencer Bank (M&S Bank) (PCA 2012). Handelsbanken

(PCA and SME) has also significantly extended its UK operations more recently almost doubling its network between 2011 and 2015.

22. Following Lloyds Bank's acquisition of HBOS in 2009, the European Commission ruled that the UK government's financial assistance to LBG constituted state aid and required a divestment which recreated TSB (PCA and SME) in 2013. Williams & Glyn (PCA and SME) is anticipated to be separated from RBS in 2016 and fully divested by RBS by the end of 2017 following a similar decision by the European Commission requiring its divestment from RBSG.

23. There are also a number of banks that have just been authorised or are in the process of being authorised including Atom Bank (authorised in June 2015, digital-only PCA and SME), Starling Bank (digital PCA), Civilised Bank (SME) and OakNorth (authorised in March 2015 SME but not BCA). In addition to traditional bank lending, alternative finance has been growing very rapidly in recent years. It has been estimated that the alternative finance sector had grown by around 160% in the year to 2014. Despite the rapid growth, alternative finance currently accounts for a very small share of SME lending (less than 2% of SME lending).

Financial crisis and subsequent initiatives

24. Our market investigation is being carried out against a backdrop of unusual macroeconomic conditions. The financial crisis in 2007/08 not only changed the regulatory environment in which banks operate but also banks' strategies and how they fund their operations.

25. During the crisis, the UK government took large holdings in RBSG and LBG to restore financial stability. Since 2008, banks have sought to rebuild their balance sheets and improve their capital position. Use of wholesale funding markets has reduced significantly and banks are generally relying more on retail deposits as a source of funding.

26. In addition, partly in response to tighter capital requirements and high levels of impairments, there has been a general contraction in lending activity in particular by the larger banks to SMEs. This has in part facilitated the entry of new banks and non-bank lenders such as peer-to peer lenders. It also prompted the UK government to set up the British Business Bank and, in conjunction with the BoE, the Funding for Lending Scheme (FLS) to incentivise banks and building societies to increase their lending to SMEs.

27. The prolonged economic downturn in which the central bank interest rate has been held at a very low level (0.5%) since March 2009 has reduced the

opportunity costs to personal and SME customers of holding credit balances in PCAs and BCAs while banks have sought to attract new PCA customers in particular by offering interest-bearing PCAs.

28. In January 2011, the UK government introduced a bank levy on all banks and building societies in the UK. The levy, currently set at 0.21%, is an annual charge on the value of bank liabilities (with some exceptions) including deposits. The bank levy raised £2.2 billion in 2013/14.

29. In July 2015, alongside changes to the bank levy, the Chancellor announced a new bank corporation tax surcharge. This will be a supplementary tax on banking sector profits of 8%, which will apply to all banks and building societies from January 2016. If a bank's annual UK profits were under the £25 million allowance, it will not be subject to the surcharge. A number of building societies and smaller banks in particular have expressed concerns about the new supplementary tax and the impact it will have on new entry and on their ability to expand. This is a current policy development and we will be considering further the implications of the new supplementary tax in light of submissions we receive.

Future developments

30. In addition to the regulatory changes, new entry and the government initiatives highlighted above our assessment of competition is also made against the backdrop of significant continued technical innovation in banking and of other ongoing changes:

(a) The UK has one of the highest rates of mobile banking adoption in the world and it is estimated that customers now log on to their mobile banking applications 10.5 million times a day to transfer £2.9 billion each week in the UK. The development of mobile banking and the wider digitalisation of banking has lowered the cost of new entry, facilitated digital-only new entry as well as new product and service innovation such as contactless payment technology and mobile payment systems (PAYM). Digital banking has also had a significant impact on customer behaviour. For example, the FCA found that signing up to text alerts and mobile banking reduced the amount of unarranged overdraft charges incurred by customers by 24%. Innovation in the sector – much of which has been prompted by innovations outside the banking sector – is likely to continue to be important with increased adoption of mobile banking and other technical developments such as cheque imaging and remote ID verification.

(b) The EU Payments Account Directive must be implemented by September 2016 and is aimed at increasing the information available on products and charges to consumers. It also requires the UK to ensure that consumers have access, free of charge, to an independent price comparison website (PCW) for comparing fees of payment service providers for the most commonly used services, to BBA provision and a switching service.

(c) The Small Business, Enterprise and Employment Act 2015 enables secondary legislation requiring designated banks to share data on their SME customers with other prospective lenders through credit reference agencies.

(d) Midata is a UK government-led programme of work to give consumers more control over and better access to their personal data held by businesses including banks and building societies. The aim is to give consumers access to their transaction data in an electronic, portable and secure way to enable them to make more informed choices.

(e) The UK government has announced its intention to deliver an Open Application Programme Interface (API) standard in UK banking. HM Treasury is working closely with banks, building societies and financial technology firms to develop the detailed framework for this by the end of 2015. Open APIs will facilitate the sharing of customer data and assist firms such as PCWs to make more accurate comparisons of different banking products for individual customers.

(f) By 2019, as recommended by the ICB, larger UK banks will be required to separate fully certain core banking services critical to personal and SMEs customers from other banking services. These ring-fencing requirements will apply to all banks with deposits of £25 billion or more (which would initially be expected to include HSBCG, Barclays, RBSG, LBG, Santander and Co-op).

Financial performance of retail banks

31. We analysed financial information from banks' annual reports and accounts, together with selected industry publications, reports by equity analysts and consulting/accounting firms, to inform our understanding of the overall profitability of UK retail banking. These indicate that banks are benefiting from improved economic conditions, lower impairments and improved net interest margins. However, persistent low interest rates as well as high customer compensation and conduct costs continue to limit profits.

32. While the total reported income of the larger UK retail banks' retail divisions remained relatively stable between 2012 and 2014, reported profit in general showed an upward trend largely driven by reducing impairments. Reported returns on equity (ROE) improved from 7.5% in 2012 to 11.8% in 2014 again primarily due to lower impairments. The limited evidence we reviewed does not suggest that ROE are significantly above banks' cost of equity. Similarly, while our analysis focused on overall industry trends, the evidence we looked at did not suggest that the largest UK banks had significantly higher ROE or net interest margins than smaller banks. At an early stage in this investigation we considered possible methods that would enable us to form a view as to whether banks were achieving levels of profitability that were in excess of what we might expect in a competitive market. We decided that there were inherent difficulties with such an exercise which would imply that the findings could not be regarded as sufficiently reliable as to inform our overall judgement. In particular, none of the larger banks was able to produce separate profit and loss accounts or balance sheets for each of their PCA or SME banking businesses. Moreover, there were particular problems in assessing the profitability of PCAs and SME banking including the appropriate allocation of common and shared costs, equity capital and revenues.

