Retail banking market investigation: provisional findings report

Appendix 10

Barriers to entry and expansion

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Overview

1. To carry on a regulated activity in the UK, firms must apply for permission from the relevant UK financial regulator(s) under Part IV of the FSMA.[1] This applies to new firms entering the retail banking market organically, to existing firms wishing to vary their permissions to undertake new regulated activities, and to firms operating in the EEA seeking to expand activities to the UK.[2]

[1] Some entities are exempt from the requirements to be authorised. These are appointed representatives, professional firms that run regulated activities alongside their main business, and local authorities or some housing groups. See FCA firm authorisation.
[2] A firm authorised in an EEA state can offer certain products or services in the UK and other EEA states if it has the relevant passport. This is referred to as 'inward passporting'. In most cases the firm will still be regulated by its home state regulator. See FCA firm passporting.

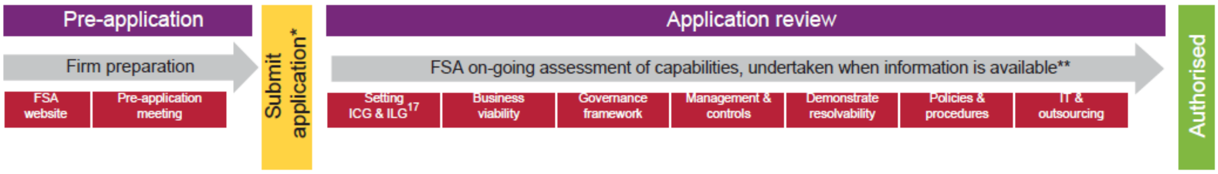
2. The regulated UK financial activities include accepting deposits, which applies to all PCA and BCA providers.[3] The PRA is responsible for the prudential regulation and supervision of all deposit-taking institutions (banks, building societies and credit unions), insurers and major investment firms.[4] These firms are regulated by the FCA for the way they conduct their business (that is, they are 'dual regulated' by the PRA and the FCA).

3. Dual regulated firms seeking authorisation are required to make a single application to the PRA. The PRA and FCA work together to assess the firm's application against their respective threshold conditions.[5]

The authorisation process prior to 1 April 2013

4. The new authorisation process for banks was introduced in April 2013. Prior to this date, firms seeking authorisation to carry out regulated UK financial services submitted an application to the FSA.

Figure 1: Authorisation process under the FSA



Source: FSA and BOE (2013), *A review of requirements for firms entering into or expanding in the banking sector (FCA barriers to entry)*.
*Past experience is that applications are often not complete, leading to a longer application review period.
**These assessments are not sequential and timing is dictated by the firm's preparation.

5. Under the FSA, the authorisation process consisted of two phases: the pre-application phase and the application assessment phase (see Figure 1 above). During the pre-application phase firms would be given the opportunity to discuss their proposals with the FSA to identify any immediate issues and help them to understand what information they would be required to submit. Once the application was submitted, the FSA would use this information to assess a number of factors, including the viability of the business model, the capital and liquidity requirements necessary to support the level of business proposed and whether the firm could be resolved in an orderly way.[6]

[3] Other regulated UK financial activities include issuing e-money, carrying out or helping to administer insurance contracts, investment activities and arranging, advising on, entering into and administering home finance. For full list of regulated UK financial activities, see FCA regulated activities.
[4] More about the PRA on the BoE website.
[5] See FCA firm authorisation and also Appendix 3.1 for details on the threshold conditions.
[6] *FCA barriers to entry*.

6. The FSA required an applicant to be fully operational before granting authorisation. This meant the applicant needed to show that all the regulatory capital was in place, staff had been hired and trained, IT systems were fully tested and operations and business continuity arrangements were in place.[7]

7. In March 2013 the FSA and the BoE published a review of requirements for firms entering into or expanding in the banking sector. This review set out some significant reforms to the authorisation process for banks, which are discussed in the following sections.

The authorisation process since 1 April 2013

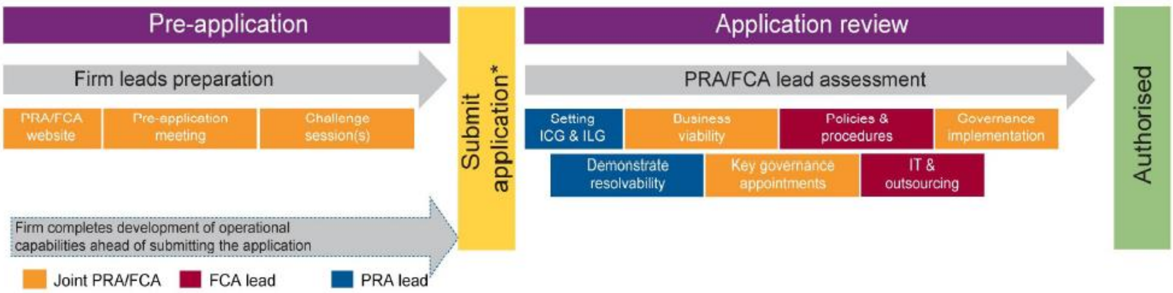
8. The reforms to the authorisation process introduced different options for firms to reflect the wide variation in applications received by the FSA and in the needs of firms.

9. Two options are now available for the authorisation of new banks:

   (a) Option A – for firms that have the development backing, capital and infrastructure to allow them to set up the bank relatively quickly (eg firms with IT and other infrastructure in place). From the start of the process to the end, a firm authorised through this option could start trading within six months (see Figure 2); and

   (b) Option B – for firms that cannot immediately fund the upfront investment required to set up a bank or that have longer lead times for raising capital and setting up infrastructure. This option gives firms the certainty of authorisation before committing to all the necessary investment (see Figure 3).

Figure 2: Revised authorisation process – Option A



Source: *FCA barriers to entry*.
*A firm targeting authorisation within six months (Option A) must submit in the application all the information required for the PRA and FCA to complete their assessments in the application review stage.

[7] ibid.

Figure 3: Revised authorisation process – Option B

Source: *FCA barriers to entry*.
*The application for the Mobilisation option only needs to include the information required for the assessment and authorisation stage, which is less than required in the application for Option A.

10. Regardless of whether firms follow Option A or Option B, the FCA and PRA are committed to providing greater pre-application support than was available under the FSA arrangement. During the pre-application phase, the regulators provide (potential) applicants with detailed information about the application process, the information to be submitted by the firm and the level of detail that this information must contain. This stage also currently involves an initial informal meeting, feedback meetings and a challenge session(s).[8]

11. In addition to receiving greater support from regulators throughout the pre-application stage, firms are also required to provide less information overall (regardless of which option is chosen) than under the previous authorisation regime. Firms applying through Option B need only provide the minimum amount of information that relates to activities that will be carried out later on (eg whether IT infrastructure will be built in-house or outsourced).

12. Once an application for authorisation has been submitted,[9] the PRA and FCA have six months from the point at which the application is deemed complete to determine the outcome of that application.[10]

Mobilisation of firms under Option B

13. Providing a firm meets the threshold conditions,[11] a firm applying under Option A will obtain authorisation and a firm applying under Option B will be authorised with a restriction. A restriction is a standard regulatory tool that, in this instance, allows the bank to accept deposits but will limit the scale of

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[8] The purpose of the challenge session is to increase the likelihood of the applicant submitting a fully-completed application. The challenge session usually takes place when a firm's business model and strategies for meeting capital and liquidity standards are nearly complete (see *FCA barriers to entry*).
[9] Details of the processes involved in submitting an application and reviewing it once submitted are provided in *FCA barriers to entry*.
[10] So long as this does not exceed 12 months from the submission date. The PRA and FCA have 12 months from the submission date to determine an incomplete application.
[11] The threshold conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage, see Appendix 3.1 for more information.

deposit-taking activities, and sometimes also the type of activity that the bank can engage in, acknowledging the lack of infrastructure and controls in place.

14. During this time the firm is said to be in 'mobilisation'. During the mobilisation phase the bank may raise capital, put in place and test an appropriate IT platform or outsourcing arrangements, hire the necessary staff, finalise policies and procedures that are appropriate to the activities it will carry out, and conduct any relevant training.[12]

15. Firms are able to begin some or all of the activities related to mobilisation during the application assessment stage – it is up to the firm. However, these must be finalised during the mobilisation stage, which is capped at 12 months to ensure the information on which the authorisation was granted does not become outdated.

16. Once the firm has completed all of these activities during mobilisation and is entirely operational, it must apply for a variation of permission in order to have the restriction on its authorisation lifted. Once the restriction is lifted (providing regulators are satisfied), the bank can increase the scale of the activities it has been authorised to undertake.[13]

Changes to capital and liquidity requirements for new entrants

17. As part of the reforms to the authorisations process that came into force on 1 April 2013, changes were made to the capital requirements imposed on entrant banks.[14] These changes involve the following:

    (a) The automatic additional requirements ('Pillar 2 scalars') that were previously applied to reflect the uncertainties inherent in start-ups will not be applied simply because the bank is new.

    (b) Following full implementation of Basel III, start-ups are required initially only to meet a minimum common equity tier one capital of 4.5% of risk-weighted assets. Entrants will be given longer to build up the additional 2.5% of capital (the 'capital conservation buffer').[15]

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[12] A list of activities that can be deferred to the mobilisation stage and those that must be completed prior to application are listed in, PRA/FCA (2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*, p8, paragraph 28.
[13] If the PRA/FCA ascertain that the firm does not meet the conditions for the restriction to be lifted, the PRA may take steps to remove the bank's authorisation once the 12-month period has passed.
[14] These changes apply to entrant banks that the PRA judges can be resolved in an orderly fashion with no systemic impact. More detail on the changes made can be found in *FCA barriers to entry,* section 6.
[15] Banks (including entrants) can operate below the 2.5% capital conservation buffer but in doing so must accept automatic restrictions on distributions of dividends, variable remuneration etc, and agree a plan with the PRA to

18. Under authorisation Option B, only the minimum overall capital requirement as required by the CRD IV (£1 million) needs to be injected at authorisation.[16] However, given that mobilisation is capital intensive, the PRA may require firms to hold additional capital during the mobilisation phase (such that a firm's capital holding does not fall below £1 million at any time).

19. In addition to the changes made to capital requirements, liquidity requirements have been revised. All banks, including entrants, now face lower liquidity requirements and there is no longer a differential in liquidity requirements for entrant and incumbent banks.[17]

Observations since the implementation of reforms to the authorisation process

20. The PRA and FCA, in a review one year after implementation of the reforms, note a number of positive developments, including:

    (a) a substantial increase in the number of firms discussing with the PRA the possibility of becoming a bank; and

    (b) an increase in the level of pre-application support offered to firms by the PRA and the FCA.

21. The PRA has authorised seven new retail banks since 1 April 2013; all but one of these banks applied for authorisation via the new Option B and include Paragon Bank, Atom and OakNorth. Following a three-month mobilisation, Paragon Bank became fully operational in May 2014. Atom is currently in the mobilisation stage having been granted authorisation in June 2015.

Table 1: Retail bank authorisations since 1 April 2013

Bank	*Date of authorisation*	*Products included*
Union Bank of India	September 2013	PCAs
Paragon Bank	February 2014	SME lending products
Charter Court*	December 2014	SME lending products
OakNorth	March 2015	SME lending products
Atom	June 2015	PCAs, BCAs, SME lending products
Habib AG Zurich UK Plc	July 2015	PCAs, BCAs, SME lending products

Source: PRA.
*Charter Court varied its permissions to accept deposits. Formerly an FCA solo specialist mortgage lender, Charter Court is now a deposit taker offering residential mortgage lending and second charge lending.
Note: One additional retail bank has been authorised since 1 April 2013 but does not provide products within the scope of the CMA's market investigation and have been excluded from this table. The PRA has also authorised six wholesale banks since 1 April 2013.

(re-)build the buffer. See *FCA barriers to entry,* p11. More information on the CRD IV is contained in Appendix 3.1 on the regulatory framework.
[16] The minimum of £1 million is for small specialist banks; most recent entrants and firms in the pipeline meet this requirement. This £1 million only covers the Individual Capital Guidance (which is Pillar 1 plus Pillar 2A).
[17] See *FCA barriers to entry,* p47, box 5.

22. One retail provider is currently in the application stage of the authorisation process and a further twenty retail firms that are active in the pre-application stage, ten of which plan to enter with current account propositions for personal and/or SME customers (or both).[18]

23. In March 2015 the PRA recognised that while the number of banking licences granted in each of its first two years was close to the average number of licences granted per year by the FSA, over one-third of the licences granted by the PRA have been to new entrants (as opposed to variations to existing licences) compared to 10% of new banking licences under the FSA's regime.[19]

Experience of recent entrants

24. Recent entrants' (and those currently in the authorisation process) experience of the authorisation process is varied, as illustrated in our case studies of Metro, Virgin Money and prospective entrants.

25. Metro, which launched in 2010, found the authorisation process a slow and challenging one.[20] However, its founder and former chairman Anthony Thomson, who went on to set up Atom (now the chairman of Atom), notes that the authorisation process has since improved significantly. In particular, Atom found that the clearer structure, which is organised into different stages, provides more clarity to the authorisation process. Mr Thomson also believes that there has been a big shift culturally in terms of the regulators' view of new entrants and a focus on promoting competition. Mr Thomson did, however, explain that the long lead times continue to present a problem for new banks and told us that it is not possible to wait until the firm is authorised (with restriction) to begin mobilising because this phase is limited to 12 months. For example, Atom told us that it was advised by FPS that it could anticipate a 12- to 18-month onboarding period after the granting of its licence for direct access, and that this period would vary on a case-by-case basis.[21]

26. Paragon Bank and OakNorth told us that the authorisation process remained a substantial exercise. While Paragon Bank believed the authorisation process was no longer the barrier into entry to retail banking that it once was, OakNorth believed that it did continue to act as a barrier but recognised that

[18] Source: PRA.
[19] BoE (2015), *Two years on from March 2013 publication of 'A review of requirements for firms entering into or expanding in the banking sector* – Speech by Martin Stewart.
[20] See Metro Bank case study in Appendix 10.2.
[21] Atom will access payment systems indirectly via an indirect access provider, at least initially.

the process was appropriate for institutions seeking to hold customer deposits.

27. Finally, Starling and CivilisedBank noted no concerns with respect to the authorisation process and commented that the reforms had improved the process.

Capital requirements

28. We set out below the additional evidence to support our analysis on capital regulation. It includes:

    (a) a comparison of risk weights under the standardised approach and internal ratings-based (IRB) approach;

    (b) a list of UK banks that are approved to use IRB approach; and

    (c) an analysis comparing levels of capital required under standardised approach and IRB approach for different assets.

Comparison of risk weights under the standardised approach and IRB approach

29. Under current capital regulations all banks in the UK are required to maintain a minimum ratio of capital to their risk-weighted assets. The principal aim of this is to protect customer deposits, banks' trading counterparties and the economy by ensuring that banks have sufficient capital to absorb losses in the event of the bank becoming insolvent or near insolvent.

30. When calculating capital ratios, assets are weighted according to their associated risk to ensure banks with riskier assets hold more capital against these compared with banks that hold less risky assets.

31. The regulations allow banks to use one of two approaches when calculating risk weights:

    (a) the standardised approach, where risk weights are set by the regulator based on information supplied from credit rating agencies; or

    (b) the IRB approach, where banks can calculate their own risk weights based on their own internal risk model. Banks wishing to use their own risk models need to seek approval from the regulator[22] to use these.

[22] In the UK, the PRA.

32. Table 2 below compares risk weights for credit risk under the two approaches. It is based on analysis conducted by the PRA. The average risk weights of banks on the IRB approach have been weighted by their exposure amount. As can be seen from the table below, risk weights under the standardised approach are higher for retail mortgages and SME lending. Conversely risk weights for higher risk assets, such as credit cards and commercial real estate are lower for banks on the standardised approach.

Table 2: Comparison of risk weights under the standardised approach and IRB approach

%

	Standardised risk weights	*Exposure weighted average risk weight*	*Low range risk weights*	*Upper range risk weights*
Mortgages (prime)				
0%<=LTV<50%	35	3.3	2.8	3.8
50%<=LTV<60%	35	6.0	5.1	7.0
60%<=LTV<70%	35	8.9	7.5	10.2
70%<=LTV<80%	35	12.7	10.8	14.6
80%<=LTV<90%	36	18.4	15.6	21.1
90%<=LTV<100%	43	31.4	29.9	36.1
>=100%		53.9	45.8	62.0
Mortgages (buy to let)				
0%<=LTV<50%	35	4.1	3.5	4.7
50%<=LTV<60%	35	9.7	8.2	11.1
60%<=LTV<70%	35	12.5	10.6	14.4
70%<=LTV<80%	35	17.5	14.9	20.2
80%<=LTV<90%	36	32.0	27.2	36.8
90%<=LTV<100%	43	43.1	36.7	49.6
>=100%				
Credit cards revolving retail expo				
UK credit cards	75	107	91	123
International credit cards	75	168	143	193
Corporate				
Large corporates		54.1	46	62
Mid corporates		79	67	91
SMEs	100	77.7	66.1	89.4
Commercial real estate	100	125	100	150

Source: PRA**.**
Note: LTV = loan-to-value ratio.

IRB-approved banks

33. Table 3 below lists all the banks that are currently IRB-approved in the UK. As can be seen most large banks are IRB-approved for all asset classes including mortgages and SME lending. [✂] The table below also shows that there are a number of smaller banks that are IRB-approved for mortgages, including Nationwide, TSB, Co-op, Virgin and Principality Building Society.

Table 3: IRB-approved banks

[✂]

Comparison of capital for banks on IRB and the standardised approach

34. This subsection compares the total capital banks would have to hold under the standardised approach and the IRB approach when issuing a £100,000 SME loan or residential mortgage. It is a stylized example, shown in Table 5 below, designed to show the potential impact to banks' capital holding between two approaches for calculating risk weighted assets.

