RETAIL BANKING MARKET INVESTIGATION

Notice of provisional findings made under Rule 11.3 of the Competition and Markets Authority Rules of Procedure (CMA17)

1. On 6 November 2014, the Competition and Markets Authority (CMA), in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (EA02) made a reference to the chair of the CMA for an investigation into the supply of retail banking services[1] to personal current account (PCA) customers and to small and medium-sized enterprises (SMEs) in the UK.

Provisional findings

2. The CMA inquiry group (the Group) appointed to consider this reference has provisionally found, pursuant to section 134(1) of EA02, that there are features of the relevant markets, which alone or in combination, prevent, restrict or distort competition in the supply of PCAs in the UK and in the supply of certain retail banking services to SMEs in the UK such that there is an adverse effect on competition (AEC) within the meaning of section 134(2) of EA02.

3. We have provisionally found that a combination of the following features in the provision of PCAs in each of GB and NI respectively give rise to AECs:

   (a) Barriers to accessing and assessing information on PCA charges and service quality: PCA charging structures are complex, particularly for overdraft charges, and there is limited comparable information on service quality. In order to identify the best account for them customers need to be able to combine this complex information on charges with a detailed knowledge of their own account usage and access information on service quality. It is therefore difficult for customers to compare different banks' products and services and there are few effective tools available to help them choose the best account.

   (b) Barriers to switching PCAs: customers perceive that switching accounts is burdensome and there is still a fear that something will go wrong.

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[1] As defined in the terms of reference. All references in this notice to retail banking services should be read accordingly.

Awareness of and confidence in the Current Account Switching Service (CASS) is still low. There are additional barriers to switching for overdraft users because of uncertainty surrounding the acceptance and timing of an overdraft approval.

(c) Low levels of customer engagement: few customers search for better offers and the number of customers switching PCAs, in part or in full, remains very low. A lack of triggers for customers to engage in the market, the low cost of PCAs for many customers, reported satisfaction despite low levels of searching and a belief by many customers that there is little to be gained from searching and/or switching, together with features (a) and (b) contribute to continued low levels of customer engagement. Overdraft users, despite being those who would potentially gain most from switching, generally show limited awareness of and engagement with their overdraft usage and have a lower tendency to switch.

(d) Incumbency advantages: customer acquisition costs are high because of features (a) to (c), and as a result longer-established banks have advantages over new entrants and smaller banks wishing to expand.

4. The combination of these features means that there is a weak customer response to differences in prices or service quality and established banks have incumbency advantages. As a result, the incentives on banks to compete on prices, service quality and/or innovation are reduced.

5. Longer-established banks benefit from having a larger existing customer base over which they have unilateral market power and, given the weak customer response, are thus able to maintain high and stable market shares. We have also found that the main barrier to entry and expansion is the existence of incumbency advantages from having an established base of customers. This makes it more difficult for new entrants and smaller providers to expand organically which in turn weakens the constraints that new entrants and smaller banks impose on incumbent banks.

6. While competition between banks to attract new customers has increased, in particular for the primary banking relationship, and increasing digitalisation in banking is reducing the barriers to customer engagement, we have found that many customers are not benefiting from this competition. In particular, the competitive pressures on overdraft charges are low. Overdraft charging structures are complex and overdraft users are less likely to switch banks, even though these users are likely to gain the most financially from switching. Some overdraft users also face additional barriers to switching due to the uncertainty surrounding the acceptance and timing of an overdraft approval.

Other groups of customers who find it more difficult to search and/or switch PCAs are also likely to be adversely affected. This tends to be customers who are less financially sophisticated and/or less confident in the use of the internet.

7. We have also provisionally found that a combination of features in the provision of BCAs in each of GB and NI respectively give rise to AECs. These features are as follows:

(a) Linkages between PCAs and BCA: many SMEs open their BCA with their existing PCA provider, often without searching for alternative providers.

(b) Barriers to accessing and assessing information on BCA charges and service quality: BCA charges are complex and there is a multiplicity of BCA charges and fees. There is also limited comparable information on service quality. In order to identify the best account for them, SMEs need to combine this information on charges with a detailed knowledge of their own expected account usage, and access information on quality. Information on own account usage can be difficult to access and/or, for some SMEs, uncertainty as to future usage makes it difficult for SMEs to compare different BCA products, and there is a lack of effective comparison tools and advice from intermediaries to help SMEs choose the best account.

(c) Barriers to switching BCAs: the account-opening process for SMEs can be lengthy, onerous and time-consuming because of banks' processes in particular relating to anti-money laundering and know-your-customer requirements. Use, awareness of and confidence in CASS remains generally low. In addition, the switching process can also be and is perceived to be by many SMEs time-consuming, difficult and importantly risky. Payments and/or receipts being delayed and/or not received can have a significant impact on an SME as well as potential loss of historical and payment data when switching through CASS. In addition, for some SMEs, access to finance may deter them from switching BCA for fear that doing so would reduce their ability to continue to access finance and/or access finance in the future.

(d) Low levels of customer engagement: as with PCAs, there are limited triggers for SMEs to engage once they have a BCA; BCAs are low cost relative to other business costs and many SMEs are satisfied with their BCA. In addition, many SMEs consider that there is little to be gained and potential disadvantages from searching and/or switching, in full or in part. Together with features (a) to (c) this leads to low levels of customer engagement more generally in particular as shown by the significant

number of SMEs who do not search and by the low number of SMEs switching BCAs, in full or in part.

(e) Incumbency advantages: customer acquisition costs are high because of features (a) to (d), and as a result longer-established banks have advantages over new entrants and smaller banks wishing to expand.