Market definition

33. We have provisionally identified the following markets to inform our assessment:

(a) PCAs, including PCAs both with and without overdraft facilities;

(b) BCAs, including BCAs both with and without overdraft facilities;

(c) business loans, including both short-term and medium/long-term business loans, with or without collateral; and

(d) business deposit accounts, whether instant-access or long-term.

34. For each of the above product markets, we provisionally found that GB and NI should be considered as separate geographic markets. Regulatory requirements do not differ materially across the UK. Pricing, product offering, service levels and marketing activities for each brand are determined at UK level and we found no significant variations in customers' needs and behaviour in different parts of the UK. However, we found that customers use different banks and brands in NI compared with the rest of the UK and that market shares differ accordingly. We found no such differences in relation to Wales. In relation to Scotland, while there were some differences

in market share in Scotland, these were not sufficient to suggest that Scotland should be viewed as a separate geographic market to England and Wales.

35. Defining the market merely provides a framework for our assessment of the effects on competition of the features of a market. It is therefore a useful tool but is not an end in itself. While our hypotheses are common across the product and geographic markets that we have identified, we recognise that there are, for example: significant differences between different types of PCAs and service elements within PCAs (such as overdrafts), between SMEs (eg size, sector, life stage), between different types of business loans as well as local issues, for example in relation to access to branches and SME lending. These issues are considered where relevant as part of our competitive assessment irrespective of our provisional view on market definition. Similarly, we also recognise that while we have not included, for example, alternative lending or e-wallets within our product market, these products are relevant to our assessment of competition.

Competition in PCAs

Introduction

36. A PCA comprises a number of different services: the making and receiving of payments with or without using cash; the storing of money; and most also offer a facility to borrow money on a short-term flexible basis (overdraft facility) whether arranged in advance with the bank or unarranged.

37. Banks offer a range of PCAs and there have been new product developments such as accounts which, subject to eligibility requirements, pay interest on credit balances, offer cashback on particular types of payments from the account and/or other rewards such as preferential terms on other bank products. Some of these newer ‘reward’ accounts require a fee to be paid although this is usually more than offset by the cash benefits received if the eligibility requirements of the account are met. Approximately 75% of all PCAs in the UK in 2014 were standard or reward accounts and the proportion that are reward accounts is increasing. For most such accounts customers are not charged regular fees for using the account’s core transaction services if the customer is in credit (the so-called free-if-in-credit (FIIC) model). However, they pay indirectly through interest foregone on credit balances, and pay directly for other services, beyond core transactions, such as fees for overdraft usage (unarranged and arranged) and foreign transaction fees.

38. Packaged accounts offer the same facilities as standard and reward accounts but include additional services such as travel insurance, car breakdown cover and/or mobile phone insurance. Such accounts have monthly or annual fees and accounted for approximately 13% of main PCAs in 2014. BBAs, while otherwise similar to standard accounts, typically do not provide a cheque book or overdraft facility. They accounted for approximately 7% of main PCAs in 2014. Student and graduate accounts are limited to UK university students or recent graduates and tend to offer extensive and lower-cost or interest-free overdraft facilities compared with standard or reward accounts and comprised nearly 3% of main PCAs in 2014. Youth accounts are typically available to 7 to 17 year olds and often have reduced functionality depending on the age of the account holder. They also accounted for approximately 3% of main PCAs in 2014.

39. We found that PCAs or personal banking, depending on how each bank assesses profitability, are profitable. Packaged accounts tend to be the most profitable type of PCA as they generally require a monthly fee that exceeds the cost of the benefits provided and are more likely to be held by main banking customers who are more active, have higher credit balances and use other banking products. BBAs and non-adult PCAs (youth, graduate and student) tend to be less profitable than standard or reward accounts due to lower credit balances and/or no access or interest-free access to overdraft facilities.

PCA market structure

40. The PCA markets in both GB and NI are concentrated but not highly concentrated, whether concentration is measured by volume of active PCA accounts or, for the UK, by net revenue. Apart from the impact of mergers and divestments, market shares by volume in GB and NI have remained broadly stable since 2005. The four largest banks in GB have collectively lost less than 5% market share since 2005, although they have a lower share of the flow of new PCAs than of all PCAs.

41. In NI, the four traditional clearing banks (RBSG/Ulster, Danske, AIB and BoI) have more rapidly lost market share to former and continuing building societies such as Santander, Nationwide and LBG/Halifax. Santander is now the third largest PCA provider in NI. Like the largest GB banks, the four traditional clearing banks have a lower share of the flow of new PCAs.

42. However, notwithstanding high rates of net account opening for other smaller and new entrant banks this has not translated into a significant impact on concentration levels in the provision of PCAs either in GB or NI.

Pricing, quality and innovation in PCAs

43. As explained above, the most common charging structure for PCAs in the UK is the FIIC model. Approximately 75% of all PCAs in the UK in 2014 were FIIC accounts. Despite the pervasiveness of FIIC, the complexity of the services provided under a PCA means that price comparisons between PCAs are not straightforward, as the actual prices paid by consumers will depend on the mix of PCA services they use including overdraft usage. We therefore undertook a range of comparisons across a sample of PCA customers. For banks operating in GB, these show considerable variations between average PCA prices. Moreover, in GB, recent entrants and expanding brands (including brands owned by the larger established banks) tend to offer lower average prices and banks with the highest market shares tend to have the highest average prices. A similar exercise for NI did not show much evidence of a positive correlation between market share in NI and average price. However, there were some limitations to the data for NI and we attach less weight to the comparison for NI than to that for GB.

44. We complemented our PCA pricing analysis with comparisons between the banks based on a number of indicators of service quality. In relation to quality, our analysis similarly shows some variation between banks. We did not, however, find any general tendency of higher quality offsetting higher pricing.

45. Moreover, in general, we found that while banks appearing to offer lower average prices and/or better quality tend to have been gaining market share this was at a very slow pace.