35. The example includes the following components of the risk-based capital framework:

(a) Pillar I requirements – This is the minimum level of capital banks must hold to protect against credit, market and operational risk. Under current regulations banks have to maintain a minimum ratio of 8% capital to their total risk-weighted assets.

(b) Pillar II – This requires banks to hold an additional amount of capital to cover risks that are either not covered or inadequately covered under Pillar I. Pillar II is firm specific and set by the PRA. We have used values of Pillar II for 2015 supplied to us by the PRA.

(c) Additional capital buffers.[23] These include:

(i) Capital conservation buffer, set at 2.5% for all banks.

(ii) Countercyclical buffer; set at 0%.

36. The example does not include:

(a) Additional buffers for domestic systemically important banks. This is because the Financial Policy Committee have yet to designate which banks will be required to hold these buffers and their values. Additional buffers for domestic systemically important banks will be implemented in 2019. It is expected that Santander, LBG and Nationwide will all be subject to an additional buffer for domestically systemically important banks.

(b) Capital conservation buffer for new banks. Currently the PRA allows newly authorised banks more time to build up their capital conservation buffer.[24] We have not included this in our example because none of the banks we considered in our example are using this provision.

[23] For an explanation of each of these please refer to Section 10 on capital regulation.
[24] For further information please see Bank of England website.

37. These exclusions mean that the results may overestimate the difference between the IRB approach and the standardised approach.

38. Table 4 below summarises the components of capital of the risk-based framework and their values as well as the designated body responsible for setting these.

Table 4: Summary of capital requirements

	Total capital requirement	*Of which common equity Tier 1*	*Set by*	*Applicable to*
Pillar I (minimum capital requirements)	8%	4.5%	EU	All banks
Pillar II				
Pillar IIA	Firm specific	Same composition as Pillar I requirements	PRA	All banks based on PRA assessment
Pillar IIB (PRA buffer)	Firm specific	Only CET1	PRA	All banks are subject to an assessment by the PRA, but the PRA only sets buffers if it judges that existing buffers under the CRD IV are inadequate
Capital buffers				
Capital conservation buffer	2.5%	Only CET1	EU	All banks
Countercyclical buffer	0–2.5% Currently 0	Only CET1	BoE (FPC) discretion	All banks
Systemic buffers				
Globally systemic banks	1–2.5%	Only CET1	Financial Stability Board	HSBC Barclays RBSG (list updated annually)
Domestically systemic banks: ring-fenced banks and large building societies with >£25bn core deposits	To be set in 2016 following a consultation by the BoE FPC: between 0% and 3%	Only CET1	BoE (FPC)	The following banks are likely to be subject to systemic risk buffers when it is implemented in 2019: HSBC Nationwide Building Society LBG Santander RBS Barclays

Source: PRA data and CMA analysis.

39. The analysis shows that once the main components of capital risk based framework are taken into account the differential between the IRB and standardised approach for SME lending is virtually eliminated. A large globally systemically important bank on IRB will be required to hold between £[✂] and £[✂] worth of capital, compared with between £[✂] and £[✂] for banks on the standardised approach, [✂].

Table 5: Capital requirements under the standardised and IRB approach for £100,000 SME loan – a stylised example

[✂]

40. [✂]

41. For residential mortgages an advantage still remains for banks on the IRB approach even after accounting for Pillar II and capital buffers for globally systemically important banks. This varies from approximately £[✂] for residential mortgages with a loan to value less than 50% to just over £[✂] for residential mortgages of between 80% and 90% loan to value. [✂]

Table 6: Capital requirements under the standardised and IRB approach for £100,000 residential mortgage

[✂]

Source: CMA calculations based on PRA data.

Anti-money laundering

42. As set out in Section 3 and Appendix 3.1, UK banks must comply with AML regulations (enacted in the UK through the MLR) aimed at preventing money laundering and combating terrorist financing. Banks are required by the MLR to put in place policies and procedures, including the carrying out of CDD, to prevent and detect money laundering. Firms found to be in breach of AML regulations can be sanctioned and fined, with the fining amount based on considerations of what may be 'effective, proportionate and dissuasive'.

43. As with other forms of regulation, AML regulations could potentially raise barriers to entry and/or expansion if it is particularly difficult or costly to establish and operate the internal processes necessary to comply with the regulatory requirements.

44. AML regulations also place demands on customers, who must gather and present the necessary information and identification documentation required by CDD processes; the review of this documentation may also prolong the account opening time. Where this extra effort and/or time expended are factors in deterring customer shopping around and switching, AML processes may also raise barriers to expansion.

AML regulations as a barrier to entry

45. We set out in our UIS that we had not seen evidence to suggest that AML regulations were a barrier to entry. This remains the case, as we have not received further representations to the contrary.

46. Potential entrants, for example those with whom we spoke in the course of our case studies, did not raise any concerns regarding the necessity to

comply with the MLR. On the contrary, some saw CDD processes as an area in which they could differentiate themselves:[25]

(a) Fidor saw these controls as part of its business model;

(b) Starling noted that existing banks' processes were not optimally implemented – more effective and faster processes could be delivered using more customer friendly technology; and

(c) CivilisedBank said that it was investigating how detailed this process actually needed to be as it considered that existing banks might be unnecessarily stringent.

AML regulations as a barrier to expansion

47. As discussed in more detail in Sections 7 and 8 and Appendix 8.2, customers are deterred from switching by, among other factors, the administrative requirements of opening a new bank account. These include the CDD processes required under AML regulations. We therefore considered evidence on how banks implement the AML regulations.

48. The guidance on AML compliance available to firms is relatively high-level. Firms are expected to apply this guidance in a risk-based, proportionate way taking into account such factors as the nature, size and complexity of the firm.[26] Their CDD measures and monitoring should be applied on a risk-sensitive basis depending on the type of customer, business relationship and product or transaction.[27] A bank's approach can therefore be influenced by numerous factors such as its business model, customer base, IT systems and internal processes, and risk appetite. Banks which operate internationally potentially face additional challenges as they will be more exposed to firms with complex cross-border ownership structures and funds flows, as well as being required to comply with varying domestic regulation.

49. Accordingly, the implementation of AML regulations varies by bank[28] and while the AML regulations[29] allow a bank to rely on the CDD measures undertaken by another bank, in practice this is rare as the relying bank remains liable for any AML deficiencies. Furthermore, reliance is not risk free: see, for example, the FCA's thematic review published in November 2014 of

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[25] See Appendix 10.2 for more details.
[26] FCA Handbook, SYSC 6.3.1.
[27] FCA website.
[28] Similarly, the FCA found that, when it considered AML legislation in its cash savings market study report, banks had a range of approaches to verification. See in particular paragraphs 5.79–5.83 and 9.70–9.75.
[29] Regulation 17 of the MLR.

how small banks manage money laundering and sanctions risk,[30] which found that a number of banks relied on other banks to carry out CDD and enhanced due diligence on their behalf but did not take steps to ascertain whether the due diligence on which they were relying was commensurate with their customer risk assessment.

50. Data collected from banks shows that in practice, account opening times can vary considerably both between banks and within a bank depending not only on individual banks' policies and capabilities as described above, but also factors such as the product in question, the complexity of the customer's circumstances and the channel through which the customer opens the account.

(a) *Product:* The customer risk profile for a BCA is intrinsically greater than for a PCA and hence the CDD requirements are stricter.

(b) *Customer:* As noted above, the customer identification process for SMEs is more complex than for individuals:

(i) A bank should ensure that it fully understands the company's legal form, structure and ownership, and must obtain sufficient additional information on the nature of the company's business, and the reasons for seeking the product or service. This will include, for example, obtaining details of the business' trading address, any future funding requirements, Companies House registration number and HM Revenue & Customs certificate; and obtaining information on all or some of its customers and sources of funds.

(ii) Businesses with complex ownership structures or business models will necessitate more complex information gathering and documentation that will require longer periods to process, for example because personal identification is required for each director and each entity with controlling rights. Furthermore, specific rules apply to certain types of SMEs such as charities, clubs and associations.

(c) *Channel:* The ways in which a customer can open an account also vary by bank and the customer experience will vary accordingly. In-branch account opening is typically quickest. Not all banks allow online account opening (particularly for BCAs) and where they do, practices vary as to whether identification can be presented online or must separately be provided by post or in branch.

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[30] The FCA's most recent thematic review was a follow up review looking at how small banks manage money laundering and sanctions risk.

51. A firm's internal procedures and IT systems are also likely to be a factor in the above as banks vary in terms of how internal authorisations are conducted, have different online account opening and electronic verification capabilities and smaller banks such as Metro have indicated that their IT systems give them an advantage over incumbents in processing new applications more efficiently.

52. Evidence collected by the CMA suggests that many banks can open a PCA on the day or shortly thereafter in branch (although providing cards may take longer). Online applications can also be very quick, but this depends on whether identification is subsequently required by post or in-branch. However, even if the process is often relatively straightforward it might not be perceived that way by consumers, especially when applications cannot be completed online; and customers can experience difficulties in providing documentation.

(a) Yorkshire Building Society noted in response to our UIS that the 'hassle factor' of opening an account, including KYC checks, was a further barrier to customer activity in the market.[31]

(b) Consumer groups participating at a roundtable with the CMA following the UIS also indicated that identification was believed to be an important issue, noting that: 'Even if a consumer used CASS, they might still need to go into a branch to show some form of identification [and] ... some customers did not own a passport or they did not have another form of ID, eg utility statements'.[32]

53. BCAs, on the other hand, can take significantly longer to open, even in the best case where all the information is available upfront (in practice complex information requirements may lead to further delays as the SME collates the information). While there is significant variation in the information on average opening times provided to the CMA by banks, and due to the differences in banks' processes it is not always clear if the data are comparable, time lags of ten days upwards between initial approach and account opening (which may include a wait for a branch appointment where mandated) do not seem uncommon and can be significantly higher. For example:

(a) LBG noted that the average time between an initial approach and completion of contractual paperwork varied between 48 hours and ten days for simple applicants and an average of six to 12 weeks to open an

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[31] Yorkshire Building Society response to UIS, p4.
[32] Consumer roundtable summary.

account for more complex applicants – additionally an average of five or more days were required thereafter before the account could be used.

(b) Barclays commits to opening a BCA within 48 hours of receiving all documentation in-branch for SMEs with a turnover [✂] that are not switching from another bank and for SMEs with a turnover [✂] averaged a turnaround of [✂] throughout 2014.

54. LBG told us that the complexity of the application process and the length of time taken to open a bank account was in large part determined by the need to comply with increasingly onerous mandatory regulatory requirements such as AML regulations and the time taken by applicants (and where relevant their professional advisers) to provide the required information.

55. The evidence above confirms that the actual account opening experiences of more complex SMEs are likely to bear out customers' reservations about the account opening process and that the CDD processes play a significant part in that.

56. However, the rise of online banking and corresponding increase in online account opening is changing banks' approaches. Banks are increasingly investing in enhancements to their account opening processes, both by offering customers more choice in how they can open accounts and by simplifying and streamlining the process.[33] Banks are particularly focusing on extending their online capabilities:

(a) For example, [✂].

(b) Banks are also investing in electronic verification which is often used for account opening across all channels, not only online (alongside supplementary checks if necessary). A number of banks (including Barclays, HSBCG, LBG, RBSG, Nationwide, Santander and TSB) already have some capability in this regard. Some banks, such as LBG and RBS, are also starting to accept photographic copies of IDs sent as electronic files as backup where the customer fails the electronic verification process. These trends suggest that AML requirements to carry out enhanced due diligence[34] when a customer has not been physically present for identification purposes are not unduly hindering innovation in this space.

57. In the next few years there will be changes in the AML regime that may be relevant. The Better Regulation Executive, as part of the government's red

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[33] See the separate discussion on the use of branches and other distribution channels in this appendix.
[34] See Appendix 3.1.

tape challenge, is consulting on the implementation of the MLR. The UK must also implement the European Fourth Anti-Money Laundering Directive into UK law, which is intended to further embed the risk-based approach across Europe. In 2018 the UK's AML regime will be subject to a mutual evaluation by the Financial Action Task Force which will consider the extent to which the UK AML regime meets its standards as well as the effectiveness of the system.

Natural or intrinsic barriers

Branches

The decline of bank branches

58. Branches have traditionally been the principal distribution channel for banks, used by customers for checking account balances, handling cash payments/withdrawals and obtaining advice. The advent of telephone banking in the 1990s, and online and mobile banking more recently[35] (collectively, 'direct channels'), has changed how customers (personal and SME alike) interact with their bank(s), and multi-channel banking has become the new norm.

59. In recent years the number of bank branches in the UK has been in decline. This has been driven by a combination of demand-side and supply-side factors. For consumers, the ease and convenience of direct banking is driving down demand for branches. For banks, consolidating their branch networks can generate significant cost efficiencies. To ascertain whether branches create a potential barrier to entry and expansion in UK retail banking it is important to understand how these drivers interact.

60. In 2013, there were 10,208 bank branches in the UK (see Table 7 below). This fell to 9,661 at the end of 2014. The UK's branch network has remained relatively concentrated by brand and by geography: Barclays, HSBC, Lloyds, NatWest and Santander accounted for 63% of branches in the UK in 2013 and 2014.

[35] This includes 'digital wallets' that facilitate the storage of payment (and possibly other) credentials and enable users to make payments, either online or via a mobile device. For more details see section 4 and appendices 4.2, 5.6 and 6.6.

Table 7: Total number of branches in the UK*

	2013	2014	% YoY change†
England	8,208	7,799	–5.0
Scotland	1,123	1,037	–7.7
Wales	596	562	–5.7
NI	281	263	–6.4
Total	10,208	9,661	–5.4

Source: CMA analysis.
*Based on data from AIB, Barclays, BoI, Clydesdale, Co-op, Danske, HSBCG, LBG, Metro, Nationwide, RBSG, Santander, TSB and Yorkshire Building Society. Data provided as at 1 January 2014 (approximated stock 2013) and at 1 January 2015 (approximated stock 2014). Includes retail branches and co-located business centres. Excludes branches (business centres) that only service SME customers.
†Year-on-year change in the stock of branches between 2013 and 2014.

61. Some banks also have stand-alone branches or business centres for SME customers that provide services such as a dedicated business banking counter service and relationship/business banking advisers. The total number of business centres in the UK has been more stable than retail branch numbers since 2013 (see Table 8 below).[36]

Table 8: Total number of business centres in the UK*

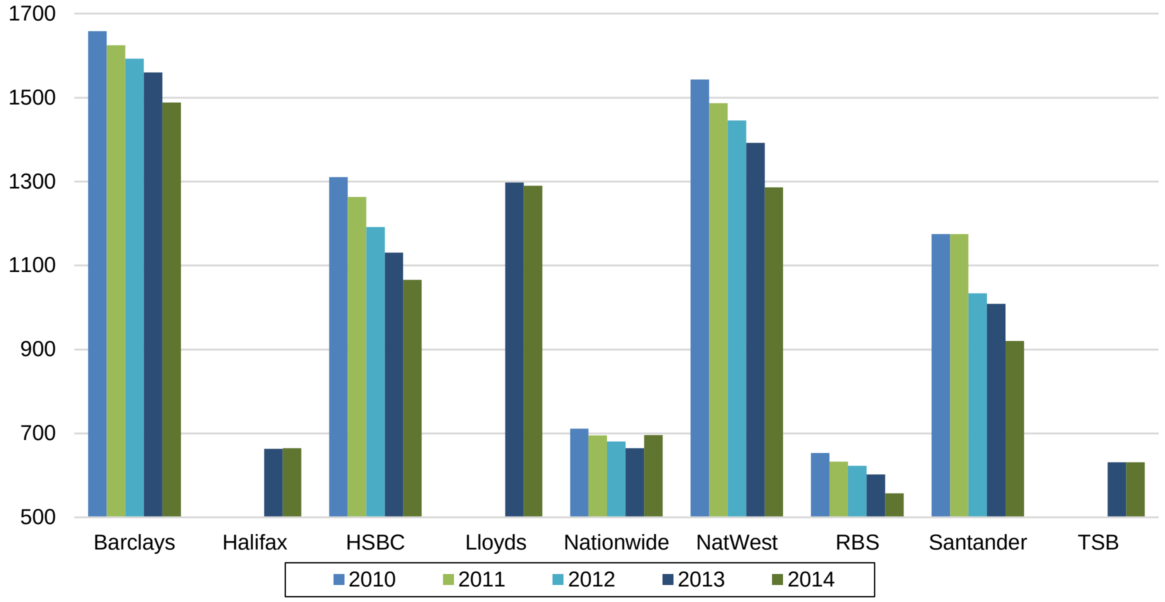
	2013	2014	% YoY change†
England	395	394	–0.3
Scotland	63	63	0.0
Wales	22	19	–13.6
NI	20	19	–5.0
Total	500	495	–1.0

Source: CMA analysis.
*Based on data from AIB, BoS, Clydesdale, Danske, HSBC, Lloyds, RBSG, Santander and Yorkshire Building Society. Data provided as at 1 January 2014 (approximated stock 2013) and at 1 January 2015 (approximated stock 2014). Branches (business centres) that service SME customers only.
†Year-on-year change in stock of business centres between 2013 and 2014.

62. Figure 4 and Figure 5 plot the decline in the number of (retail) branches since 2010 for banks with greater than 500 and fewer than 500 branches respectively. With the exception of Halifax, Nationwide and TSB, banks with relatively large branch networks (more than 500 branches) have been closing branches in every year since 2010. Nationwide also had a smaller branch network in 2014 compared to 2010. A similar trend of branch closures can be seen for those banks with relatively smaller branch networks. Metro, which entered the market in 2010 with a strategy focused on branch and customer service, is the exception; it has been steadily growing its branch network and plans to continue to do so at least until 2020.