8. The combination of these features means that there is weak customer response to differences in prices or service quality and established banks have incumbency advantages. As a result, the incentives on banks to compete on prices, service quality and/or innovation are reduced.

9. Longer-established banks benefit from having a larger existing customer base over which they have unilateral market power and given the weak customer response, they are thus able to maintain high and stable market shares. We have also found that the main barrier to entry and expansion is the existence of incumbency advantages from having an established base of customers. These incumbency advantages are particularly strong for banks with an existing base of PCA customers given the product linkages between BCAs and PCAs. This makes it more difficult for new entrants and smaller providers to expand organically which in turn weakens the constraints that new entrants and smaller banks impose on incumbent banks.

10. Many banks offer initial free banking periods for start-ups, as well as free banking periods inducements to BCA switchers, but beyond that banks' acquisition and retention strategies tend to focus on larger SMEs. Some banks have sought to simplify charging structures and/or have developed some new services in particular to reduce the need for branch access. However, there has been limited new entry in the provision of BCAs, limited new product development and less innovation compared with the PCA market. Small and small- to medium-sized enterprises that no longer benefit from their free banking period are most likely to be adversely affected by the reduced competitive constraints on banks.

11. We have also provisionally found that a combination of features in the provision of SME lending in each of GB and NI respectively give rise to AECs. These features are as follows:

(a) Strong linkages between BCAs and SME lending products: the large majority of SMEs go to their BCA provider for finance having done little or no searching. SMEs also place significant weight on their relationship with their BCA provider when considering finance, because they perceive that they are more likely to get funding, on better terms and/or more quickly

with less inconvenience from their BCA provider as a result of their existing banking relationship.

(b) Barriers to comparing lending products: charges are opaque and lending terms including early repayment and penalty clauses can also be complex. There is a lack of effective comparison tools which may particularly affect smaller SMEs that do not have specialist financial capability.

(c) Nature of demand for SME lending products: in addition to the importance of a banking relationship to SMEs, SMEs require finance for a number of different reasons and quite often require finance on short lead times, for example to assist with cash flow. Applying for finance can take time both in preparing and gathering the necessary financial information to make an application, in waiting for the lender's decision as well as in negotiating relevant terms where applicable. This increases the costs for SMEs to obtain quotes from several providers.

(d) Information asymmetries between an SME's BCA provider and other providers of lending products: BCA providers will benefit from better trading and credit history on an existing SME customer than other providers and are therefore at an advantage over other providers in pricing and assessing credit risk as well as in reducing the time involved in and the inconvenience to SMEs of the application process. Such advantages are particularly relevant for smaller SMEs as there is a lack of publicly available information on the trading and financial performance of such SMEs.

(e) Incumbency advantages: customer acquisition costs are high because of features (a) to (d), and as a result longer-established banks have advantages over new entrants and smaller banks wishing to expand.

12. The combination of these features means that there is weak customer response to differences in prices or service quality and established banks have incumbency advantages. As a result, the incentives on banks to compete on prices, service quality and/or innovation are reduced.

13. Longer-established banks benefit from having a larger existing customer base over which they have unilateral market power and, given the weak customer response, they are thus able to maintain high and stable market shares. We have also found that the main barrier to entry and expansion is the existence of incumbency advantages from having an established base of customers. These incumbency advantages are particularly strong for banks with an existing base of BCA customers given the strong product linkages between

BCAs and SME lending, and the information asymmetries between an SME's BCA provider and other providers of lending products. This makes it more difficult for other lenders to expand organically in turn weakening the constraints that other lenders impose on incumbent providers.

14. While banks have sought to improve the terms, availability and speed of decision-making, such developments have primarily been aimed at retaining their existing BCA customers, larger SMEs or prompted by regulatory or governmental initiatives rather than competition. Smaller SMEs that are less able to negotiate terms are most likely to be adversely affected by the reduced competitive constraints on banks in SME lending.

15. While we have identified three separate AECs in PCAs, BCAs and SME lending respectively for each of GB and NI, these AECs are linked. An incumbent bank with an established base of PCA customers will benefit from that established base not only in the provision of PCAs but also in the provision of BCAs, given the linkages between the two products. This in turn will give such an incumbent bank advantages when competing in the provision of SME lending given the even stronger linkages between BCAs and SME lending. The detriment arising from each AEC that we have identified will therefore arise not only within each of the individual product markets in which we have identified the AEC as arising but also in the individual product markets of the other AECs.

16. The Group's reasons are set out in full in the provisional findings report, which will be published shortly, and are summarised in the summary of the provisional findings report accompanying this notice.

The next steps

17. The Group now invites interested parties to submit reasons in writing as to why these provisional findings should not become final (or, as the case may be, should be varied).

18. These reasons should be received by the Group no later than **5pm on Friday 20 November 2015** unless otherwise agreed with any party.

19. Unless a different date is agreed with any party, the Group will have regard to any such reasons provided by this date in making its final decisions in this investigation.

20. The Group is today also publishing a Notice of possible remedies which it considers might be taken by the CMA or others to remedy the AEC it has provisionally identified, comments upon which should be received no later

than **5pm on Friday 20 November 2015** unless otherwise agreed with any party.

Alasdair Smith
Group Chairman
22 October 2015

Note: A copy of this notice and the summary of the provisional findings report will be placed on the CMA website on 22 October 2015. The CMA proposes to publish the provisional findings report on its website as soon as possible thereafter. The published version of the provisional findings report will not contain any information which the Group considers should be excluded from the report, having regard to the three considerations set out in section 244 of EA02.

Comments should be made by email to retailbanking@cma.gsi.gov.uk or in writing to:

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