46. There have been a number of innovations in the PCA market in recent years including the introduction of interest-paying and reward accounts, changes in overdraft fee structures and developments in mobile banking (as part of the wider digitalisation of retail banking). Innovations in IT platforms and in digital banking have also facilitated new entry. In contrast, other innovations, such as the use of account aggregation services and digital e-wallets, are in the early stages of development.

Customer engagement in PCA markets

47. Despite the variation between banks in prices and quality, market shares have remained broadly stable. This suggests that there may be a lack of responsiveness by PCA customers to variations in price and quality. We therefore focused on understanding the level of customer engagement in the market and the reasons for what we observed.

Levels of customer engagement

48. Our consumer survey found that in 2014:

(a) 37% of respondents had been with their main PCA provider for more than 20 years;

(b) 57% of respondents had been with their main PCA provider for more than ten years;

(c) only 3% of PCA customers had switched PCA accounts to a different bank in the last year. Over the past three years only 8% switched, which compares to switching levels of 13% in savings products and 31% in energy over three years;

(d) only a further 2% of PCA customers had switched PCA accounts within their existing bank (internal switching);

(e) 79% of PCA customers had neither searched nor switched in the last year; and

(f) 16% of PCA customers had searched but did not switch in the last year.

49. Overall therefore we find that customer engagement as measured by switching and searching rates and by PCA longevity is low.

Barriers to engagement, searching and switching

50. Customers may engage in various ways from understanding the PCA products they currently hold (eg by checking their balance) to engaging more widely in the market by searching and comparing various PCA offers, and eventually either staying with their current provider or applying for a new account and switching providers to obtain a better deal.

51. We considered the process by which consumers engage and make choices in this market in order to understand the reasons for the low levels of search and switching. We found the following:

(a) A lack of trigger points because PCAs have no contract end date, which means that customers are not required periodically to consider if their PCA is best for them.

(b) High levels of stated customer satisfaction with their existing account, with 52% and a further 39% stating that they are ‘very satisfied’ and ‘fairly satisfied’ respectively. This is despite differences in the prices and quality of service offered by different banks. In addition, the low levels of

searching suggest that customers are not always making an informed decision to remain with their existing PCA provider and may not realise there are other PCAs that may serve them better.

(c) For many customers, PCAs are low-cost products, particularly for those who remain in credit, and they perceive that there are few gains from switching. However, our analysis indicates that customers can gain financially from switching PCAs. By switching to the cheapest PCA product, on average customers would save £70 a year, overdraft users would save on average £140 a year and heavy overdraft users would save on average £260 a year. The magnitude of these potential switching gains suggest that many customers are not sufficiently aware of available alternatives.

(d) There are barriers to accessing and assessing information on PCA charges and service quality. In order to identify the best account for them, customers need to combine the information on the different account charges, including, for overdraft users, on complex overdraft charges, with a detailed knowledge of their own account usage. Information on the latter is currently only generally available through monthly bank statements. In addition, the Midata initiative provides a means for consumers to gain this information by downloading their usage history in a file from their bank's website. Although the Midata initiative is a very positive development, it is not straightforward to use, its current application is not fully effective and its usage remains very low. Similarly, PCWs play a limited role and quality of service information is currently not available.

(e) Consumers still perceive significant barriers to switching accounts despite the introduction of CASS which has been a very positive development. Our survey found that 55% of customers considered that switching was a 'hassle' and 42% fear that something 'may go wrong'. Recent research by the FCA found that customers lacked awareness of CASS with only 51% having heard of CASS prior to the survey. The FCA also found that confidence in the service remained low and the Payments Council reported in December 2014 that less than 50% of consumers were confident that CASS would complete their switch without error.

52. Our quantitative analysis of the characteristics of customers who searched and who switched found that customers who searched had higher income, higher balances and higher education levels than those who did not. Customers with higher income and higher education levels were also most

likely to switch. Internet banking and/or having confidence in the use of the internet also increased the probability of searching and switching.

53. However, we have particular concerns about overdraft users. Our quantitative analysis of actual versus perceived behaviour found that many overdraft users believed they did not use an overdraft or they underestimated their usage. Overdraft users, despite having the most to gain from switching, were less likely to switch than other customers but as likely to search. Heavy overdraft users were in particular less likely to switch but as our pricing analysis suggests have the most to gain from switching. In addition, we found that overdraft charges are particularly difficult to compare across banks, due to both the complexity and diversity of the banks' charging structures but also customers' difficulties in understanding their own usage. There are also additional barriers to switching for overdraft users due to uncertainty surrounding the acceptance and timing of an overdraft approval.

Factors increasing customer engagement in PCAs

54. The internet and increasing digitalisation of banking has facilitated customer engagement with their own account. It also reduces customers' searching and switching costs making it easier for them to access and assess their expected account usage, facilitating the choice of the best PCA. As described above, customers who used internet banking were more likely to search than those who did not and having confidence in the use of the internet had a positive effect on the probability of searching. In addition, confidence in the use of the internet was positively correlated with switching. As yet, however, these developments do not appear to have had a material impact on rates of switching between banks.

55. We also considered whether levels of internal switching (ie switching with the same provider), and of multi-banking (ie holding a PCA with more than one provider) suggested greater customer engagement and switching:

(a) Internal switching may indicate that banks are encouraged to improve offers to existing customers in order to retain them. Only approximately 2.5% of customers switched internally in 2014. In addition, our survey found that the large majority (73%) of internal switchers did not search prior to switching whereas 72% of switchers who switched banks searched before switching. This does not suggest that internal switching is imposing greater constraints on banks than our evidence on engagement and switching levels suggests.

(b) Our survey found that approximately 22% of PCA customers multi-bank. The most common reason for multi-banking was to have different PCAs for different purposes rather than to take advantage of better deals. However, multi-banking can reduce barriers to searching and switching because it increases the transparency of price and service attributes across different banks. Customers can also more easily move between different banks when they already have a relationship with more than one provider.

Banks' incentives to compete in PCAs

56. The behaviour of customers plays a central role in providing competitive constraints on providers if customers are engaged and willing to search for and implicitly to threaten to switch to another provider, which offers them a better deal. Conversely, a lack of customer engagement in the market affects banks' incentives to compete. The evidence we gathered indicates that competition is focused on acquiring the primary banking relationship and targeting more affluent customers. Consistent with this, LBG, with its Halifax and Lloyds brands, and Santander are the largest spenders on advertising and Lloyds and Santander have launched new PCAs with conditions that encourage affluent customers to move their primary banking relationship to these brands.