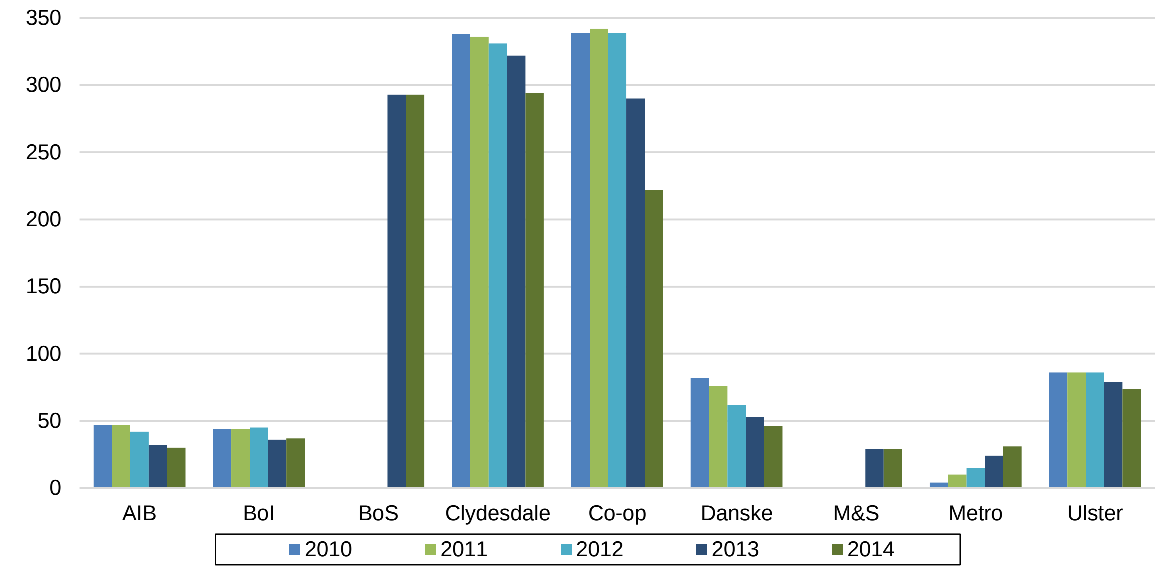
[36] In our information request to banks, we asked parties to exclude retail branches which provide basic services such as deposit facilities to SME customers. Some banks have co-located branches and business centres that they cannot separate for data collection purposes. These figures may overestimate the number of business centres.

Figure 4: Number of branches by brand, 2010 to 2014 (banks with more than 500 branches)



Source: CMA analysis.

Figure 5: Number of branches by brand, 2010 to 2014 (banks with fewer than 500 branches)*



Source: CMA analysis.
*Clydesdale refers to Clydesdale Bank Plc, which includes trading names Clydesdale Bank and Yorkshire Bank.

63. For the nine banks included in Figure 4, the average branch network size in 2014 remained significant at 961. A report by Deutsche Bank[37] quotes research by CACI,[38] which found that 80% of the UK market today can be covered by a bank through around 800 branches. CACI forecasts that 600

[37] UK Retail Banking 2014: Bank to the Future, Deutsche Bank Equity Research, September 2014.
[38] CACI is a location planning consultancy that has worked with a number of banks to assess their optimal branch network size.

branches will 'deliver effective nationwide customer coverage' in five years' time.

64. The Campaign for Community Banking Services (CCBS)[39] told us in response to our working paper, *Barriers to entry and expansion: branches* that it agreed with CACI's estimates of optimal branch networks for incumbent banks. However, it told us that it also believed that neutral transaction handling outlets (which might be Post Office counter services, discussed later in this section, or shared-use branches) would still be required in many other centres to supplement the remaining branches and offset smaller, geographically imbalanced branch networks of smaller banks such as TSB and Williams & Glyn which is soon to be divested from RBSG.[40]

Reforms to existing branches

65. In addition to an overall branch network consolidation by existing banks, remaining branches are being replaced with smaller, more digitally-focused outlets. A number of aspects of banks' branch optimisation strategies are common across firms and include the following:

(a) **Assisted digital** – a migration to self-service technology (including 'smart ATMs' with enhanced functionality such as cash and cheque paying-in facilities, and mobile technology) and reformed staff interactions with customers. HSBC, for example, is introducing tablets in its branches during 2015 to enable improved services to customers. TSB's analysis suggests that increasing self-service facilities in branches can deliver a cost reduction of around [✂]% 'without impacting customer service'. Barclays told us that one of the ways of ensuring the accessibility of digital banking for all its customers is the introduction of more than [✂] (specially trained staff) in all of its branches to provide technology advice to customers and the general public.

(b) **Reduced counter services and teller staff** – according to Barclays, [✂]% of bill payments by its customers are made through online and mobile banking, with less than [✂]% of bill payments made in branch. Barclays also noted the importance of alternative physical channels like the Post Office for cash handling. Meanwhile, HSBC noted that while most visits to its branches remained for cash and cheque deposits, it expected

[39] CCBS is a co-ordinating body for national organisations representing sectoral interests adversely affected by the closure of local bank branches. CCBS has 18 members including consumer organisations Which? and Age UK. See CCBS website.
[40] CCBS response to working paper on branches.

this to decline as cheque usage was decreasing and the use of mobile payments and peer-to-peer payments increasing.

(c) **Remote/virtual advice** – replacing static branch-based advisers with a central pool of advisers that engage with customers via video-conferencing. Barclays and Nationwide are examples of banks using this technology to link customers with advisers or relationship managers.

(d) **Alternative branch formats** – temporary pop-up branches and smaller branches are being used to fulfil demand where banks may be under-represented (or not present at all). Halifax, for example, has trialled pop-up branch operations in Scotland, where branch staff provide customer advice and assistance in shopping centres, supported by access to online banking facilities provided in the pop-ups. Barclays has introduced a new distribution format with Asda, called 'Barclays Essentials'. Barclays currently has eight Barclays Essentials branches, which it says offer its customers convenience and extended opening hours. RBSG has extended counter services to mobile banking vans. It told us that this service was used by [✂] SME customers in the [✂].

66. Smaller branch networks and reforms to remaining branches are enabling banks to focus investment more narrowly, increase efficiency and cut costs.[41]

Importance of branches to customers

67. Customer preferences may be driving a response by banks (existing banks and new entrants) as well as responding to a reduction in the supply of bank branch services. Banking is increasingly becoming a self-serve activity for consumers. Consumers are, according to a report by Deloitte, demanding greater convenience and expect a seamless integration of remote and in-person channels wherever they may be.[42]

Importance of branches to PCA customers

68. Between 2012 and 2014 the total number of branch visits by PCA customers in the UK fell by 15%.[43] Over the same period, the number of logins to mobile banking apps rose fourfold, overtaking logins to internet banking for the first time in 2014 (as shown in Figure 6 below). While the rate of growth in mobile

[41] Although branch reforms are not without cost: RBS noted in its response to our IS that the refurbishment and updating of its branch network carried a 'significant' cost. [✂]
[42] Deloitte (2014), *Bricks and clicks – Mapping the future of branches*.
[43] Calculated excluding Danske, Ulster and M&S Bank, for which data was not provided. Data on transactions by channel is not consistent across banks and has not been presented here. Visits/logins/calls may not be representative of the number of transactions made by channel.

registrations (by PCA customers) has slowed since 2011 as the stock of adopters has grown,[44] the rate of decline in the importance of branches is expected by some banks to accelerate as it is 'eroded by technological innovation'.

Figure 6: Proportion of usage by PCA customers by channel (branch visits/logins/calls)*

[✂]

Source: CMA analysis.
*Branch visits data is missing from Danske, Ulster and M&S Bank. Danske and Ulster have been excluded from this chart. M&S Bank has been included where data is available. Clydesdale did not provide data on banking logins and has been excluded from Figure 6.

69. Despite the recent trends observed in branch footfall, consumer research undertaken by GfK and independently by parties illustrates that some customers continue to place a high value on branch availability and accessibility.

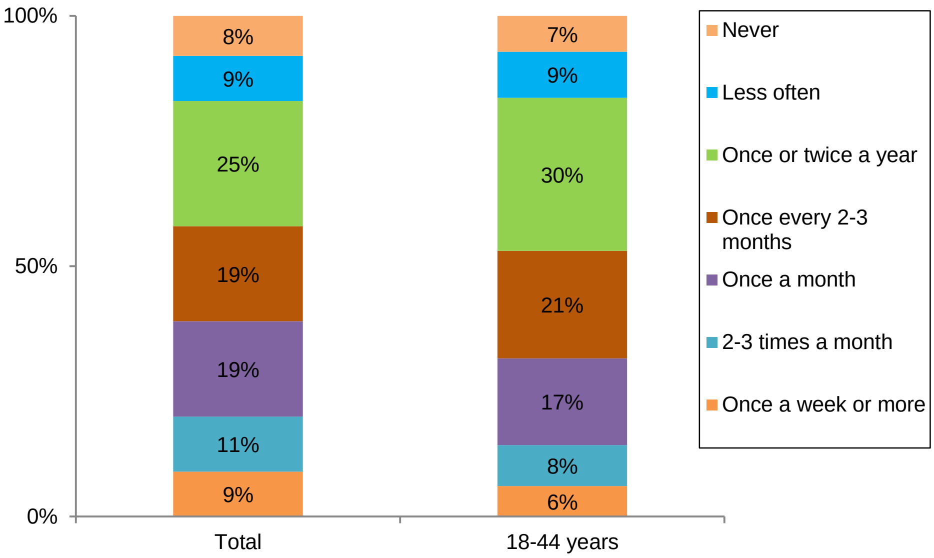
70. GfK PCA consumer research shows that branch convenience (location and opening times) is considered the third most important feature of a PCA for customers (joint with internet banking) after quality of staff and customer service, and quality and speed of handling problems. Local branch convenience is considered as essential or very important to more customers (63%) than having a national branch network available (58%).

71. TSB carried out its own customer research and found that for 69% of customers, having a branch close to where they lived was important.[45]

72. Despite the reported importance of bank branches, according to GfK PCA consumer research, less than two-fifths (39%) of PCA customers visit their branch at least once a month (see Figure 7). This falls to 31% for PCA customers aged between 18 and 44 years. 42% of respondents use a branch less than twice a year (this includes those who said they 'never' use a branch). Consumers may, therefore, place some intrinsic value on a branch presence even where they are not frequent users. In contrast, 66% and 74% of respondents use internet banking and mobile banking respectively and most are frequent users (logging on to their account at least once a week).

[44] Mobile registration rose 148% from 2011 to 2012, 80% from 2012 to 2013 and 37% from 2013 to 2014. Note: data is not available for TSB for mobile banking channel, and for LBG the figures for number of customers registered for mobile/internet banking are calculated by aggregating the individual figures for each LBG brand and therefore will overestimate the total number of customers registered due to double-counting of customers registered with more than one LBG brand.
[45] TSB (2014), *Why branches matter in a digital age*. Research carried out by ComRes for TSB, poll of 2,010 people (2014).

Figure 7: Frequency of branch visits*



Source: GfK PCA consumer survey.
*Respondents were asked 'How often, if at all, do you go into a bank branch for anything to do with your main current account?'
Base: All (total = 4,549; low income = 966; only one channel = 1,239; 18 to 44 years = 2,090).

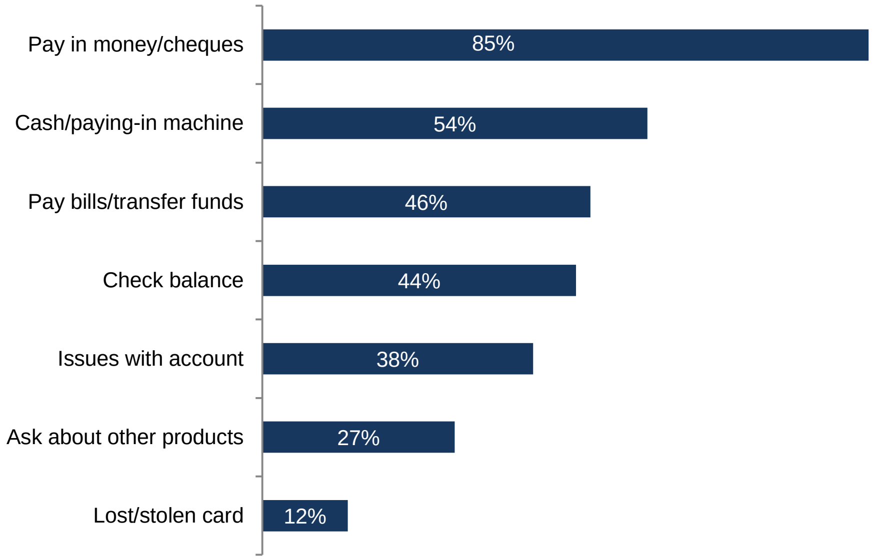
73. RBSG told us that currently, and increasingly, customers made use of multiple channels combining frequent digital access with less frequent in-branch or telephone interactions. It told us that despite reducing its branch network, the number of customer interactions with RBSG had increased in recent years (from [✂] customer interactions with the bank in [✂] to [✂] in [✂]). RBS predicted this would rise to [✂] in [✂] as more people used digital technology to interact with the bank.

74. The most common reasons for visiting a branch cited by respondents to GfK PCA consumer survey were to pay in money or cheques (either over the counter or by machine) (85%) and to use cash machines or paying-in machines (54%), as depicted in Figure 8. Accenture's report, *Winning the race for relevance with banking customers,* found that more than twice as many PCA customers making deposits prefer to do so through an adviser at a counter rather than using a self-service ATM.[46]

75. Further, nearly half (46%) of respondents to GfK PCA consumer survey that use branches visited their branch to pay bills or transfer funds between accounts. This was more common among those aged 45 years or over (50% versus 41% of 18 to 44 year-olds) and those who did not use internet banking (58% versus 40% of those who did).

[46] Accenture report (2014), *Winning the race for relevance with banking customers*. Accenture's research consisted of online interviews with 3,604 UK current account customers, conducted in March 2014.

Figure 8: Reasons provided for visiting a bank branch*



Source: GfK PCA consumer survey.
*Respondents were asked: 'Have you used any of the following in the last year when going inside a branch?'
Base: All those who have visited a branch in the last year (3,764).

76. LBG told us that a significant proportion of current branch activity occurred because customers were not yet aware of, or comfortable with, using digital channels. It noted that branches were key enablers of the multi-channel experience as they were used as a point of contact for branch staff to educate customers about digital channels and sign them up to digital banking. While not accounting for a significant proportion of branch visits at present, LBG noted that an increasing proportion of branch visits were for complex conversations across a range of products and its branch strategy reflected this.

77. There is evidence that branch usage differs between PCA customer segments. First, age appears to be a factor in determining branch usage. GfK PCA consumer research found that, as shown in Figure 7 above, those aged 18 to 44 tend to be less frequent visitors to a bank branch than the average population. However, having a national network of branches was more important to younger respondents (68% of 18 to 44 year-olds versus 51% of those over 65) who may be more likely to relocate (eg moving away for university or moving jobs).

78. [✂]

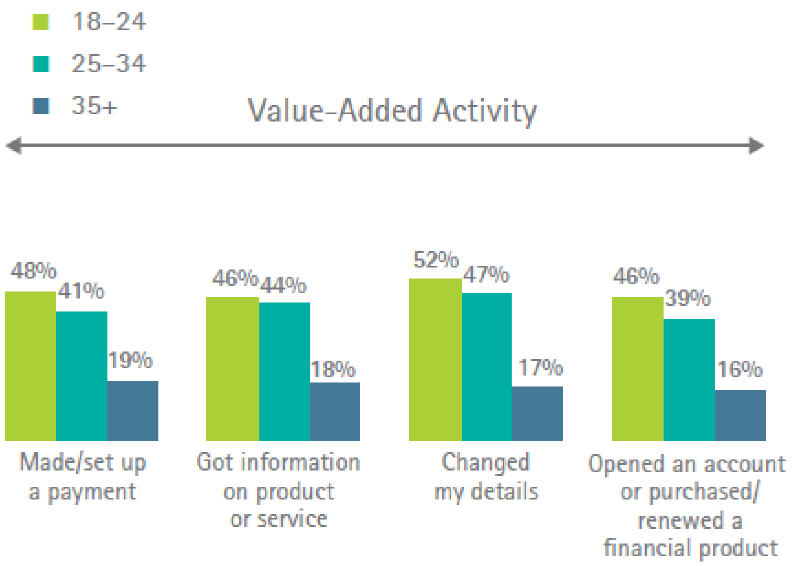
Figure 9:

[✂]

79. A report by Accenture found that in addition to those around retirement age, 18 to 24 year-olds were most likely to visit branches, reflecting 'changing needs over life stages'. According to Accenture's research, younger

customers have a greater bias for physical interaction pointing to their need for face-to-face contact, advice and reassurance as they begin their financial journey.[47] As Figure 10 depicts, 18 to 34 year-olds are more likely than over 35s to engage in 'value-added activity' in branches (defined as non-transactional activity).

Figure 10: 'Value added' activity in branches by age group*



Source: Accenture UK Financial Services Customer Survey 2014. Accenture (2014), *Winning the race for relevance with banking customers*.
*Responses to the survey question: 'Which of the following activities did you do during your last visit to your bank's branch?' The research consisted of online interviews with 3,604 UK current account customers conducted in March 2014.

80. Second, branch usage is correlated with usage of other channels. Frequent users of telephone banking are, according to GfK PCA consumer survey, also more frequent branch users. Further, over half (55%) of high frequency branch users (once a week or more) have never used internet banking. 74% of consumers that do not use internet banking consider having a convenient local branch to be either essential or very important compared with 56% of consumers that do use internet banking.