57. There appears to be an increasing number of initiatives in product development by banks, with the introduction of reward accounts, which offer benefits to customers such as credit interest and/or cashback on transactions, and the introduction of one-off switching incentives, typically in the form of cash payments.

58. Such pricing competition is an important aspect of the overall competitive behaviour. However, there has been less active competition on aspects such as arranged and unarranged overdraft fees with no evidence of banks specifically targeting overdraft users with marketing. Many of the recently introduced changes to overdraft fees have been driven by regulation rather than the banks. This less active competition on arranged and unarranged overdraft fees is consistent with our analysis of the levels of engagement, searching and switching by overdraft users.

59. We have considered whether the FIIC model contributes to lower customer engagement and low switching levels and how it may impact overdraft users in particular. While FIIC reduces to some extent awareness of the costs (direct and indirect) that customers are incurring, we have not found that the FIIC model is contributing to low switching rates. The UK is almost unique in having this pricing structure, but switching rates are also low in countries

where customers pay for their PCAs. Rather than the FIIC model itself, the lack of triggers and customers' perceptions of the lack of benefits of searching and switching are the most significant factors for low customer engagement. Moreover, banks have an incentive to set high overdraft charges due to the lack of customer engagement on overdraft charges and the existence of barriers to searching and switching for overdraft users, whether or not banks operate an FIIC model.

60. We also considered whether, as the predominant price model, banks, in particular new entrants and smaller banks, may find it difficult to deviate without losing/being unable to gain customers. We have not found that the FIIC model limits banks' abilities to adopt different pricing structures to differentiate themselves with many banks, including new entrants and smaller banks, adopting alternative pricing models in recent years including interest-bearing and reward accounts. These alternative pricing models have been successful in attracting new customers and account for an increasing proportion of accounts.

Provisional finding in the provision of PCAs

61. There have been positive developments in recent years such as product innovation, new entry including by firms with new business models, and innovation in digital banking.

62. The low customer engagement we have found in the PCA markets means that the discipline imposed by customers on banks through switching and the threat of switching is not as strong as it would be if more customers were engaged. This reduces banks' incentives to compete on price and/or quality and/or to innovate.

63. As longer-established banks have a larger base of existing PCA customers including less engaged customers, they have market power and given the weak customer response, are able to maintain high and stable market shares. The weak customer response also makes it difficult for new entrants and smaller providers to expand organically as the cost of acquisition of customers is high. This weakens the constraints that new entrants and smaller banks impose on longer-established banks.

64. We have therefore **provisionally found that a combination of low customer engagement, barriers to searching and switching and incumbency advantages in the provision of PCAs in both GB and in NI is leading to AECs**. With greater customer engagement we would expect banks to have stronger incentives to compete and develop products to benefit all customers which are clearer to and valued by customers. In

addition, we also provisionally found that certain customer groups may be particularly affected by the AECs we have provisionally identified:

(a) Non-engaged customers who face higher barriers to searching and switching. These customers tend to be the less financially sophisticated and/or less confident in using the internet; and

(b) Overdraft users, due to the lower competitive pressure on overdraft charges.

Competition in SME banking

Introduction

65. BCAs are an indispensable service for the vast majority of SMEs. How an SME will use its bank and what it will need from its bank will depend on a range of factors such as the stage and life cycle of the SME, its size, the type of business and sector in which it operates, the complexity of the business, whether it is an employing business and its growth ambitions.

66. Unlike PCAs, there is little variation between types of BCA but banks will typically either charge for each transaction or charge a monthly fee which will include a specific volume of transactions within the fee. Anything not covered by the fee will be paid for on a per-transaction rate. Larger SMEs may negotiate bespoke pricing terms for their BCAs and most banks offer start-up SMEs (and to a lesser extent SMEs switching BCAs) a period of 'free banking' during which transaction fees are waived.

67. Alongside transactional services, banks may also offer overdraft facilities (usually subject to an annual arrangement fee) and advisory and support services to SMEs as well as other products such as lending, deposit and mortgage products. How and what advisory and support services are provided by most banks to SMEs will vary depending on the size of the SME. The smallest SMEs will generally have access to a call centre whereas larger SMEs (over £2 million turnover) will generally have a personal relationship manager.

68. For many SMEs, banks are an important source of finance both during critical periods of growth when businesses are seeking to expand, as well as during difficult periods when a business may need short-term financial assistance, for example to manage cash flow. There is a variety of business lending available, including general-purpose business loans and commercial mortgages, credit cards, asset and invoice finance and alternative lending platforms. Different types of finance address different needs and their

suitability will depend, for example, on whether short- or long-term finance is needed, whether security is available and the urgency for finance.

69. In 2014, 48% of SMEs had credit cards and 43% had overdraft facilities. However, only 18% of SMEs had held a loan in the last 12 months and very few SMEs with turnover below £2 million take out commercial mortgages, invoice finance or asset finance. Most lending is taken out by larger SMEs (above £2 million turnover). While SMEs with turnover below £2 million account for 95% of SMEs, such SMEs accounted for around three-quarters of new loans by volume and less than half by value.

70. Each year a number of new SMEs will start trading and will cease to trade. This natural turnover in SMEs is partially reflected in the level of churn in BCAs. Approximately 12% (8% in NI) of BCAs were opened and closed in 2014. Start-up and younger SMEs have the highest failure rates. For example, only 60% of SMEs will still be in business after three years and less than half (around 40%) will be in business after five years. However, while there are high churn rates among start-up and younger SMEs, approximately 46% of SMEs are over ten years old and 26% are over 20 years old.

71. We collected data on banks' UK revenues to assess the profitability of their SME operations and, where possible, the profitability of individual products and customers. As with PCAs, BCAs or wider SME banking, depending on the bank, are profitable. The volume and type of transactional activity is particularly important to the profitability of BCAs. Charities, clubs and societies are the least profitable SMEs as they usually get free banking, are likely to have lower credit balances and are more likely to use cheques, which are more costly for banks to process. Start-up SMEs and switching SMEs often receive free banking for a limited period and such free banking periods are regarded as a cost of acquisition with a view to longer-term profitability over the life of the SME. Larger SMEs are the most profitable as they tend to hold higher credit balances, have higher transaction volumes and a need for a broader range of banking products and services.