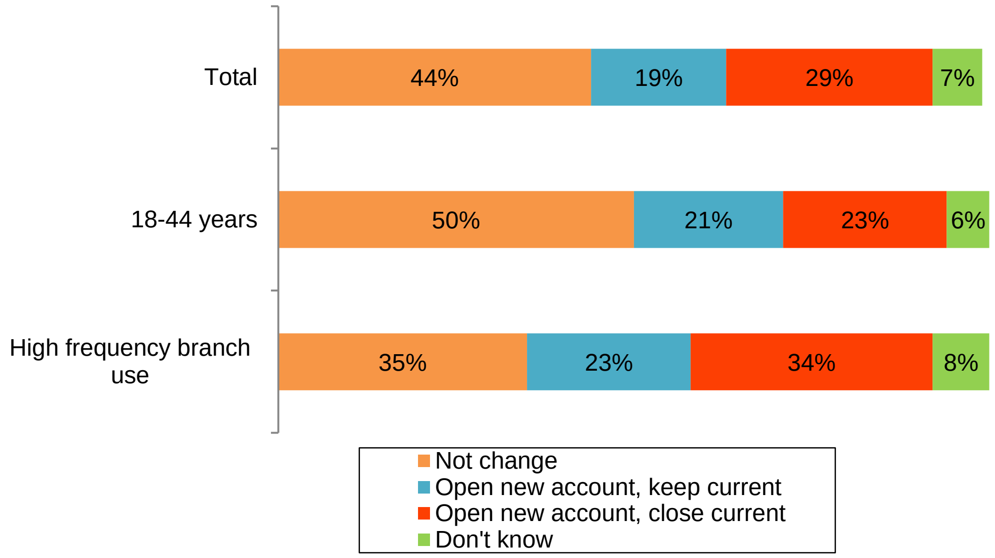
81. Third, GfK PCA consumer research found that PCA holders who are on a low income (defined as less than £12,000) tend to visit their bank branch (of their main current account) more frequently. 47% of customers on low incomes visited their bank branch at least once a month compared to 39% on average.

82. The difference in channel preferences by consumer type are reflected in Figure 11, which shows reported customer behaviour in response to the (hypothetical) closure of their main bank branch. On average, 44% of customers would stay with their existing 'main' bank if their most-used branch

[47] Accenture (2014), *Winning the race for relevance with banking customers*.

closed but 29% of customers would open a new account and close their current account. Half of 18 to 44 year-olds would not take any action if their main bank branch closed versus 35% of frequent branch users (those that use a branch at least once a week). This analysis does not take into account the proximity of a customer's alternative branch either with their existing bank or a different bank.

Figure 11: Reported behaviour if most-used branch closed*†



Source: GfK PCA consumer research.*Responses to the survey question 'Thinking about the branch of bank that you use most often, if that branch was closed permanently, would you open an account with a bank with a more convenient branch? If yes would you keep your account [with the bank that closed its branch] open or would you close it?'
†High frequency branch use defined as those customers that visit a branch at least once a week.
Note: Base = all those who have visited own bank branch in the last year (3,764).

83. GfK's qualitative consumer research found that individuals' responses to a branch closure are likely to be determined by the availability of alternative branches in their area and the extent to which they use digital resources. The closure of a branch network (ie branches across the country), however, is considered by most to be a severely detrimental development. Younger consumers saw this as a significant challenge to their relationship with the bank, while older consumers saw it as the termination of the relationship.[48]

Importance of branches to SME customers

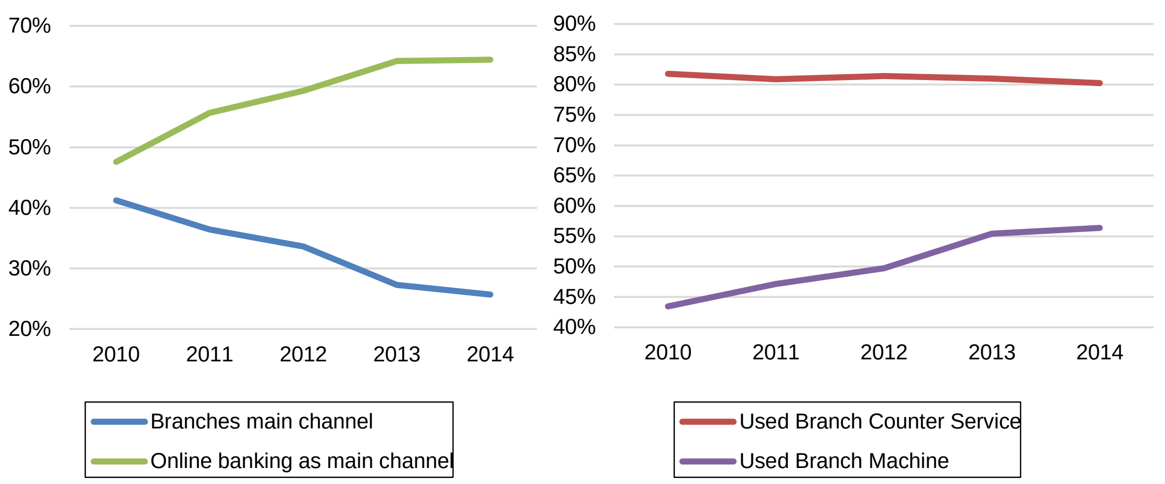
84. According to survey data from Charterhouse, the proportion of SMEs reporting they use branches as their main banking channel has fallen in every year of the past four years, decreasing from 41% of SMEs in 2010 to 26% in 2014. However, over the same period the number of SMEs using branch counter services in the 12 months prior has remained level at around 80%.

48 GfK PCA consumer survey.

Meanwhile, the proportion of SME customers using online banking as their main channel rose to 64% in 2014 from 48% in 2010. This is shown in Figure 12 below.

Figure 12: SME channel usage*

(a) Branch and online usage 2010–2014† **(b) Counter service and machine usage 2010–2014‡**



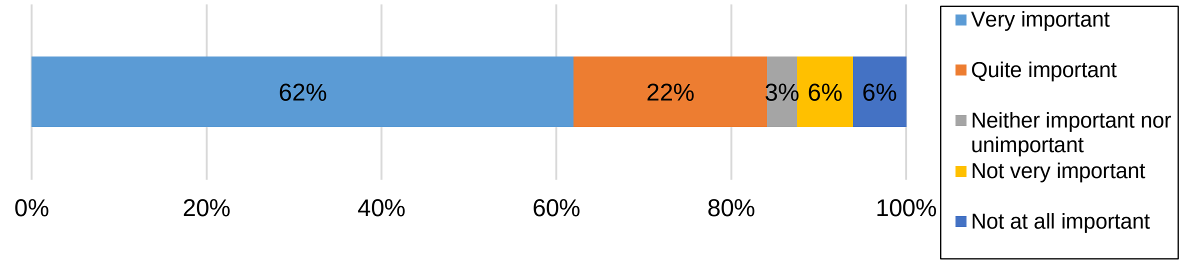
Source: Charterhouse BBS 2010–2014.
*Data from the Charterhouse BBS. This is a quarterly survey, collecting approximately 14,000 to 16,000 interviews with SMEs annually.
†In response to the survey question 'What is your most used banking channel?'
‡In response to the survey question 'Have you or anyone else in your business used Branches/Branch Machine in the past year?'

85. A Charterhouse survey of SME start-ups found that 82% use their local branch to open their BCA.[49] After banks' websites (29%), branch visits or leaflets from branches were the most popular source for start-ups to obtain information on BCAs (22%).

86. According to Charterhouse's survey of start-ups, having a branch in a convenient location or close to their business was the second most important reason for choosing a bank (17%) after access to free banking (19%). Further, 84% of start-ups reported that having a branch was either very important or quite important to their decision of who to bank with (see Figure 13 below).

[49] Start-ups defined as businesses which have been operating for two years or less. Survey undertaken by Charterhouse for the CMA.

Figure 13: Importance of branches to start-up SMEs*



Source: Charterhouse survey of start-up SMEs.
*In response to survey question: 'How important to you choice of bank was having a convenient branch location /or a branch that is close to your business?'

87. Paying in cash or cheques and taking out cash were the main reasons start-ups provided for requiring access to branches. 84% of respondents to Charterhouse's survey of start-ups quoted this as being the most important reason for having access to a physical branch. The next most important reason was for meeting a relationship manager/bank staff, but this was only true for 19% of respondents. Access to a network of branches across the country was viewed as 'not very important' or 'not at all important' for the majority of start-ups (62%). 29% considered a branch network as very/quite important.

88. Consumer research undertaken by Research Works found that SMEs consider it important to know branch staff, particularly counter staff and the relationship manager.[50] Being known personally implied to the customer that the bank knew their business well and this was given as a reason for staying with their bank.

89. [✂]

90. The services demanded of, and available to, customers in branch is also often dependent on the size of business and the complexity of their needs. For example, RBSG told us that the extent to which a business customer made use of branch counter services depended primarily on how cash/cheque heavy the business' operations were. In addition to branch services that served RBSG's business customers' simplest needs (day-to-day transmission requirements such as cash/cheque deposits and withdrawals), relationship managers[51] were assigned according to complexity of the relationship, sophistication of customer, size of customer, growth expectations, financial requirements and business needs. Customers with annual turnover of £250,000 to £2 million, or that had debt greater than £25,000 were managed by relationship managers (who were typically based in retail branches) on a

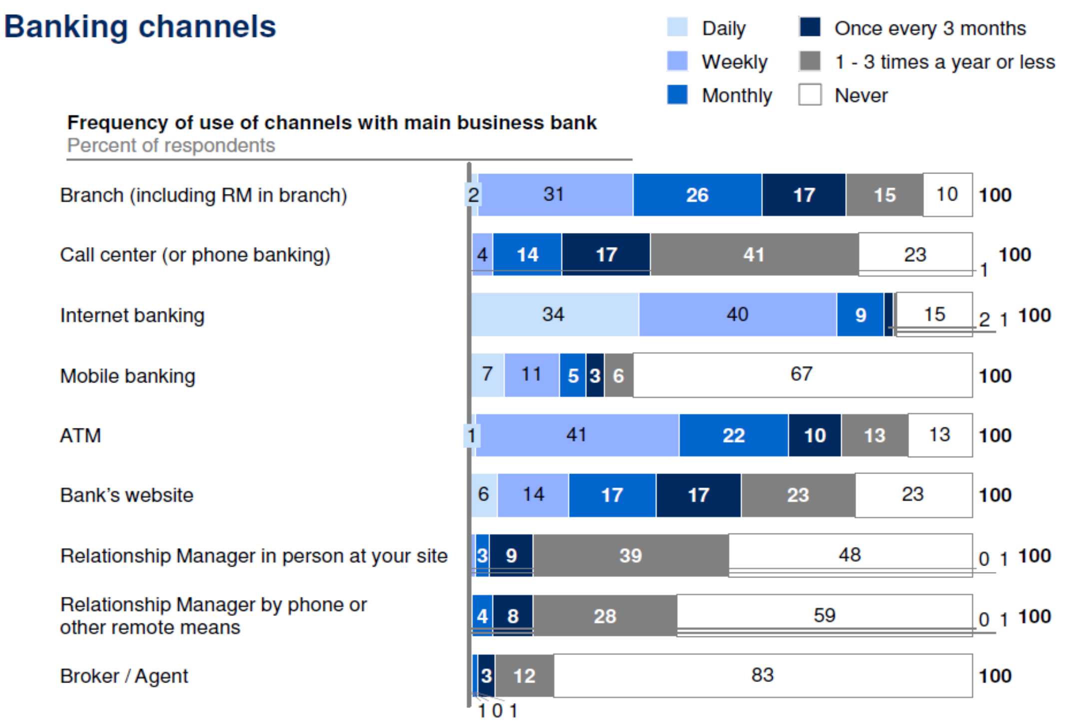
[50] Research Works SME qualitative research report.
[51] Which would also include business managers, business specialists and the RBS Connect team.

face-to-face basis. These relationship managers, RBSG told us, interacted with their customers to satisfy ‘more complex needs’ including borrowing requirements and introductions of experts in asset and invoice finance. RBSG’s larger SME customers with annual turnover between £2 million and £25 million were managed by relationship managers operating out of separate ‘commercial banking centres’. These did not have counter facilities, and engagement was by appointment only.

91. Similar to the trends observed in personal retail banking, digital channels are playing an increasingly important role in SME banking. RBSG told us that digital channels accounted for [✂]% of SME servicing activity and this was expected to grow to [✂]% by [✂]. Further, [✂]% of RBSG’s SME sales are delivered through online or telephone banking services. A separate Charterhouse customer survey undertaken for RBSG shows that [✂]% of its SME customers would value banking services through mobile.

92. A McKinsey survey of SMEs with less than £0.5 million turnover found that one-third of customers use a branch at least once a week whilst 74% use internet banking with the same frequency (see Figure 14).[52]

Figure 14: Banking channel usage by SMEs (less than £0.5 million turnover)



DC1: How often do you use the following banking channels to interact with your main Bank?

Source: McKinsey small business banking survey: UK.

[52] McKinsey small business banking survey: UK. (Submitted by LBG).

93. Handelsbanken told us that while demand for mobile technology from SMEs had increased, it had done so from a lower base and to a lesser extent than for personal customers. Handelsbanken noted that the demands it was seeing for application ('app') functionality was at present limited to basic balance and transaction information (without the need for payments functionality). It considered that there was continued and growing demand from SMEs for branch-based, local relationship banking across the UK and it would continue to open branches alongside investing in its internet and telephone banking offering for SMEs and developing mobile banking for SMEs.

Importance of branches to banks

94. Branches continue to fulfil a number of valuable functions for banks. Namely, branches enable banks to acquire new customers and (to a lesser extent) to retain existing customers. In addition, a high street presence helps build brand recognition and thus loyalty among customers.

Branches and market positioning

95. Figure 15 and Figure 17 depict a strong positive correlation between banks' market shares of PCAs and BCAs and the number of branches.[53] Banks that have a large branch network also tend to have a larger share of the PCA and BCA market. Barclays, RBSG, LBG and HSBC are the four largest banking groups by number of branches and by PCA and BCA market share. Barclays is the exception in that all of its retail branches service its SME customers as well as personal customers, which might explain Barclays' position in Figure 17 and Figure 18.

96. While there is a strong correlation between market shares and branch numbers at the national level (this is more marked for PCAs), local effects also exist; analysis undertaken by Deloitte for TSB shows that TSB outperforms in areas where it has a strong branch presence due to a 'network effect'.

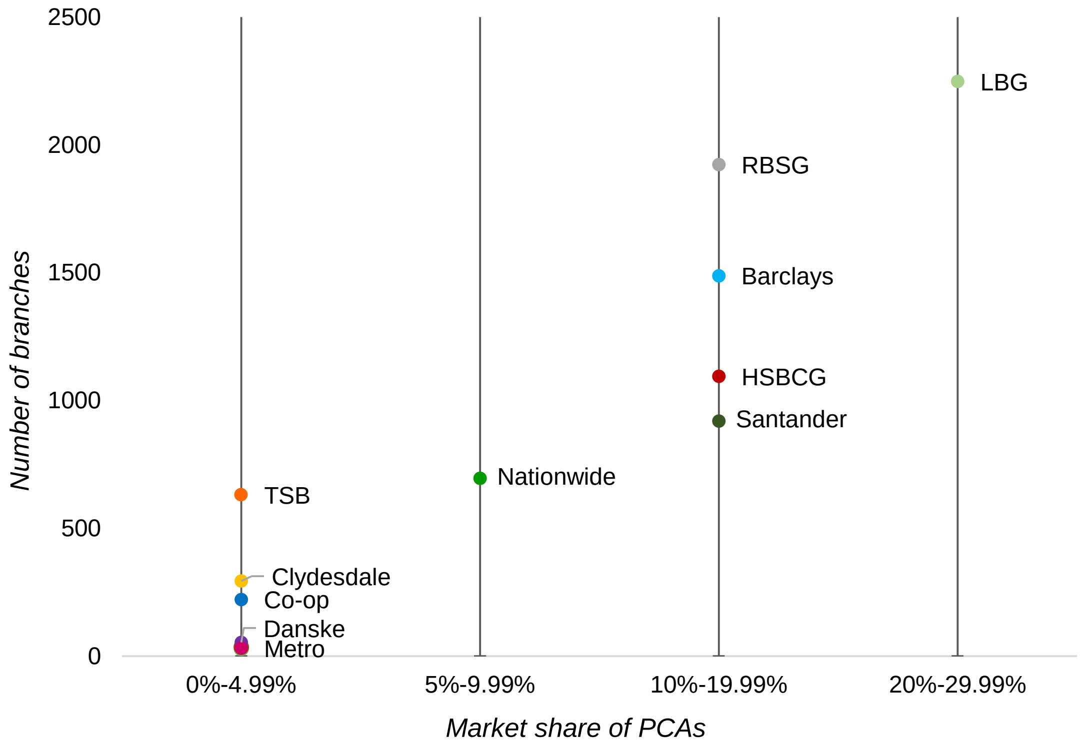
97. However, as Figure 16 and Figure 18 illustrate, the relationship between net account openings of PCAs and BCAs and branch numbers is less clear. Santander is a clear outlier in the PCA market (and to a lesser extent in the BCA market)[54] and Metro outperformed several banks with substantial branch

[53] Banks' individual market shares are considered to be confidential. Figure 15 to Figure 17 present market shares in ranges.
[54] This may be due to the success of its 123 current account that launched in 2012 and its high spend on advertising relative to other banks.

networks on net PCA openings despite having only 36[55] branches (all of which are located in London and the south-east).

98. While we observe these relationships, it is not possible to draw from them any conclusions with regard to causality. It is not necessarily a direct result of having a large branch network that some banks have a high market share. Those banks with the largest market shares are also those that have been present in the market longest and have therefore been able to build up larger customer bases. Given what we know about customers' behaviour in the PCA market, there is likely to be a 'first-mover' advantage to these banks.[56] Importantly though, the lack of relationship between net account openings and branches suggests that having a small branch network does not necessarily create an insurmountable barrier to customer acquisition (as Metro's experience illustrates).

Figure 15: Market share of PCAs and branch numbers by banking group 2014*



Source: CMA analysis.
*Number of branches excludes dedicated business centres.

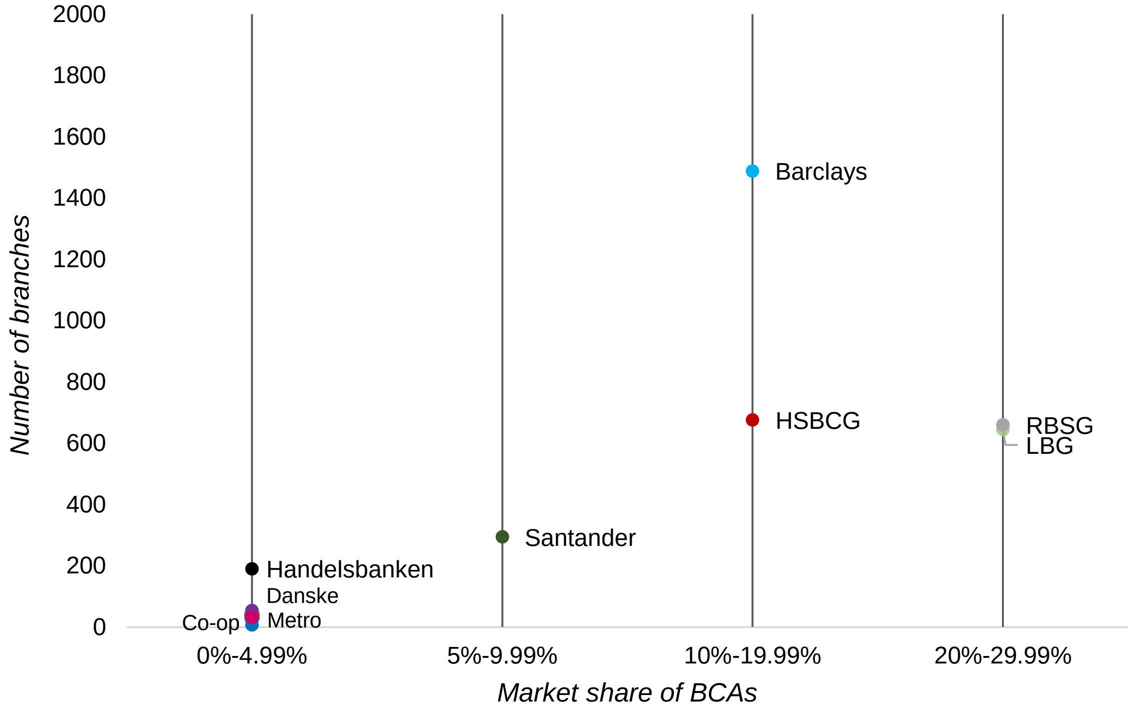
Figure 16: Net PCA openings and branch numbers by banking group 2014*

[✂]

Source: CMA analysis.
*[✂]

[55] As at September 2015.
[56] See Section 7 for more details.

Figure 17: Market share of BCAs and branch numbers by banking group 2014



Source: CMA analysis.
Note: Barclays considers that all of its branches offer some type of business services.

Figure 18: Net BCA openings and branch numbers by banking group 2014

[✂]

Source: CMA analysis.
[✂]

Customer acquisition

99. Some banks have told us that branches remain at the centre of their customer acquisition strategy.[57] This is supported by the data presented in Figure 19 below.

100. After day-to-day management of PCAs (which accounts for the majority of total branch visits by consumers),[58] branches of the banks in Figure 19 (with the exception of Nationwide) are most commonly used by personal banking customers to open a PCA.

BoI

[57] Metro and TSB.
[58] 89.4% of all branch visits on average. Average proportion of branch visits for day-to-day account management for Barclays, HSBCG, Nationwide, RBSG, Santander and TSB. Data on day-to-day account management was unavailable for LBG.

Figure 19: Proportion of branch visits to open a PCA, savings account, mortgage, and personal loan in 2014

[✂]

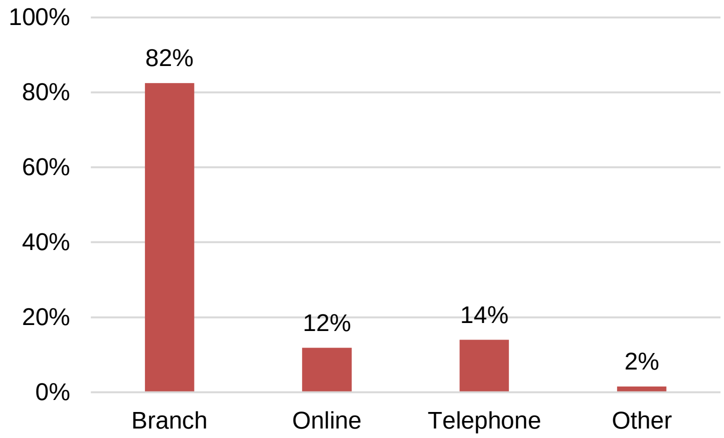
Source: CMA analysis.
Note: RBS did not submit figures for mortgage opening.

101. On average 78% of PCAs were opened in branch in 2014, down from 81% in 2013.[59] Nationwide, TSB and Halifax are leading in their customer acquisition via online channels.

102. The number of successful online applications is likely to continue to rise as banks invest in technology that enables online account opening (such as RBS's photo ID checker, an electronic document verification initiative). Barclays told us that technological advances in recent years had enabled significant enhancements in online account opening. Currently [✂] of Barclays' customers that start an online application successfully open a current account online; [✂].

103. Although we do not have comparative data on SME customer acquisition by channel, a survey of start-up SMEs undertaken by Charterhouse shows that on average 82% of start-ups open their BCA in branch (see Figure 20). This suggests that branches are important in the acquisition of SMEs, particularly for new businesses.

Figure 20: BCA openings by channel, SME start-ups*



Source: Charterhouse survey. Base: 252 SMEs.
*In response to the survey question 'What channels did you use to open your account?'

[59] Average calculated from data from Barclays, BoS, Clydesdale, Danske, Halifax, HSBC, Lloyds, Nationwide, RBS/NatWest, Santander and TSB.

104. For Metro, all of its personal customer relationships began in branch since it did not offer remote account opening,[60] and the majority of its customer acquisition, it believed, had been driven through expanding its branch network.[61] It also acquired new SME customers through its local business managers and local directors in its branches. Metro's branches were designed to be large open spaces in prime retail sites on busy high streets and retail parks to attract customers, and were open early and late seven days a week for customer convenience. It told us that by providing a great experience to existing customers and opening new stores, word of mouth drove in new customers.

105. TSB considered that the majority of its customers preferred to open a new PCA in branch. Although TSB told us that it had recently seen an increase in its customers' propensity to open PCAs online, and to a lesser but growing extent through mobile channels, it believed that a bank's ability to attract large volumes of PCA customers online was dependent on the presence of a high street network. This, TSB noted, raised confidence and brand awareness among prospective customers. Branches therefore remained important to TSB's customer acquisition strategy; its internal documents stated that over [✂]% of product sales took place in branches.

106. Danske [✂].

107. Handelsbanken also told us that branches were particularly important for the acquisition of SME customers. HSBC told us that it observed a fall in BCA openings following a wider business change initiative that included, among other things, a reduction in the number of business specialists available in its branches.

108. Some banks are recognising the need to invest in their online account opening service. [✂]

109. Similarly, LBG is investing in technology that will enable more customers to be successfully acquired through direct channels. LBG told us only half of its online applicants can open a PCA entirely on line. Of those that cannot successfully open an account, only one-fifth visit a branch, which is required to complete the application: the remainder 'drop out of the process'. LBG believed that by reducing or eliminating the number of customers that were unable to complete their application process online, it would successfully

[60] Metro offers online account opening for secondary accounts only. Online account opening accounted for 0.5% of successful PCA applications in 2013 and 3% in 2014.
[61] See Appendix 10.2.

acquire more customers through online channels and reduce further the need for branches.

Brand recognition

110. Related to customer acquisition, branches are often viewed by banks as being key to building and maintaining brand awareness and recognition. Branches are increasingly being developed into customer experience centres or showrooms. HSBC, for example, has plans to open high visibility concept stores, designed primarily to build a strong brand presence in key locations. [✂]

111. In its response to our IS, Santander told us that to create brand awareness in the PCA market as well as ensure it met its existing customers' needs for a local branch network, [✂].[62] Santander also noted that branchless models (either by banks or financial technology companies offering focused retail banking services) were relatively untested. With reference to its own Cahoot brand (which launched in June 2000 as the internet-based banking brand of Abbey National plc)[63] and other online-only PCA providers, Santander told us that providers had been unable to make significant inroads to the PCA market.

112. Consumer research undertaken by Optimisa for M&S Bank indicates that branches increase confidence in the M&S Bank brand as well as being an important factor in encouraging customers to open a PCA (identified as a pull factor). The research notes that M&S Bank branches make customers feel reassured and confident they made the right decision to switch to M&S Bank.

113. Finally, as stated in our Tesco case study,[64] while Tesco Bank accepts PCA applications (and processes other basic transactions) at only three of its stores, it leverages its large national store network primarily to raise awareness of its PCA among Tesco customers, to whom its products are primarily targeted.

114. Whilst providing a practical alternative to owning a large branch network for basic customer transactions, the apparent advantages of branches in building and maintaining brand awareness and recognition cannot be achieved through arrangements such as interbank agency agreements or through use of the Post Office network.

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[62] Santander response to IS.
[63] See the Cahoot website.
[64] See Appendix 10.2.

Retention

115. Branches may be used by banks to retain their existing customers. Deloitte's report on the future of branches notes that for traditional urban centres (one of the micro-markets it identified) in particular the challenge for banks is to not only attract new customers through their branches but also to build a long-term relationship through high-quality, tailored services.[65]

116. In April 2014, HSBCG undertook a survey of a sample of its business customers to understand their branch preferences. It found that if customers were unable to visit their preferred HSBC branch, retention levels would fall by [✂]% (to [✂]%) for businesses with annual turnover of less than £2 million and by [✂]% (to [✂]%) for businesses with annual turnover of between £2 million and £30 million. This was unaffected by distance to the next closest HSBC branch. When analysing alternatives to branches that maximise customer retention, HSBC found that services at the Post Office and self-service machines outside an HSBC branch are the most preferred alternatives (providing respective uplifts to retention of [✂]% and [✂]%).[66] Retention is also greatest when the cost of alternative services is lower and when distance to travel to branch is lower (less than 5 miles).

Payment systems

Background

117. To compete in the retail banking market, financial institutions require access to the payment systems infrastructure (see Figure 21). Payment systems enable the transfer of funds between people and institutions in the UK.[67] The main retail-oriented interbank payment systems that are a prerequisite to PCA and BCA provision are:

(a) **Bacs**: which offers a service handling electronic payment orders. It processes payments through two principal electronic payment schemes: Direct Debit and Bacs Direct Credit.[68]

(b) **C&CC** (cheque and credit clearing): which processes paper items such as cheques and credit vouchers[69] in England, Scotland and Wales. **NICC**

[65] Deloitte (2014), *Bricks and clicks – Mapping the future of branches*.
[66] This analysis includes corporate customers with annual turnover in excess of £30 million.
[67] FCA (2014), *The PSR and UK payments industry*.
[68] ibid.
[69] *Payment systems in the United Kingdom*.

(Northern Ireland cheque clearing) is the interbank payment system in NI that processes cheques and other paper instruments.[70]

(c) **CHAPS**: which is the UK's real-time, high-value sterling interbank payment system where payments are settled over the BoE's real-time gross settlement system. It provides continuous (real-time) settlement of funds transfers individually on an order-by-order basis.

(d) **FPS**: through which virtually all internet and telephone banking payments (as well as other services such as Paym)[71] in the UK are now processed. It provides near real-time payments as well as SOs.

(e) **LINK** network: which enables the banks' customers to access their accounts from any participating institution's ATMs.

118. Banks and building societies will usually also need access to the core UK card systems, Visa and MasterCard, for card issuance.

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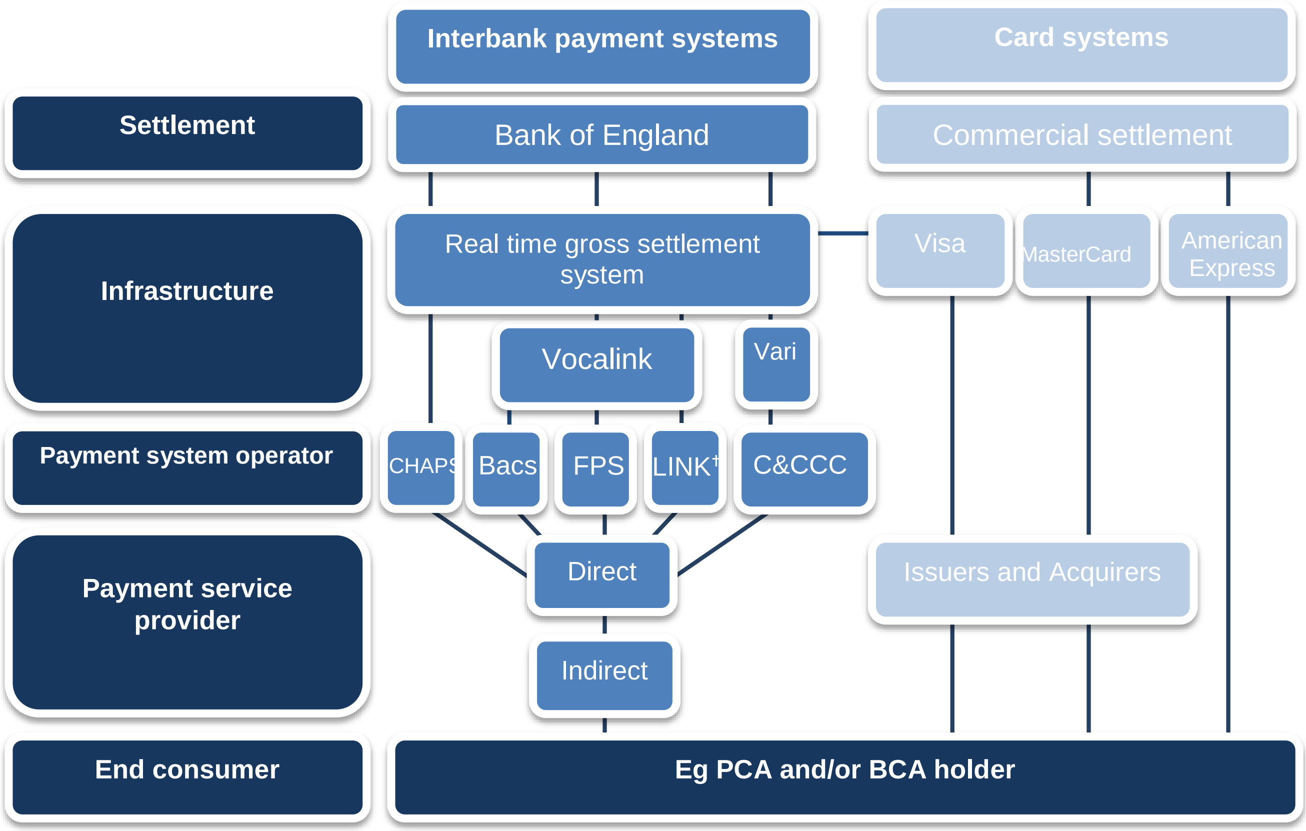
[70] No issues have been raised with us by parties in relation to NICC, and we note that NICC is not within the scope of the PSR's market review into the supply of indirect access to payment systems or its market review into the ownership and competitiveness of infrastructure provision.

[71] Paym enables customers to make person-to-person payments using the recipient's mobile phone number.

The structure of payment systems

Figure 21: Stylized view UK payment systems



Source: CMA analysis.
†LINK does not have indirect PSPs.

119. These clearing systems (with the exception of LINK and UK card operators) currently operate a two-tier access structure with 'direct' settlement members and 'indirect' participants. Direct members own an interest in the company (eg CHAPS, Bacs) that manages and operates the payment system and may nominate a director to sit on the operator's board.[72] The PSR defines a PSP with indirect access as one that has a contractual agreement with a PSP to enable it to provide services to individuals or businesses who are not participants in the system, for the purpose of enabling the transfer of funds using that payment system.[73,74] Indirect PSPs are not entitled to nominate

[72] See FCA (2014), *The PSR and UK payments industry*, p13. It is possible that a board member of one operator also sits on the board of another operator. According to the PSR, this is not likely to happen in practice where individuals have expertise in different payment systems. Also see FCA, *A new regulatory framework for payment systems in the UK*, p31.The PSR is introducing a direction that interbank operators (except NICC) must take all reasonable steps to ensure that individuals may not simultaneously be a director of an interbank operator and a central infrastructure provider to that payment system.
[73] *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1.
[74] Indirect participant and agency banks are used interchangeably in this appendix to refer to a bank or building society that accesses payment systems via another bank (its 'sponsor') but it should be noted that, whilst agency banks have the use of their sponsor's unique sort codes, not all indirect PSPs do.

directors and therefore do not have the same opportunity to influence board-level decision making for payment systems. For example, TSB notes that, by the nature of agency bank arrangements, indirect PSPs have less influence over the strategic direction of these systems.[75]

Table 9: Number of current direct participants of payment systems

System	*Current direct PSPs*
Bacs	16
C&CC	11
NICC	4
CHAPS	21
FPS	10
LINK	37

Source: Websites of individual payment schemes.

Direct access

120. Scheme operators have established a range of access requirements that PSPs must meet to be eligible for direct access:[76]

(a) PSPs must hold a settlement account at the BoE to gain direct access to Bacs, CHAPS, C&CC and FPS. Under the BoE's current policy, banks and building societies[77] are eligible for settlement accounts but e-money institutions and payment institutions are not.[78]

(b) A range of technical requirements exist that require the commitment of significant time and resources to adhere to.[79]

121. Other requirements, such as legal, regulatory and risk management requirements, present an additional cost to prospective direct PSPs.[80]As a result of the above access requirements, there is a cost and resource implication of becoming a direct access user. There is an initial cost that PSPs incur to establish direct access, as well as ongoing fees that operators charge to recover the system's costs.[81] The PSR estimates the set-up cost associated with becoming a direct member to be in the region of [✂] (though

[75] See Appendix 10.2.
[76] *Access to payment systems*, CP14/1.4.
[77] Defined as a deposit-taking institution that is required to report its eligible liabilities. See Bank of England Act 1998, Schedule II, paragraph 1.
[78] *Bank of England Settlement Accounts*, p9.
[79] *Access to payment systems*, CP14/1.4, p16.
[80] *Access to payment systems*, CP14/1.4, p16.
[81] *Access to payment systems*, CP14/1.4, p13.

this varies between providers and will not be mutually exclusive of IT expenditures).