SME banking market structure

72. The markets for BCAs in GB and NI are concentrated whether measured in terms of the total number of BCAs, active BCAs, new BCAs or unique customers. Excluding the impact of mergers and divestments, shares (by volume) in GB and NI of BCAs have remained relatively stable since 2010.

73. The combined market shares of the four largest providers of BCAs in GB (RBSG, LBG, Barclays and HSBCG) and in NI (RBSG, Danske, BoI and

AIB) have declined by only 1% and 2% respectively since 2012. Their share of the flow of new accounts is lower than for all BCAs. While market shares vary between banking groups if segmented between SMEs with turnover above and below £2 million, concentration levels are similar across the two segments.

74. Due to data constraints we have not been able to calculate concentration levels for all business loans. However, we found that levels of concentration in general-purpose business lending (including commercial mortgages) are similar to those in the BCA markets in both GB and NI. The markets in GB and NI for general-purpose business loans to SMEs with turnover of less than £2 million are highly concentrated and are more concentrated than for larger SMEs.

75. Based on data from banks, concentration levels in invoice finance are similar to general-purpose business loans. However, a significant number of finance providers are not captured by our data and, given the larger number of providers and larger banks' lower market shares in invoice finance, concentration levels are likely to be lower than in general-purpose business loans. Similarly in relation to asset finance, concentration levels are likely to be even lower. We therefore anticipate that concentration levels for the total business loan market will be lower than for general-purpose business loans.

Pricing, quality and innovation in SME banking

76. BCA charges are complex and will vary significantly between SMEs depending on whether the SME is able to negotiate fees, whether it benefits from 'free' banking, whether it pays a per-transaction or a monthly fee and the volume and type of transactions on the account. Such complexity makes comparisons of BCA pricing across the banks challenging, and in order to do so, we have applied banks' current BCA charging tariffs to a set of 17 representative SME customer profiles.

77. Our analysis of the BCA pricing structures for the set of SME customer profiles showed substantial variations in BCA monthly charges between banks. For GB BCA providers, the difference between the highest and lowest monthly costs was over 100% for 15 of the 17 customer profiles. For five of the profiles, the highest monthly cost was over three times as large as the lowest monthly cost. Similar results were found for the NI BCA providers and we noted that their monthly prices are generally higher than those of GB BCA providers. However, we did not find evidence of a clear association between price and market share in GB or NI.

78. The generally bespoke nature of SME loan pricing, which will typically reflect the specific risks associated with a given SME customer, has meant that it is difficult to carry out an equivalent analysis of prices on SME lending products. Estimating the default risk in the absence of external data on credit risk for all SMEs would involve significant data requirements, would be very complex and unlikely to yield any meaningful insights.

79. To assess the quality attributes of SME banking services, we considered indicators such as customer satisfaction ratings and net promoter scores (NPS) and also measures of satisfaction with relationship managers. We found that many new entrants in the provision of BCAs in GB had higher satisfaction scores compared with the larger longer-established banks, which all had similar satisfaction scores. Similar results applied across NPS. In NI, however, results were more mixed. As with price, we did not find a clear association between quality and market share in GB or NI.

80. However, we found that some banks appear to offer a combination of above-average performance on both quality and price indicators while other banks appear to be below average on both quality and price indicators. We observed that banks which appear to offer above-average pricing and below-average quality are gaining market share and conversely that banks appearing to offer below-average prices and above-average quality are either losing market share or are gaining market share at a very slow pace.

81. We also assessed the levels of innovation in SME banking and found that in relation to SME-specific innovations, these have tended to focus on the digitalisation of banking and reducing customer reliance on branches. These innovations have lagged behind the levels observed in the PCA markets. For example, some banks do not offer mobile banking to SMEs and/or offer less functionality than they offer to PCA customers. However, this is likely to be explained, at least in part, by the size of the respective markets.

SME engagement in BCA markets

82. The levels of concentration and stability in market shares despite variations in price and quality between banks and the more limited levels of new entry and innovation suggest that competition is not fully effective. As with PCAs, this appears to be because of weak customer engagement and/or barriers to searching or switching which prevent SMEs from identifying the best offers in the market and acting on these to switch their BCA.

Levels of engagement in BCAs

83. In analysing SME engagement in retail banking we identified three broad stages in the life of an SME which will impact on an SME's demand for banking products and the nature of its engagement in the market: first the start-up phase when first opening a BCA and establishing a business banking relationship; second, the end of the free banking period usually after 12 to 24 months when an SME will have a more established relationship with its business banking provider and its banking needs may begin to extend beyond the transactional aspects of its BCA; and third, more established SMEs whose needs for other business products and services, including in particular lending, may increase and the banking relationship may become stronger.

84. In relation to BCAs, our analysis of the Charterhouse survey data and our additional surveys, found the following:

   (a) 51% of start-up SMEs go to their PCA provider and 36% do so without searching at all.

   (b) 58% of all start-up SMEs did not compare providers and a further 23% only did so in a superficial way.

   (c) Only 4% of SMEs in GB had switched BCA provider in the last year and only 2.6% of SMEs in NI had switched.

   (d) 70% of SMEs in GB and 77% in NI that had been in business for over ten years have been with their main bank for at least ten years. 79% of SMEs in GB and 88% in NI that have been in business for at least five years have been with their main bank for at least five years.

   (e) Over 77% of SMEs between two and five years old said that that they never compared the costs of their BCA with other providers and 67% of SMEs did not consider switching at the end of the free banking period.

85. Overall, therefore, we found that SME engagement was relatively low both at start-up where many SMEs did not compare banks and after the end of the free banking period where few SMEs searched or switched.

86. While satisfaction with their provider was the main reason given by SMEs for not considering switching BCA, 35% of SMEs dissatisfied with their bank did not consider switching. Our qualitative research on SME behaviour also found examples of SMEs which, despite being dissatisfied, were unwilling to consider switching. In addition, the low levels of searching and the differences in price and quality between providers suggest that SMEs may

not be making an informed decision to remain with their BCA provider. We therefore investigated whether there are other factors which act as barriers to searching and switching.