122. Direct members of the interbank payment system tend to be larger organisations than indirect members (measured by total business revenue) and they tend to process more inbound and outbound transactions (in terms of volumes and values).[82] This could imply that direct membership is only practical or feasible for credit institutions that process large transaction volumes.

Table 10: Direct membership of payment systems by bank

Bank	*Bacs*	*C&CC*	*CHAPS*	*FPS*	*LINK*
Barclays*	✓	✓	✓	✓	✓
HSBCG*	✓	✓	✓	✓	✓
LBG*	✓	✓	✓	✓	✓
RBSG*	✓	✓	✓	✓	✓
Santander	✓	✓	✓	✓	✓
Co-op	✓	✓	✓	✓	✓
Clydesdale	✓	✓	✓	✓	✓
Nationwide	✓	✓		✓	✓
Virgin Money	✓				✓
Danske†	✓		✓	✓	✓
AIB	✓				✓
Metro					✓
TSB					✓
Handelsbanken			✓		

Source: Payment systems' websites.
*Currently offers sponsor bank services.
†Danske is not a direct member of C&CC. It is a member of Belfast Bankers' Clearing Company, which in turn is a member of C&CC.
Note: Building societies, with the exception of Nationwide, are indirect participants of payment systems.

123. As a consequence of the cost and time involved in attaining and maintaining direct member status, most new banks opt to access payment systems indirectly via an indirect access provider. Metro told us that the timeline to join different payment schemes varied by scheme and was usually between six and 18 months. Further, Atom told us that the need to run a banking licence application and engagement with payment schemes in sequence could be considered a barrier to entry.

The PSR's work on direct access

124. The PSR's access directions, which came into effect on 30 June 2015, require scheme operators to ensure fair, open and risk-based criteria for access.[83] Operators are also required to publish their access requirements and on an annual basis report to the PSR on progress and changes. The access

82 [✂]
83 PSR update on access, August 2015.

obligations are meant to ensure that operators' access requirements do not 'unnecessarily or disproportionately restrict direct participation in payment systems and do not act as a barrier to entry and expansion for new and emerging PSPs'.[84] The PSR will keep the market under review and if it is of the view that access to a regulated payment system could be improved according to the PSR's statutory objectives, then it can require changes to be made.

125. The PSR told us that operators had also taken steps to make the process less onerous and more proportionate for providers seeking to become a direct member of payment systems.[85] This had obvious implications for the timing and the on-boarding process associated with becoming a direct member.

Indirect access

126. Four banks with direct access to payment systems currently provide the vast majority of sponsoring services to indirect PSPs in the UK. Barclays, HSBCG, LBG and RBSG facilitate access to the four main payment systems (Bacs, CHAPS, C&CC and FPS) for indirect participants.[86] Some sponsor arrangements will also include access to counter services and/or bank branches.

127. The majority of indirect PSPs have just one sponsor bank, but some have an agency agreement with more than one sponsor (for example, [✂] accesses some payment systems via [two sponsor banks] [✂]). This is most likely to ensure security of supply or to meet different business needs.

Figure 22: [✂] Sponsor bank relationships in the UK

[✂]

Source: CMA analysis.

128. Aspects of indirect access arrangements have been raised with us by parties as a barrier to entry and expansion in retail banking. These fall broadly into four categories:

(a) Quality of service provision.

(b) Fee arrangements between sponsor banks and indirect participants.

[84] See PSR PS 15/1: A new regulatory framework for payment systems in the UK, p4.
[85] PSR Hearing Summary.
[86] *Access to payment systems*, CP14/1.4, p11.

(c) Information provision by sponsor banks to enable comparison by (potential) indirect PSPs.

(d) Reliance by indirect participants on downstream competitors.

The evidence we have gathered in regard to each issue is set out in more detail in the following sections.

Quality of service provision

129. A number of banks[87] that access payment systems indirectly told us that the quality of service they could offer their customers was constrained by the quality of service (in terms of speed, reliability and security of supply) that their sponsor bank provided, thus limiting their ability to effectively compete and innovate. Secure Trust told us in response to our UIS that the service level agreements it had with its clearing bank were not fit for purpose.[88] We have also received evidence that the quality of service provided by sponsor banks can have an impact on the ability of indirect PSPs to participate in certain service offerings. These issues appear to be more pertinent for indirect PSPs that also have indirect technical access (see below) and arise mainly in the context of faster payments.

130. Technical access to payment systems is required for PSPs to send and receive payment messages that enable the processing of fund transfers.[89] Indirect PSPs can gain technical access to payment systems either through their sponsor bank's infrastructure (indirect technical access, as represented by (i) in Figure 23) or by connecting directly into the payment system's central infrastructure (direct technical access, as represented by (ii) in Figure 23).[90,91] According to the PSR, only one indirect PSP has direct technical access arrangements for FPS;[92] indirect technical access may be less costly to obtain.

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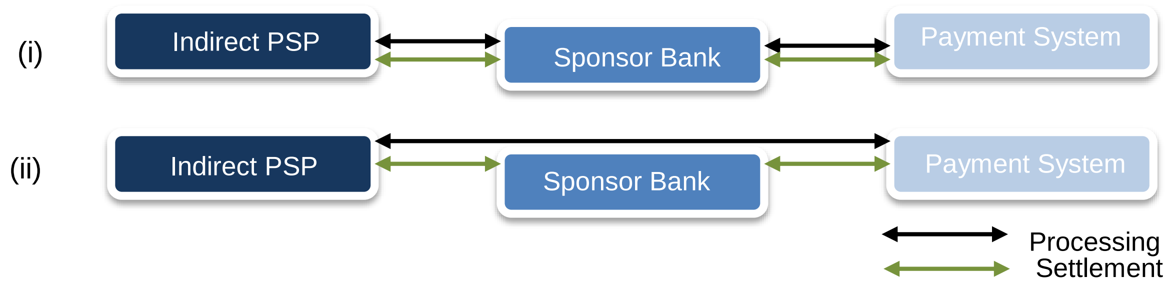
[87] For example [✄], Tesco Bank, Metro and Secure Trust.
[88] Secure Trust response to UIS.
[89] *Access to payment systems*, CP14/1.4.
[90] Direct technical access, which is less common because of the associated costs, enables direct technical connectivity between the indirect PSP and the payment system for the processing of payments, but it still requires the use of a sponsor bank for the provision of settlement services.
[91] *Access to payment systems*, CP14/1.4.
[92] *Access to payment systems,* CP14/1.4.

Figure 23: Technical access channels for indirect PSPs



Source: PSR, *Access to payment systems*, CP14/1.4, p47.

131. [✂] told us that it had inferior access to faster payments compared with its sponsor bank. It told us that, whilst direct PSPs had 24/7 access to faster payments, its current arrangement entitled it to a service limited to between approximately 9am and 5pm Monday to Friday. In addition, [✂] customers had experienced delays in payments (including employees' salaries and expenses) as a result of inefficient processing or errors made by its sponsor bank.

132. Tesco Bank also accesses FPS via a sponsor arrangement with [✂]. It told us that [✂] transmitted payments via SWIFT and, because SWIFT gateways were closed for maintenance between 4pm Saturday and 6am Sunday each week, FPS could not be accessed during this time.[93] This had prevented Tesco Bank from offering Paym services (which required near real-time payment capability). First Trust Bank told us that it, too, had been prevented in the past from offering Paym because of the functionality constraints of its sponsor bank for faster payment transfers. However, First Trust Bank's sponsor bank had informed it that, with effect from June 2015, it would offer the functionality required for it to provide Paym services to its customers. It would be a commercial decision as to whether or not it subscribed to the enhanced functionality.

133. A KPMG report commissioned by the PSR notes that challenges are common with posting and reconciliation of customer accounts 24/7, as in the case of faster payments.[94] When SWIFT is used by sponsor banks to exchange messages between themselves and the agency bank, SWIFT scheduled downtime disrupts faster payments availability. Given that alternative messaging options are available, one might expect to see indirect PSPs switching sponsor banks in order to offer services that rely on near real-time settlement. However, as KPMG's report notes, this can be disruptive for

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[93] See Appendix 10.2.
[94] *UK Payments Infrastructure: Exploring Opportunities*.

agency banks and their customers because of the requirement to reallocate sort codes.[95]

134. Metro has Direct Corporate Access to faster payments that is provided by [✄]. This is a form of direct technical access whereby bulk payment files from the corporate (Metro) are submitted directly to FPS.[96] Metro told us that it had experienced outages of its faster payment functionality as a result of outages to the Direct Corporate Access system.[97] Metro noted that this affected only indirect PSPs accessing FPS via this arrangement, and not direct members. These outages had an impact on all of its customers who attempted to make transactions online, via the mobile application and/or via the contact centre. Its customers awaiting funds were also affected by outages, as were any beneficiaries of payments made from Metro accounts.

135. Agency banks may also rely on their sponsor banks to notify them in the case of scheme outages. Tesco Bank told us that this put them at a disadvantage compared with direct PSPs and sponsor banks, which were able to receive and react to information regarding outages in a timelier manner. It gave us an example of an outage to FPS in 2014. The notification to FPS members was supported by real-time unsolicited messages that had not been passed on to Tesco Bank by its sponsor bank. It told us that, because the outage had occurred outside normal office hours, it had not been notified until the following day, which had been too late to alert its customers to prevent customer detriment.

The PSR's work on the quality of indirect services

136. Three areas of the PSR's work will look to address concerns around the quality of service provision. First, the PSR is supporting the development of technical access by industry which is meant to enable bank and non-bank indirect PSPs to gain improved technical access to payment systems.[98] In particular, FPS has set out its proposals for extending direct technical access via a technical aggregator that combines demand from multiple PSPs.[99] The PSR believes that the progress made by industry to date is encouraging and, although it will continue to engage with industry participants, it does not deem

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[95] *UK Payments Infrastructure: Exploring Opportunities*.
[96] FPS and Direct Corporate Access.
[97] [✄]
[98] *Access to payment systems*, CP14/1.4.
[99] See FPS press release and FPS report on New Access Model.

it appropriate or proportionate to be more prescriptive on the development of technical access solutions at this time.[100]

137. Second, the PSR's market review into the supply of indirect access to payment systems will look to assess outcomes experienced by indirect PSPs.[101] This will include determining whether the prevailing quality of services (and prices) is consistent with a competitive market.

138. Third, the PSR expects that the industry code of conduct,[102] which was published in August 2015 following approval from the PSR, will help to address certain concerns regarding security of supply, contractual arrangements and the communication of information (such as information on outages).

Fee arrangements between sponsor banks and indirect participants

139. As discussed earlier, there is a cost implication in acquiring and maintaining direct membership of payment systems. Direct PSPs incur fees and charges that are paid to scheme operators and infrastructure providers to recover the costs of running the interbank payment systems.[103] Interbank payment systems are run as not-for-profit entities and scheme operators set charges to only recover costs.[104] The costs involved in running the payment systems include the scheme operators' infrastructure and staff and administration costs. These are usually apportioned on a tiered basis according to the volume of transactions processed by each direct member.

140. Sponsor banks charge the indirect PSPs to which they provide access to payment systems.[105] The fees and charges that indirect PSPs pay to their sponsor bank are levied on transactions. For example, indirect PSPs are charged fees on inbound and outbound payments for FPS and Bacs services, and cheque-clearing fees for C&CC services. There may also be fixed fees or fees for other ad hoc services. Tesco Bank told us that it also paid connectivity charges for each payment system it accessed, and the costs of changes made to those systems.

141. The per-transaction fee, which indirect PSPs focused on when speaking to us, is dependent upon the volume of transactions processed by the agency bank.

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[100] PSR, *A new regulatory framework for payment systems in the UK*.
[101] *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1.
[102] Code of Conduct for Indirect Access Providers, Version 1.0.
[103] *Access to payment systems*, CP14/1.4, p13.
[104] FCA (2014), *Ownership, governance and control of payment systems, CP14/1.3*, p11.
[105] This is the case for indirect PSPs that have indirect technical access through an arrangement with a sponsor bank. They will have a single contractual agreement with their sponsor bank. Indirect PSPs, which have direct technical connectivity, have at least two contractual relationships: (1) with the infrastructure provider/third-party provider for technical access, and (2) with the sponsor bank for settlement and other support services.

This means entrants that do not have the scale advantages of larger banks are charged a higher price for access. [✂]

142. Metro and Tesco Bank told us that they believed they were charged significantly for indirect access to payment systems, and that this was reflected in a mark-up on the transaction fee that the sponsor bank paid to the scheme operators. For example, Metro understood that direct members of FPS were charged a fee of £[✂] per transaction, [✂] of what Metro had told us it was paying to [✂]. Tesco Bank told us that it paid [✂] for each outgoing faster payment vis-à-vis the £[✂] that it understood direct members of FPS were charged.

143. Secure Trust told us in response to our UIS that it had no negotiation power and its clearing bank had repeatedly refused to engage with it to negotiate the charges it levied. It said that charges in addition to the per-transaction levy were penal.

144. Handelsbanken told us that its discussions with CHAPS about becoming a direct member confirmed that the tariffs charged by sponsor banks for access to those schemes acted as a barrier to entry, making direct membership a far more cost-effective option.

145. However, we are aware that it is not only the marginal cost of transactions the clearing bank fee that direct members of payment systems have to recover. As described earlier, there are a number of fixed costs involved in being a direct member that indirect PSPs are not explicitly charged by the scheme operator or their sponsor bank. The PSR will be assessing the price of access as part of its indirect access market review.[106]

Information provision by sponsor banks

146. Information about fee structures and service provision in the payment systems industry is complex and opaque according to some parties we have spoken with. This applies to the information that is provided to both prospective indirect and direct PSPs.[107] Atom told us that there was a lack of consistency in information provision across schemes, both with regard to the type of information available and its presentation. In Atom's case, it was necessary to 'tease [information] out' of the sponsor banks. Atom believed that new entrants were not likely to be well informed and therefore might not ask the

[106] *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1.
[107] We have only heard from indirect PSPs about this particular issue – namely Atom – but the PSR notes in its consultation document, *Access to payment systems*, CP14/1.4., that this is an issue for direct PSPs.

right questions. This asymmetry of information could reduce the power of prospective PSPs to compare offerings and to negotiate terms and prices.

147. TSB noted that a criticism of payment systems with regard to new entrants had been the lack of transparency in agency bank charging arrangements. TSB told us that it was unable to judge accurately whether the fees it paid to [✄] to access payment systems represented good value in comparison to those of other banks. However, Tesco Bank, which migrated from [✄] for its access payment systems, told us that prices were relatively easy to compare.

148. Tariff cards, which detail the cost of access (fees) and services available to indirect access users, are obtained once negotiations between the prospective indirect PSP and sponsor bank are underway. Examples of tariff cards were collected during the OFT's phase 1 market study; these are long and complex documents and not easily comparable across banks.

149. Finally, the lack of transparency and comparability of information provided by sponsor banks on prices and service offerings also potentially creates a barrier to indirect members switching sponsor banks. Switching sponsor banks is often perceived to be complex, time consuming and costly.

The PSR's work on information provision

150. In addition to its access rule, the PSR has introduced a direction requiring the four primary sponsor banks to publish access-related information for prospective indirect PSPs.[108] The PSR believes this will enhance transparency and improve PSPs' ability to make informed choices about their sponsor services. The direction came into effect on 30 June 2015. The Building Societies Association noted in its response to the PSR's consultation that the direction was a positive step towards increasing the competitive pressures on sponsor banks and strengthening the bargaining position of indirect PSPs.[109]

151. The PSR, as part of its review into indirect access to payment systems will be looking at the choice indirect PSPs face when trying to secure access to payment systems and any barriers to entry and expansion which may be preventing more PSPs from providing indirect access.[110] The review will

[108] PSR specific direction on access.
[109] Building Societies Association response to PSR, CP14-1: *A new regulatory framework for payment systems in the UK* (provided to the CMA by the Building Societies Association).
[110] *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1, p8.

include considering the initial and ongoing elements involved in becoming a sponsor bank.[111]

152. The PSR also expects that the industry code of conduct will help to address concerns around the communication of information. This will be kept under review and, subject to its findings, the PSR will consider whether it is appropriate to broaden the coverage of the direction and the code of conduct to include additional providers of indirect access.

Finally, the PSR also supports the launch of the Information Hub, a website developed by industry to improve the disclosure and transparency of information for PSPs wishing to access payment systems.[112] Direct reliance by indirect members on downstream competitors

153. Banks that access payment systems via an agency agreement are directly reliant upon their sponsor bank, with which they compete in the downstream (retail) market for this service. Certain aspects of this vertical relationship could disadvantage indirect PSPs and weaken their competitive position relative to their sponsor bank.

Information sharing between indirect PSPs and indirect access providers

154. Before they can provide the indirect PSP with access to payment systems, sponsor banks must ensure that they have the capacity and capability to provide these services. In order to do so, sponsor banks may obtain potentially commercially sensitive information about the agency bank's business strategy and projected sales volumes and values.

155. Currently, there is no legal framework or incentive structure governing the handling of that information. The PSR's policy statement notes that the purpose of the code of conduct is to address concerns about the supply of indirect access provided by sponsor banks.[113] This includes concerns around the sharing of commercially sensitive information with sponsor banks that are also downstream competitors.

156. Although one PSP noted its concern around the sharing of potentially commercially sensitive information with its sponsor bank in response to the PSR's consultation,[114] we do not have evidence from indirect PSPs to suggest that the requirement to share information with their downstream competitors

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[111] *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1, p8.
[112] Access to Payment Systems website.
[113] PSR, *A new regulatory framework for payment systems in the UK*. .
[114] *Access to payment systems*, CP14/1.4*,* p40.

has had any implications for competition in the retail banking market. This was not commented on in parties' responses to our working paper *Barriers to entry: capital requirements, IT and payment systems*.