87. We examined SMEs' attitudes to banking and found that there are a number of factors that may reduce SMEs' propensity to search and switch BCAs. There is a lack of triggers and BCAs are low cost relative to other costs of business. SMEs perceive that remaining loyal to a bank will be beneficial, in particular in relation to future lending decisions. There is also a perception that potential gains from switching are not high and that there is limited differentiation between banks. However, as noted above our BCA pricing analysis found significant differences between the highest and lowest monthly costs of a BCA for almost all our customer profiles.

88. We also examined whether there were barriers to searching. We found that while price information is available, it is difficult for SMEs to compare fees across banks. This is because of the complex tariff structures and multiplicity of charges for BCAs, the variability in usage, and the lack of effective price comparison tools, including ones that are able to use SME usage data to calculate which BCA offers the best prices. The equivalent of Midata in PCAs does not exist for SMEs. This is likely to particularly affect smaller SMEs without specialist financial capability.

89. There are also barriers to switching BCAs. The account opening process can be lengthy and onerous, particularly because of banks' processes for undertaking anti-money laundering (AML) compliance and know-your-customer (KYC) checks. We also noted that awareness of CASS was low among SMEs, despite most being eligible. Only 10% of BCAs were switched through CASS in 2014. Half of SMEs that had not switched BCA did not know that assistance was available to switch BCA and of those that were aware of assistance the majority knew little or nothing about the nature of such assistance. Loss of historical data, potential loss of payments at the end of the CASS redirection period and loss of data on the source of payments were highlighted by SMEs as areas of concern with the CASS process.

90. In addition, for some customers, access to finance may deter them from switching for fear that doing so would make it less likely that they would be able to continue to access finance and/or access finance in the future.

Banks' incentives to compete in BCAs

91. The linkage from PCAs to BCAs, the low levels of searching and switching by SMEs and the levels of churn in BCAs impact suppliers' behaviour. When looking at how banks compete for start-up SMEs we found the following:

    (a) Most banks offer free banking periods of between 12 and 24 months to start-up SMEs for BCAs. However, there has been a lack of dynamism with few changes to the length of free banking offers to start-up SMEs in the last four years.

    (b) There are incumbency advantages for PCA providers to acquire start-up SMEs, with just over half of SMEs opening a BCA with their PCA provider, and only one small prospective entrant planning to provide BCAs but not PCAs. After free banking, the most important factors driving SME choice of BCA provider for start-up SMEs were branch location and the bank being the SME owners' personal bank.

    (c) In addition we did not find strong evidence of banks targeting start-up SMEs through marketing or advertising.

92. We also looked at how banks compete for more established SMEs and found the following:

    (a) While there are some offers of free banking periods as inducements to BCA switchers, there is evidence of these declining. Many of the newer entrants and smaller banks do not offer free banking to switchers although several of the longer-established banks have recently increased their offer of free banking to switchers.

    (b) Banks' acquisition and retention strategies tend to focus on larger SMEs (turnover of above £2 million). In particular, larger SMEs have access to relationship managers, partly to provide these customers a better quality of service but also to cross-sell other products. Where relationship managers have customer acquisition targets, these tend to be geared towards the larger SMEs (turnover above £5 million). In addition, banks are willing to negotiate with larger SMEs, which is generally not the case for smaller SMEs. However, while important for banks in terms of revenues, larger SMEs represent just 5% of all SMEs.

    (c) There has been some innovation on tariffs, particularly with the introduction of electronic banking tariffs, but this has been limited.

    (d) We observed less innovation for SMEs compared with personal banking. Most innovations have had their roots in personal banking and there has

been a lower uptake of digital channels in SME banking, most notably in mobile banking.

Provisional findings in the provision of BCAs

93. As in the case of PCAs, low customer engagement, searching and switching has two effects. It weakens the constraints on banks from customer switching or the threat of switching. It also makes it more difficult for new entrants and smaller banks to expand and compete more effectively with the larger longer-established banks. This weakens the constraints that such banks impose and the incentives on banks to compete on price, quality and/or innovation are reduced. These incumbency advantages are particularly strong for longer-established banks with larger customer bases with more inactive customers and with an existing base of PCA customers given the product linkages between BCAs and PCAs. We have therefore **provisionally found that a combination of low customer engagement, barriers to searching and switching, product linkages and incumbency advantages in the provision of BCAs in both GB and NI is leading to AECs**.

94. With greater customer engagement we would expect banks to have stronger incentives to compete and develop products to benefit all SMEs which are clearer to and valued by SMEs. We found that in particular small and small-to medium-sized enterprises that no longer benefit from a free banking period are most likely to be adversely affected by the reduced competitive constraints on banks.

Levels of engagement and barriers to engagement and searching – SME lending

95. Banks are an important source of lending for SMEs. As SMEs grow they are more likely to seek additional products from their bank or other providers. Most SME lending is taken by larger SMEs (above £2 million turnover) and lending requirements vary significantly between SMEs. The most common reasons for seeking finance are to expand the business (30%), to cover cash flow shortfalls (28%) and purchasing new equipment (22%).

96. As explained above we were not able to undertake a pricing analysis of SME lending products but we found that there are significant variations in quality between banks and no clear association between quality and market share. We therefore considered, as in PCAs and BCAs, the level of engagement and whether there were barriers to searching in SME lending which prevented SMEs from identifying the best SME lending products for their needs. Our surveys of SMEs found that:

(a) around 90% of SMEs go to their main bank for overdrafts, general-purpose business loans and credit cards respectively; 69% went to their main BCA bank for invoice discounting and factoring and 76% for commercial mortgages;

(b) 60% of SMEs considered only one provider when seeking lending; and

(c) 25% did not consider other providers because of the 'hassle' or time associated with applying for finance.

97. We found that there were three primary reasons why SMEs go to their main bank for finance:

(a) Relationship with main bank: there is a considerable amount of evidence that SMEs value the relationship with their bank and believe that loyalty to their main bank will help them obtain finance. In addition, an SME's main bank will have more information on its customers – including financial history – to enable it to assess the risk of the SME defaulting. This information asymmetry between the main bank and other lenders enables the main bank to price credit more accurately, and potentially make lending decisions more quickly.

(b) Time, effort and convenience: SMEs may not even consider providers other than their main bank because of the time and effort involved in applying for finance from other providers, particularly when finance is needed at short notice. 24% of SMEs applied for finance at the time it was needed and a further 12% within two weeks of needing finance. Time spent searching and completing applications – including gathering necessary documentation – varies significantly between lender and types of lending with 46% of applications taking less than 1 hour to complete but 9% taking over 20 hours.

(c) Barriers to searching: it is difficult for SMEs to compare prices and other terms across banks. Prices are opaque and lending products are complex. Banks do not publish indicative tables of interest rates and management fees unlike other lending products such as residential mortgages. In addition, there is a lack of tools to help SMEs make comparisons, which may particularly affect smaller SMEs without specialist financial capability. There are a small number of business loan price comparison services, although these provide no information on interest rates and only limited information on other terms.

98. Overall we found low levels of searching where the majority of SMEs consider only one provider for their lending needs and barriers to searching

primarily as a result of the opacity and complexity of lending products and charges.

Banks' incentives on SME lending

99. As previously explained, the nature of customer engagement in the market will impact on banks' behaviour. We have found evidence of banks seeking to increase their lending volumes by improving the availability of finance and the speed with which an SME can obtain a decision on lending applications. However, such initiatives appear to be mainly focused on retaining existing BCA customers rather than acquiring new customers. We also found some limited evidence of banks responding to the price offers of competitors seeking to attract customers away from their main bank at a local level. However, this seems to be mostly targeted at larger SMEs who are best able to negotiate and with a view to acquiring the main banking relationship. We found that only 38% of SMEs with turnover above £250,000 a year negotiated when applying for lending and only 9% with turnover below £250,000 did so. Relationship managers can play an important role in negotiating lending terms although this will primarily be for larger SMEs. Evidence of pricing initiatives and discounts aimed at attracting new customers is much more limited.

Provisional findings in SME lending

100. We have therefore similarly provisionally found that weak customer response is having the adverse effects in reducing banks' incentives to compete on price and/or quality and/or to innovate in SME lending. It also weakens the ability of new entrants and small banks to grow organically. These incumbency advantages are particularly strong for longer-established banks with larger customer bases of both PCA and SME customers, given the strong product linkages between BCAs and SME lending and the information asymmetries between an SME's main bank and other lending providers.

101. We have therefore **provisionally found that the combination of barriers to searching, product linkages, the nature of demand for SME lending products, information asymmetries and incumbency advantages in the provision of SME lending in both GB and NI is leading to AECs**.

102. With greater customer response we would expect banks to have stronger incentives to compete and develop lending products to benefit all SMEs which are clearer to and valued by SMEs. We found that smaller SMEs, in particular those that are less able to negotiate better prices and terms, are

most likely to be adversely affected by the reduced competitive constraints on banks in SME lending.

103. While we have identified three separate AECs in each of GB and NI in relation to PCAs, BCAs and SME lending respectively primarily arising from weak customer response and incumbency advantages, these AECs are linked. Longer-established incumbent banks will benefit from their established customer base not only in the provision of PCAs but also in the provision of BCAs given the product linkages between the two products. This in turn will give such incumbent banks advantages when competing in the provision of SME lending given the stronger linkages between BCAs and SME lending and the asymmetry of information between the BCA provider and other lending providers. Given the linkages, the detriment to customers from each AEC we have identified will therefore arise not only within each product market in which we have identified the AEC as arising but also in the products markets of the others AECs.

Barriers to entry and expansion

104. The prospect of entry or expansion within a short period of time will often stimulate competition and provide a source of competitive discipline on incumbent firms in both PCAs and SME banking. We have considered the following potential barriers to entry and expansion:

(a) regulatory barriers – the authorisation process, capital requirements, and AML regulation;

(b) natural or intrinsic barriers – access to distribution channels such as branches, access to payment systems, IT and funding; and

(c) strategic and first-mover advantages – advantages in relation to customer acquisition and, for SME banking, access to intermediaries and proprietary information.

Regulatory barriers

105. The process to become authorised to operate as a bank has undergone significant change in recent years. These changes have enabled a more flexible approach to authorisation and include the option for firms to become authorised with restrictions before committing to large, potentially sunk, upfront investments. While the cost and time implications of authorisation continue to be significant, the recent changes have facilitated entry by several new providers and a number of prospective providers are in the early

stages of seeking authorisation. We therefore provisionally found that the authorisation process is no longer a barrier to entry.

106. The capital regulatory requirements for banks are complex and impact on banks in different ways depending upon the structure of their asset book, their risk profile, whether they are classified as a systemic bank, and their business decisions. We have found that there are significant differences in the risk weights on mortgages applied to different banks depending on the approach they are authorised to adopt to calculate their risk weight. This has the potential to distort competition between banks and to act as a barrier to entry and/or expansion as some banks have to hold significantly more capital on certain classes of mortgage than other banks. We therefore intend to undertake further analysis of the impact of the capital regulatory regime on competition between banks in our reference markets and across banks' retail banking businesses as a whole. We will continue to liaise closely with the PRA and we welcome evidence from parties on this issue.

107. AML regulation aims to prevent criminal activity and safeguard the economy from fraud. We have not found evidence that AML requirements in themselves are a barrier to entry and/or expansion. However, many banks' processes for implementing AML requirements and KYC checks can make account opening more difficult and time-consuming than necessary thus contributing to barriers to switching. This is particularly the case for SMEs where more information is required to properly identify a customer, which depending on how a bank implements AML requirements and KYC checks can materially slow down or complicate account opening, especially for larger businesses and/or those with more complex ownership structures.

Natural or intrinsic barriers

108. Traditionally branches have been an important distribution channel for banks. However, branch usage has significantly declined in recent years and multi-channel banking (branch, telephone and digital) is now the most common way in which customers use their bank. Branches currently remain the most important channel for acquiring customers for PCAs and BCAs. In addition, for many customers, in particular SMEs, branches remain important. However, a number of firms are in the process of coming into the market with a mostly digital offering, which suggests that, at least for these potential entrants, the lack of an own-branded branch network is not considered an impediment to entry and expansion. Customers' greater willingness to use alternative distribution channels, new technology to facilitate customer acquisition through digital channels and lower costs of operating a branch network, should in the medium to long term, facilitate

entry by firms with new business models, which may or may not include branches.