157. Once an indirect PSP has secured access to payment systems, information sharing should be limited. Metro told us that transactions were delivered through a straight-through process via secure messaging links, and that it had not encountered any issues with information sharing at any stage of the commercial relationship.

Reduced incentives to compete

158. The nature of the vertical relationship between sponsor and agency banks may limit or reduce incentives for the sponsor bank to improve the services it provides to indirect PSPs. It may also give sponsor banks an incentive to charge a higher price of access to their competitors.

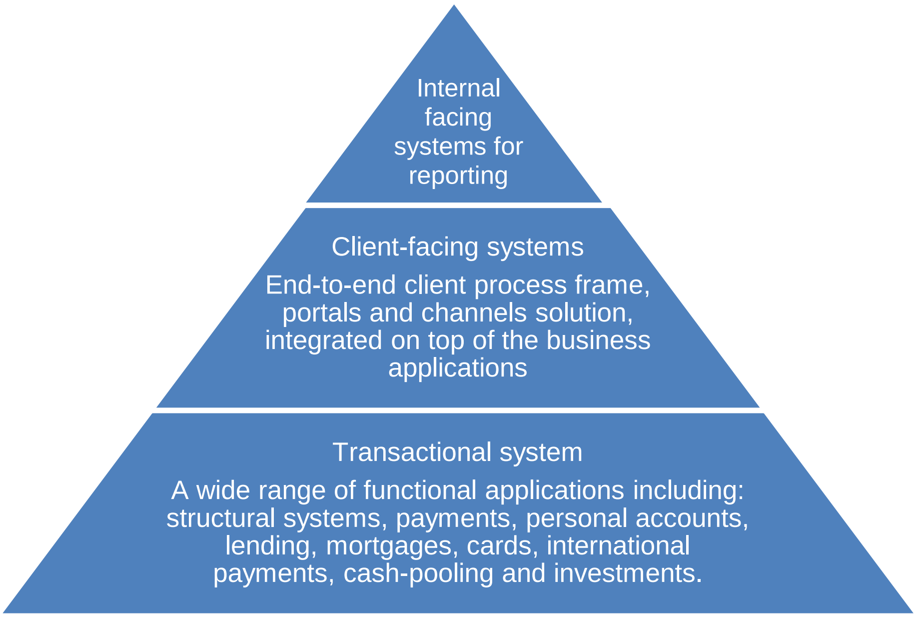
159. Metro commented in its case study submission on the reliance of indirect PSPs on their competitors to access payment systems; it believed that the evidence pointed to the fact that payment systems must be independent of banks. Handelsbanken told us that the main driver in its decision to become a direct member of CHAPS in 2013 was a desire to gain independence from third parties (sponsor banks). Handelsbanken was also currently seeking direct access to LINK.[115]

IT systems and infrastructure

160. PCA provision and the provision of retail banking services to SMEs require the setting up and maintaining of complex IT systems (see Figure 24). This presents a sunk cost of entry that has historically been significant: HSBCG told us that IT systems had traditionally accounted for around two-thirds of the cost of market entry in retail banking.

[115] A process that Handelsbanken noted had been problem free.

Figure 24: Structure of IT systems in retail banking



Source: Based on Santander's depiction of a high-level and basic overview of its IT systems.

161. [✂] Tesco Bank's experience: the IT costs associated with its PCA launch in 2014 accounted for [✂]% of the total investment to implement that programme.[116]

162. However, the advent of off-the-shelf core banking platforms and outsourced solutions that can be accessed on a pay-as-you-grow basis[117] means that cheaper solutions are now more readily available for new banks seeking to enter the market. In addition to the cost advantages, new IT systems are designed to be more flexible and to facilitate the addition of new functionality.[118]

163. Virgin Money told us that it expected the upfront entry costs of IT to continue to fall further as new technology providers made it possible for banks to establish IT capabilities without having to build their own IT infrastructure. HSBCG believed that the development of 'off-the-shelf' IT solutions had virtually eliminated IT as a fixed cost of entry.

164. The example of Atom provides evidence of falling IT costs; it estimates that IT costs will account for around [✂] of its first year's operating costs. Atom believed that technology had been a 'game changer' for firms entering the retail banking market.

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[116] See Appendix 10.2.
[117] A charging structure based on the number of transactions processed.
[118] ACI industry guide, *Replacing legacy payment systems.*

165. The evidence we have collected shows that firms' experiences as regards the cost of IT associated with their entry or expansion in retail banking vary widely. Some banks have incurred or been faced with very high costs of building, and possibly integrating, IT systems required to support the provision of PCAs (eg Tesco Bank) and SME banking products (eg Nationwide, for whom the costs, relative to other options to invest in its retail infrastructure, were a key reason for not entering the market). Others have faced much lower costs (eg Metro, Atom), particularly when outsourced solutions were adopted and integration was not required. These differences between IT costs appear to be explicable in terms of:

(a) when the initial IT investment was made; and

(b) the complexity of the project (for example, the extent to which it entailed integrating a new platform with legacy systems and/or migrating customers across to a new platform, as well as the nature of the products to be supported).

Timing of initial IT investment

166. Metro, which entered in 2010, selected from six potential suppliers an 'out-of-the-box' core banking platform solution from Temenos.[119] Metro chose to employ Temenos's pre-configured 'T24 Model Bank' solution given the high level of fit with its own business model.

167. According to a report by Temenos, a key requirement for Metro was that the core banking platform underpinning its operations be supplied on an outsourced basis to minimise the size of the initial capital outlay.[120] The T24 application is hosted for Metro by a third party, niu Solutions,[121] and accessed via the internet. Metro also has a services contract with niu Solutions to provide it with virtually all the functionality it requires outside the T24 platform.[122] Metro pays a fixed monthly rental to niu Solutions and has an account-based pricing agreement with Temenos, which means that it pays for what it uses each month. Temenos notes that this arrangement enables Metro to better control its cash flows.[123]

[119] See Appendix 10.2.
[120] Temenos's Metro case study.
[121] niu Solutions Holdings Limited.
[122] Temenos's Metro case study.
[123] Temenos's Metro case study.

168. Metro told us that choosing the pre-configured 'model bank' solution enabled it to deploy the application in a relatively shorter time and to operate as a full service retail bank from the first day of operation. [✂]

169. According to its website, Temenos's T24 solution has been developed using a service-oriented architecture that is modular, so that banks can deploy and integrate the required functionality alongside the needs of their business.[124] Metro supported this and explained that it had customised (and continued to customise) its core banking platform by purchasing new applications and licences that were horizontally integrated into the T24 platform. These were, whenever possible, SaaS solutions (where a vendor hosts an application on behalf of a customer and provides access through the internet). SaaS solutions had become one of the fastest growing segments of the IT industry.[125] They also circumvented the need for firms to periodically update their systems: repair, maintenance and system updates could be run centrally to the benefit of all users of the applications.

170. CivilisedBank, which expects to launch in Q1 2016, will follow a similar approach to that taken by Metro. It plans to use a 'bank-in-a-box' solution to be supplied by Profile (a Greek technology company). CivilisedBank told us that such a system allowed for substantial scalability. The core banking platform, which would be hosted in a private cloud environment, [✂].

171. Atom has acquired an outsourced IT solution from FIS.[126] Atom told us that it wanted to enter the retail banking market with systems that were brand new, without the constraints of technology legacy and the associated costs of running legacy systems. Atom noted that the SaaS solutions now available avoided the need for significant upfront investment and meant initial small scale was of no disadvantage.

172. Although Atom experienced some difficulties in acquiring an appropriate IT system – in particular, the due diligence involved – it told us that once an IT partner had been chosen the process was fairly straightforward. [✂]

173. Based on its anticipated SaaS contract, Atom has projected total IT costs for year 1 of £[✂] (equivalent to [✂]% of its total operating costs in that year).[127] These are forecast to grow to around [✂]% of operating costs in its fifth year of operation as projected transaction volumes rise.

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124 Temenos T24 Core Banking.
125 Software as a Service (Saas) is a software licencing and delivery model in which software is licenced on a subscription basis.
126 FIS UK.
127 £[✂] spend consists of £[✂] allocation to SaaS and £[✂] for 'other IT costs'.

Complexity of the project

174. The evidence we have gathered from market participants suggests that some financial products (eg current accounts) are more expensive to support than others (eg SME lending products), and that the need to integrate new systems with existing ones can complicate (and delay) entry and increase costs substantially. Each of these is considered in turn below.

Product type

175. The information we have collected from parties and through speaking with technology providers suggests that the costs associated with developing/accessing and maintaining appropriate IT systems are likely to be lower for a specialist provider (eg one that only offers SME lending products) than for a firm that offers a broad suite of products including current accounts.

176. Fiserv, a global provider of IT solutions for the financial industry, told us that it would be possible to support a monoline business using a modified pre-paid debit card platform for an upfront investment of less than £1 million whilst the costs associated with building a core banking system that supported full service provision had for recent entrants ranged from tens to hundreds of millions.

177. In its response to the CMA's UIS, TSB notes that it considers that IT costs create a considerable barrier to entry for challengers who aim to provide a full-service multi-channel offering.[128] In TSB's experience, no one IT provider is able to provide a comprehensive IT solution with all the functionality that would be required by a full-service multi-channel bank. Arguably, however, Metro's experience (described earlier) suggests that this is not a barrier for all firms.

178. Tesco Bank told us that the transactional nature of current accounts meant that the required processing speeds for a number of different payment types were greater than those required for lending and savings products. Tesco Bank's card transaction processing required uplifting to process 30 times more transactions than before launching its PCA whilst the system that processed Bacs payments needed to be 70 times faster.

179. Co-op told us that the outlay associated with IT costs in the provision of PCA services remained considerable. [✂]

[128] TSB response to UIS.

180. Nationwide recently considered launching a BCA for SME customers (see our Nationwide case study for more information).[129] Nationwide found IT costs to be sufficiently high, relative to other options to invest in its retail infrastructure, to be a key reason for not entering the market. It estimated that the IT spend required to launch a BCA would amount to around £[✂]. It also anticipated the project would require significant technology management resource and expertise, which would further increase its costs of expansion into the provision of BCAs.

Integration of legacy systems

181. Some banks[130] suggested that the IT systems owned by larger banks were increasingly being viewed as a disadvantage compared with the relatively low-cost solutions available to potential entrants. Whilst older systems were deployed to manage bulk and batch-based processes, there was, according to a report by ACI, little room for scalability or agility in older systems that were not designed for flexibility or real-time processing.[131]

182. Barclays told us that it considered that new entrants were often able to adapt more nimbly to technological innovations than Barclays, which incurred costs associated with integrating new technology with its existing legacy infrastructure. These costs included, for example, ensuring compatibility with its legacy systems and conducting scale tests to ensure that any new system was able to cope with the number of transactions Barclays would need to process and that the systems were robust enough to withstand this volume.

183. Replacing IT systems is costly, resource intensive and disruptive (to business and its customers). As a result, larger (established) banks tend to operate a hybrid of old and new systems: locally customising existing systems and integrating 'add-ons'. Only Santander has migrated onto a new platform: moving the systems used by the businesses it acquired in the UK onto a Partenon and Alhambra platform. Santander told us that this approach was preferred to ensure it could customise and develop as needed to create innovative payment tools.

184. A report by Deutsche Bank[132] predicts a material increase in IT spend by large banks over the next ten years. It notes that core systems are generally old and rely on too many applications patched too many times to cope with rising transaction volumes, regulatory change and digital channel changes.

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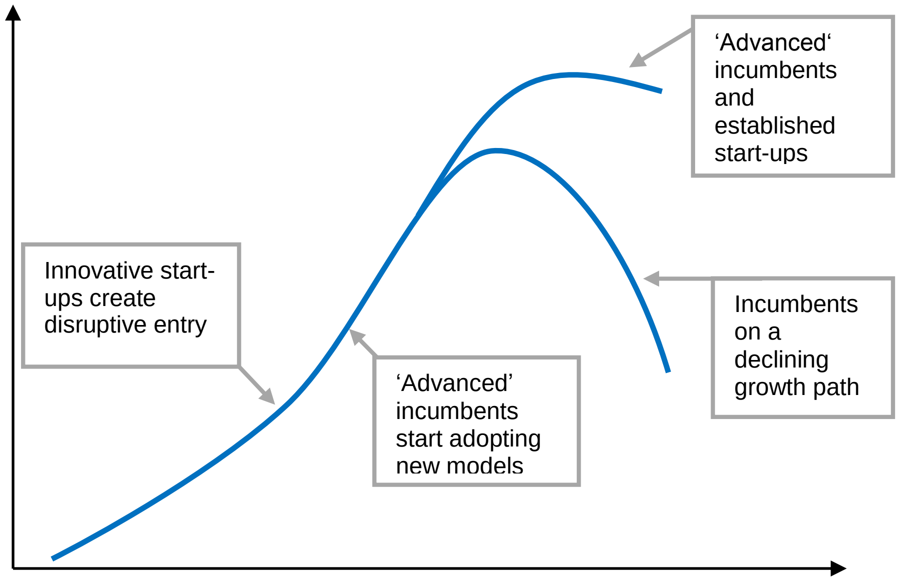
[129] See also Appendix 10.2.
[130] HSBCG, LBG, RBSG.
[131] ACI industry guide, *Replacing legacy payment systems*. ACI Worldwide delivers systems to process payments for banks, processors and retailers around the world.
[132] Deutsche Bank Equity Research, UK Retail Banking 2014, *Bank to the Future* [✂].

The required investment will, Deutsche believes, drive up to a 10% increase in overall operating costs for the banks.

Figure 25: Disruptive technology and the growth path in retail banking



Source: RBSG.

185. Figure 25 depicts RBSG's prediction that 'incumbent banks' that do not upgrade their systems and adopt new models will end up on a lower and declining growth path. RBSG told us that the impact of digital and non-bank functionality was causing it to change the way it operated its PCAs and other products.

186. RBSG described its own IT infrastructure as a [✂]. It was currently undertaking a project to simplify, rationalise and increase the robustness, usability and functionality of its IT architecture and software. The updating of its systems would be costly and time consuming but the investment was, in RBSG's view, necessary to remain competitive in what it described as a new digital era. It noted that its ability to respond quickly to shifts in the market trailed that of entrants with IT systems built using the latest technology.

187. In addition to the constraints on functionality and efficiency that larger banks' legacy systems imposed, RBSG told us that they were extremely costly to maintain compared with newer IT systems that were available off-the-shelf and centrally managed and updated.[133]

188. Similarly, HSBCG told us that the larger banks were required to undertake significant investments to upgrade their service offerings, and to adopt new

[133] Whilst hosted or outsourced solutions are centrally updated, off-the-shelf core banking platforms that are hosted internally require updating periodically (at the sole expense of the individual bank).

digital and mobile technology to configure them for changing customer requirements and demands. These included investments in branches to offer self-service machines and Wi-Fi access, for example. HSBCG explained that for larger banks with legacy systems, these investments involved significant risk when they related to new technology and IT.

189. For Tesco Bank, the launch of its PCA in 2014 required substantial investment in IT. At the point of taking full control of the business from RBSG in 2008, Tesco Bank had none of its own IT infrastructure or applications to support its banking products. In order to remove its dependency on RBSG, it acquired and built a number of IT components before migrating the existing (legacy) customer base to its own system.

190. Tesco Bank chose to use Fiserv's platform solution that had elements of off-the-shelf functionality. However, Tesco Bank told us that it required significant development and customisation to meet the needs of its customers in the UK market.

191. IT costs accounted for £[✂] of the £[✂] investment involved in Tesco Bank's current account launch programme. This included the integration of components from other suppliers, upgrading of 49 systems and completion of 85,000 IT tests. [✂]. In addition to the above programme costs, an additional £[✂] a year had been added to its existing IT support costs as a result of launching the PCA.

192. In addition to the cost implication, the end-to-end implementation, the upgrading of IT systems and the introduction of CASS were time-consuming and delayed the launch of Tesco Bank's PCA.

193. However, Barclays told us that it had been active in leading the development of innovations in retail banking, particularly in respect of payment services (such as enabling customers to pay for bus journeys with Pingit, or to pay utility bills at ATMs), despite being constrained to some extent by its legacy IT infrastructure.

Viability of new models

194. In our working paper (Barriers to entry and expansion: capital requirements, IT and payment systems) we referred to evidence provided to us by TSB that suggested that the new IT solutions available to entrants ceased to be adequate as the bank expanded beyond a particular scale.[134] However, we have not received any further evidence to support this. On the contrary,

[134] Barriers to entry and expansion: capital requirements, IT and payment systems, paragraph 69.

HSBCG stated in its response to our working paper that innovative low-cost IT solutions were fully scalable. HSBCG pointed to Metro as being a ‘prime example of an efficient operator successfully expanding in the PCA and SME banking markets’ with an off-the-shelf IT solution.[135] HSBCG also noted that to the extent that a bank faced IT costs as it expanded, there was no difference in adapting an off-the-shelf (hosted) solution to the difficulties faced by any other bank wishing to expand, including those with legacy systems.

195. As discussed above under *integration of legacy systems*, off-the shelf IT solutions may be more difficult to adopt for firms with existing legacy IT systems. In response to our working paper Santander told us that for banks other than those entering the market by pure organic growth, off-the-shelf solutions might not be adequate due to issues with integrating legacy IT systems. Indeed, [✄]. While it was possible to migrate to an off-the-shelf solution, Santander told us that this required a long-term approach, migrating back book products as they matured.

[135] Metro told us that, so long as firms maintained some discipline about the ‘add-ons’ they integrated, it should be possible to achieve scale and to avoid ‘legacy’ issues.