109. Established banks that have built up large own-branded branch networks over time have a ‘first mover advantage’, and may be able to leverage their branch network to acquire new customers and, against the backdrop of low customer switching and engagement, to retain them. Therefore while we have found that branches are not a prerequisite to entry and expansion in retail banking, at least in the short term, incumbent banks’ large branch networks may continue to contribute to the advantage that larger-established banks have in acquiring customers, given the weak customer response we have found.

110. We have identified a number of issues with respect to payment systems which suggest that indirect participants (most new and smaller banks) may be at a competitive disadvantage compared with direct members. The PSR, which has only been fully operational since April 2015, is currently looking in detail at these issues and we consider that it is best placed to address these issues. We have therefore decided to leave the issue of payment systems to the PSR with which we will continue to liaise.

111. Technological innovation has reduced the cost and risk of upfront capital investment in IT architecture, which has previously represented a significant sunk cost to firms seeking to enter the retail banking market. New entrants are now able to purchase preconfigured (‘off the shelf’) IT solutions and outsource the hosting of IT platforms and applications to third parties. We have not found evidence that such systems are not able to expand as a bank grows organically and indeed they appear to be less costly than many established banks’ existing legacy systems in enabling expansion and the development of new products and services. We therefore provisionally find that the cost and risk associated with IT systems is not a barrier to entry or expansion.

112. We have not found that accessing funding is a barrier to entry. Access to a large established base of customer retail deposits, however, gives longer-established banks with larger customer bases some funding cost advantages. However, this funding advantage is only maintained because of the weak customer response that we identified above.

Strategic/first mover advantages

113. While access to an established customer base gives incumbent banks access to information on their customers that can be used to develop products and target promotions, we have not found strong evidence that

such informational advantages are acting as a barrier to entry/and or expansion. However, in relation to SME lending, an SME's BCA provider will benefit from better financial histories on their existing SME customers than alternative providers. This gives an SME's BCA provider an advantage in pricing and assessing risk. This is particularly relevant for smaller SMEs as there is a lack of publicly available information on the trading and financial performance of such SMEs. As discussed above, access to information can also reduce the time involved and inconvenience to SMEs of the loan application process. There are a number of government reforms in train that have the potential to mitigate some of the informational advantages held by the BCA bank in relation to SME lending, however these have yet to be tested. We therefore conclude that access to transactional data is a barrier to entry and expansion to SME lending.

114. While some banks use intermediaries to acquire SME customers, and to a lesser extent, personal customers, there are wide variations between banks. Where intermediaries are used, they are complementary to other customer acquisition channels. We found no evidence that new entrants have difficulty accessing intermediaries if the use of intermediaries is part of their strategy.

115. As we have explained above, one of the biggest challenges for new banks and smaller banks seeking to enter and expand in the banking market is customer acquisition. New entrants seeking to enter and expand in the banking markets have to invest significant amounts of time and resources to attract customers away from the longer-established banks. Even then it is likely to take some time before they are able to acquire sufficient volumes of customers to recover their costs of entry and/or have a sufficient presence in the market to recoup their initial investment. We therefore provisionally find that customer acquisition is a significant barrier to entry and expansion.

Market structure and market power in the provision of PCAs and SME banking

116. The structure of a market will reflect the results of current and previous competition in the market including entry, growth, decline and exit of firms in the market. At a deeper level it will also reflect underlying supply and demand factors including the extent to which customers demand a variety of products and levels of customer engagement.

117. Market power can arise through firms having unilateral market power or as a result of firms coordinating their behaviour. We have not found evidence to suggest that coordinated behaviour is a feature of any of the markets we are investigating. As discussed in previous sections, competition in the PCA, BCA and SME loan markets is affected by weak customer response associated with lack of engagement, barriers to searching and/or switching,

information asymmetries in SME lending and the linkages between PCA, BCA and SME loans markets. This means that incumbent PCA and SME banking providers have market power over existing customers.

118. As discussed above, we found the structure of the PCA and BCA markets to be concentrated and similar levels of concentration in general-purpose business lending and other lending products. The largest four banking groups account for over 80% of the BCA markets in each of GB and NI. The same banks are also important in other SME banking markets although other providers have a larger share in asset finance and invoice finance than they do in BCAs. The position in PCAs is broadly similar except that there is stronger competition from former and continuing building societies, in particular Santander and Nationwide.

119. We saw some evidence that banks with larger PCA market shares have higher average prices and/or lower quality; we did not observe a similar association for BCAs, though the BCA pricing data is less comprehensive and subject to more uncertainties. We saw a general tendency for smaller banks over the medium to longer term to grow more rapidly than larger banks, which is consistent with smaller banks making better average price/quality offers to customers than larger banks. Finally, we did not find strong evidence of a reduction in competition following LBG's acquisition of HBOS.

120. Overall, we consider that the evidence is consistent with incumbency advantages deriving from the weak customer response as described above. We consider that it provides limited support for the current concentrated market structure having additional adverse effects over and above that of incumbency. While we observed some tendency of banks with larger PCA market shares to have higher average PCA prices, this may simply reflect their incumbency advantages arising from being longer in the market and having a higher proportion of inactive customers paying relatively high prices.

121. We have therefore provisionally found that there is insufficient evidence that the current concentrated market structures in GB or NI are themselves having adverse effects on competition and detrimental effects on customer outcomes in PCAs, BCAs or SME lending. There is some limited evidence indicating that longer-established banks, with larger market shares, are able on average to charge higher prices and/or provide lower quality, than newer banks with lower market shares. We consider, however, that this is consistent with weak customer engagement and to these banks having a larger base of established customers and a higher proportion of inactive customers.

122. We would stress that this does not imply that increases above the current level of concentration through merger would be benign. First, though the evidence in relation to market structure and market power is limited, it is sufficient to justify a cautious approach to any future merger activity which leads to material increases in concentration over and above the present level. Second, if larger banks focus their strategies on acquiring customers through mergers rather than through competing in the market, this could itself have adverse effects on larger banks' incentives to compete. Hence, while any merger proposal would need to be looked at on its merits against the backdrop of the market as it stands at the time, we would expect that any significant merger involving the four largest UK banks might lead to adverse effects and should be subject to careful scrutiny.

123. Different considerations apply to mergers involving only smaller banks. Mergers involving only smaller banks would not have the same impact on the market and have the potential to improve the competitive challenge from smaller incumbent banks by spreading fixed costs, notably the costs of IT infrastructure, across a greater number of accounts.