Case studies

Contents

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Introduction

1. This appendix sets out the findings[1] of the case studies that we undertook in order to identify what, if any, barriers to entry or expansion exist in the supply of PCA and SME banking services.[2]

2. In previous market investigations we have found that case studies of market entry and expansion can provide powerful insights into the practical difficulties that firms may face trying to break into particular markets. Such studies have

[1] These are based on the CMA retail banking market investigation's working papers on individual case studies that were completed and/or published during May-June 2015.
[2] Our guidance states that the prospect of entry and expansion within a short time can sometimes countervail against a prospective AEC decision and notes that the possibility of entry by outside firms or the expansion of incumbent firms have featured in most findings on whether or not there is an AEC in a market. CC3 (revised), paragraph 205.

contributed both to the identification of possible AECs and to the design of remedies to dismantle or lower barriers to entry.

3. The value of case studies lies in their ability to provide a very detailed understanding of the practical difficulties that firms encounter in entering particular markets, the strategies available to them in order to overcome those difficulties and the extent to which they have been successful in doing so.

4. The drawback of case studies is that, because they are quite resource intensive, the number which can be undertaken as part of a market investigation is relatively limited. In addition, since the 'sample' is small we can be less confident that the lessons we learn from them are of general application rather than relevant to the particular circumstances of the case.

5. Choice of case study, therefore, is crucial, though since market entry in retail banking has been quite rare, selecting appropriate cases for study was less of a problem than in some other markets investigated previously by the CMA.

6. We selected examples of entry and expansion in both the provision of SME banking services and of PCAs and included cases where firms had contemplated entry or expansion but had decided against doing so as well as cases where they had gone ahead. The cases we selected were:

   (a) Aldermore Bank;

   (b) the entry of Metro Bank;

   (c) Nationwide Building Society's (Nationwide) BCA;

   (d) Tesco Bank's PCA;

   (e) the entry of TSB; and

   (f) Virgin Money's PCA; and

   (g) potential new entrants.

7. In addition, in order to understand whether recent changes to the authorisation process and developments in financial IT had affected barriers to entry or expansion, we gathered information from five prospective new entrants to retail banking which were currently seeking authorisation.[3]

[3] Atom, CivilisedBank, Fidor, OakNorth and Starling.

Aldermore Bank

8. [The Aldermore case study has been redacted in its entirety for confidentiality reasons].

Metro Bank's experience of entry

9. This case study examines Metro Bank's (Metro's) experience of entry and expansion as a relatively new high street bank in the UK and what, if any, obstacles that it faced in doing so.

10. Metro launched in July 2010. It offers a range of retail banking services to personal and business customers (including SMEs), and at the end of 2014 had 31 branches in and around Greater London. Metro has grown its total number of customer accounts from 8,912 in 2010 to 447,000 in 2014, and aims to have 200 branches by 2020.

11. Although Metro has grown rapidly since launch, it told us that it faced some obstacles to further expansion. These included: the availability of suitable high street corner sites for new branches; capital holding requirements; access to payment systems both in respect of quality of service and costs; and the larger banks' ability to subsidise new customers. However, it told us that it had sought to overcome these obstacles through a strategy of providing high-quality customer service coupled with a branch-based business model, to differentiate itself from its competitors.

12. Metro successfully overcame what obstacles it encountered in launching as a new high street bank, and has grown well so far. However, Metro has chosen to focus on expanding in the South East around the London commuter belt, which if it cannot open new branches quickly enough in these areas may affect its ability to acquire customers and reach a certain scale.

Introduction and background

13. The purpose of this case study is to examine Metro's experience of entry and expansion as a relatively new high street bank in the UK. The case study begins with a background to Metro's launch in the UK which is followed by a description of its business model and strategy. Next, it discusses how successful Metro has been in growing its business since launch, and finally considers the extent to which Metro's experience suggests the presence of barriers to entry or expansion in UK retail banking.

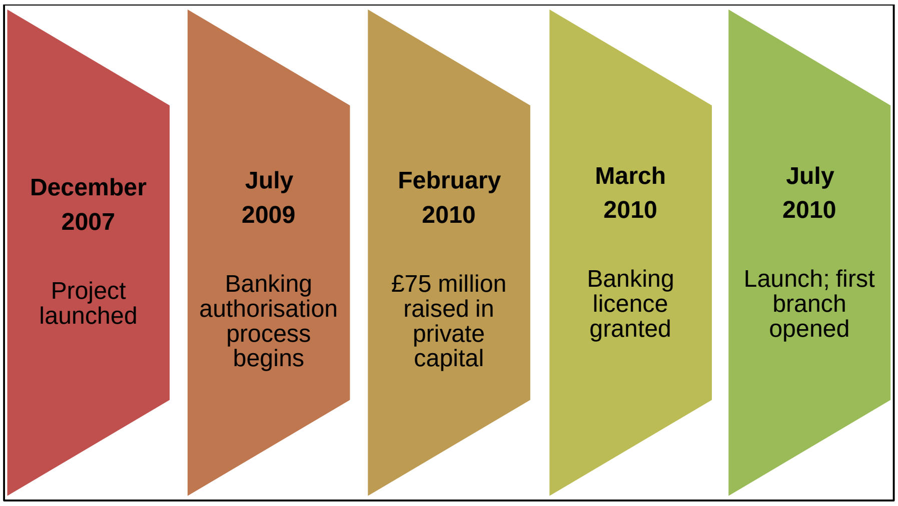
14. Metro was launched in July 2010 and was the first de novo high street bank to be granted a licence in the UK in more than 100 years. It is a deposit-taking

and lending institution which services retail (personal) and business customers in London and its wider commuter belt area. Metro's decision to enter the market was based on a belief that a significant opportunity existed for a new bank in the UK that provided customers with high levels of customer service and convenience, whilst providing good returns for its shareholders.

15. Metro's launch in the UK was based on a successful antecedent – Commerce Bank – that was established by Vernon Hill in the USA in 1973.[4] At the centre of Commerce Bank's strategy was the branch, in contrast with other banks which were generally steering customers away from their branches to cheaper-to-serve channels. Commerce Bank started with a single branch in 1973 to become one of the largest banking groups in the USA before it was sold to Toronto-Dominion Bank for $8.5 billion in 2007.[5]

16. Following his discussions with the Financial Services Authority (FSA), Mr Hill launched the Metro project in December 2007, and raised £75 million in initial capital in February 2010 from a pool of investors, including Fidelity and Wellington Capital.[6,7] Figure 1 shows key milestones leading up to Metro's launch in the UK.

Figure 1: Key milestones leading up to Metro's launch



Source: Metro.

17. Metro told us that its decision to launch in the UK was a direct response to what it called lack of choice for consumers and businesses. Its aims are to

[4] Vernon Hill, the founder and chairman of Metro Bank is an American businessman. He is also the former Chairman and President of Commerce Bank which he founded in 1973 in the USA.
[5] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise (2010), pp9–10. Temenos is a software company which was founded in 1993 in Geneva, Switzerland. Its stated mission is 'to rid the banking industry of its legacy software.
[6] ibid, p12.
[7] The Financial Conduct Authority (FCA) replaced the FSA from 1 April 2013.

differentiate itself from other banks by presenting to its customers a service-based rather than a product sales model. Metro has decided to initially set up its branches (referred to as 'stores' by Metro) in and around London – learning from the Commerce Bank's success in New York where it had 250 branches in Manhattan alone. Metro's first branch at Holborn, London, opened in July 2010 (Figure 2).

Figure 2: Metro's branch in Holborn, London

Metro's business model

Strategy

18. Metro's strategy is based on building a strong brand, creating loyal customers and offering its customers best experience from their banking.[8] Metro aims to implement this strategy through a customer-focused culture, retailer-type operations, and reliance on its customers telling their friends about their experiences, in order to attract more people to visit its branches.[9]

19. A key element of Metro's business model is its focus on service and not price. As Craig Donaldson, Metro's CEO told the Parliamentary Commission on Banking Standards (PCBS), 'If you [customers] want the very best pricing on deposits, you can go to other people … I do not expect to win everybody, just those who value real service and convenience, because that is what we offer'.[10]

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[8] In Mr Hill's words 'Our model in Britain, as it was in America, is this idea of building customers as fans. Great companies build fans who stay with the company and recommend them to a friend.' House of Commons Treasury Select Committee, 14 December 2010. Vernon Hill's oral evidence. Answer to Question 442.
[9] Hill, Vernon (2012), *Fans Not Customers*, Profile Books.
[10] Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q52.

20. Metro's PCA offers free-if-in-credit banking and currently pays 0% interest, and it has no imminent plans to introduce credit interest in the event of a base rate movement. Metro does not offer any incentives for new customers, and told us that 'Our products are designed to appeal to as wide a range of customers as possible. Our model, focussed on high-quality service, is designed to attract all types of customers.'

21. In August 2013, Metro acquired SME Invoice Finance Limited, a company which specialised in invoice discounting, factoring and cash-flow funding for businesses.[11] Metro told us that it wanted to provide full-service range to SMEs, and in order to do so, wanted to include invoice and asset finance as part of its product portfolio.[12] Metro stated that since these markets were specialised in nature it thought it best to find an existing provider that had the technology, processes, expertise and resources in these businesses.

Importance of branches

22. Metro's branches are modelled like retail outlets, are located on high street corners, and represent its main sales channel, although telephone, mobile (for PCA customers) and internet banking are also available to its customers. It believes that customers are willing to pay more for superior service, because they enjoy the experience, likening this effect to the customers of Starbucks.[13]

23. Metro believes that having physical branches is important because it enables it to provide traditional banking services, and build relationship with customers. To build a relationship with customers, Metro wants its first interaction with a customer to be face to face, through a branch.

24. Metro's strategy is to build a branch network organically rather than buying branches of existing banks, and is focusing on building these in London, the South East and commuter belt locations near to where people live and work.

25. Metro's service offering to its customers in its branches includes the following:

(a) Open seven days a week for extended hours.[14]

(b) Instant account opening (cards + cheque book printed in store).

(c) Free coin counting.

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[11] Metro-Bank 'The-Entrepreneur's Bank' acquires SME Invoice Finance, August 2013.
[12] The deal involved Metro purchasing an end-to-end Invoice Finance and Asset Finance capability – ie systems, processes and people.
[13] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise (2010), p13.
[14] Opening hours for all Metro's branches are Monday–Friday: 8am–8pm Saturday: 8am–6pm Sunday: 11am–5pm Bank holiday: 11am–5pm.

(d) Internal ATMs.

(e) Safety deposit vault.

(f) Toilet and baby changing facilities.

(g) Dog friendly with dog bowls of fresh water in the lobby.

Product strategy

26. Metro offers a range of products but claims not to cross-sell, and its staff are not incentivised to do so, but are rewarded based on customer satisfaction. (see Annex B for details of Metro's products).[15]

27. Metro's retail proposition for personal customers rests on offering superior levels of service and convenience. It aims to focus on simplicity and transparency by offering one type of PCA for all its customers, and having a simple overdraft pricing model. Metro claims that the simplicity of its product offering ensures that it does not cross-subsidise between customer segments, and provides its best rates and offers to all its customers.[16] The key elements of Metro's retail proposition include:

    (a) developing and communicating a series of commitments to its customers including giving them the best saving and mortgage rates it has, and simpler overdraft rates; and

    (b) keeping the product range simple while addressing some gaps in the range and also improving the availability of a number of existing propositions and channels.

28. Metro's strategy for its SME customers is based on a need to offer something on the high street to serve the SME market.[17] It categorises SME customers based on turnover, and its local business managers based in its branches focus on serving the needs of smaller businesses with under £2 million turnover; larger businesses are serviced by its Relationship Managers who also focus on specific sectors, including property, healthcare, not for profit, franchising and leisure. Metro told us that its SME business was key to its wider banking strategy, and SMEs represented 47% of deposits and 45% of its lending at the end of 2014.

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[15] 'No Stupid Bank Rules. Metro Bank case study', *Customer Insight* (November 2011), p15.

[16] Metro indicated to the CMA that this was in contrast with the practices followed by many other banks, which offer attractive offers for their new customers but not to their existing customers.

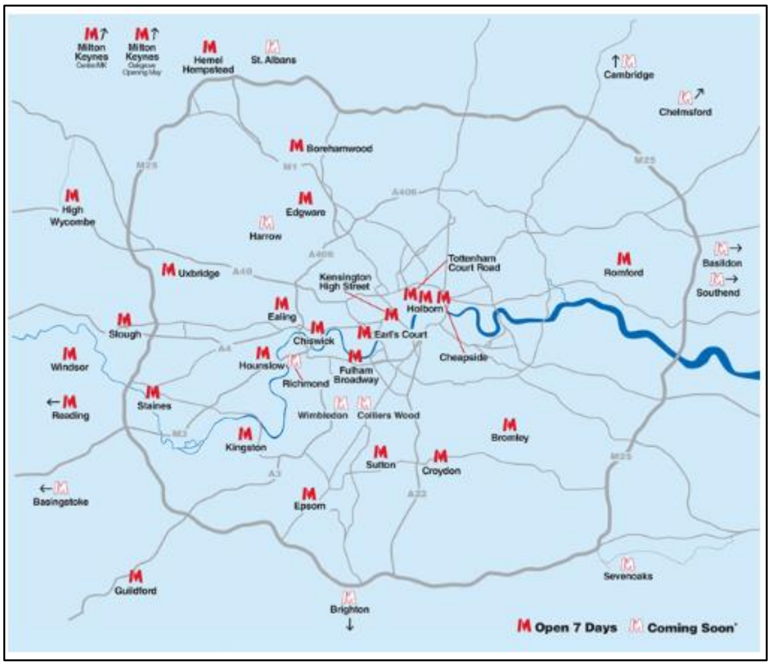
[17] As Craig Donaldson told the PCBS 'what they [SMEs] tell us they want is the high street presence, continuity of relationship and somebody who will get to know their business' Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q49.

29. Describing its product strategy, Metro had told the House of Commons Treasury Select Committee ('Select Committee'): 'We believe [that] people will buy other products from you if you have fair products—not if you are aggressively out to sell them, but because they have faith in your brand.'[18]

Metro's growth and plans

30. Since its launch in 2010, Metro has grown organically through de novo branches, and at the end of 2014, had 31 branches in the Greater London area (Figure 3).[19] It also continues to plan towards an initial public offering on the London Stock Exchange and, assuming favourable market conditions, is targeting 2016.

Figure 3: **Location map of Metro's branches**



Source: Metro website (accessed 13 January 2015).

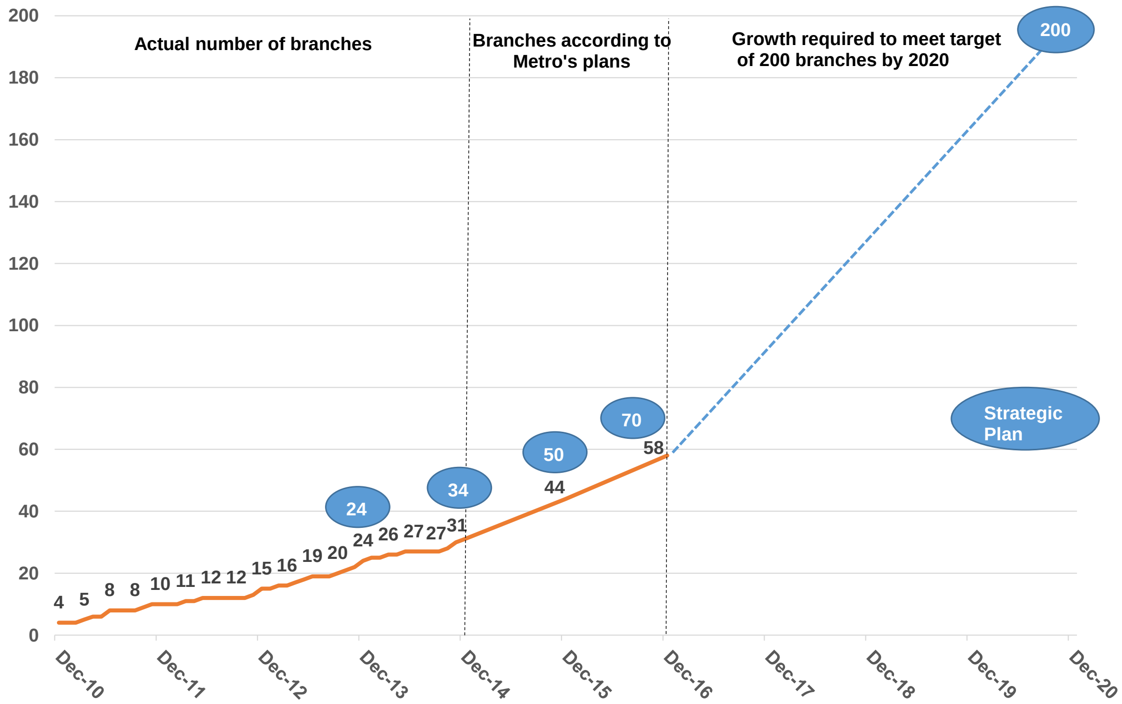
31. Figure 4 (left panel) shows that Metro's number of branches at the end of 2014 – 31, is slightly behind its Strategic Plan of 34. Metro has plans to almost double its number of branches to 58 by the end of 2016 (middle panel of Figure 4). However, the predicted number of branches (as stated in Metro's branch acquisition plan) at the end of 2015 and 2016 is lower than the corresponding forecast in its Strategic Plan (middle panel of Figure 4); it

[18] House of Commons Treasury Select Committee, Vernon Hill's oral evidence, 14 December 2010. Answer to Question 470. The Treasury Select Committee is one of the select committees related to government departments, established by the House of Commons. When the committee has chosen the subject of an inquiry it normally issues a press notice outlining the main themes of inquiry and inviting interested parties to submit evidence. In this instance, Metro was providing evidence to the Committee regarding Competition and choice in the banking sector.
[19] A list of Metro's branches at the end of 2014 is in Annex A.

expects to have 44 branches by 2015 (50 according to the Strategic Plan) and 58 branches by 2016 (70 according to the Strategic Plan).

32. Figure 4 also shows (right panel) that although Metro has quickly grown its number of branches over the last four years, it will need to grow much faster to achieve its target of having 200 branches by 2020.

Figure 4: Number of Metro's branches – actual, planned and target

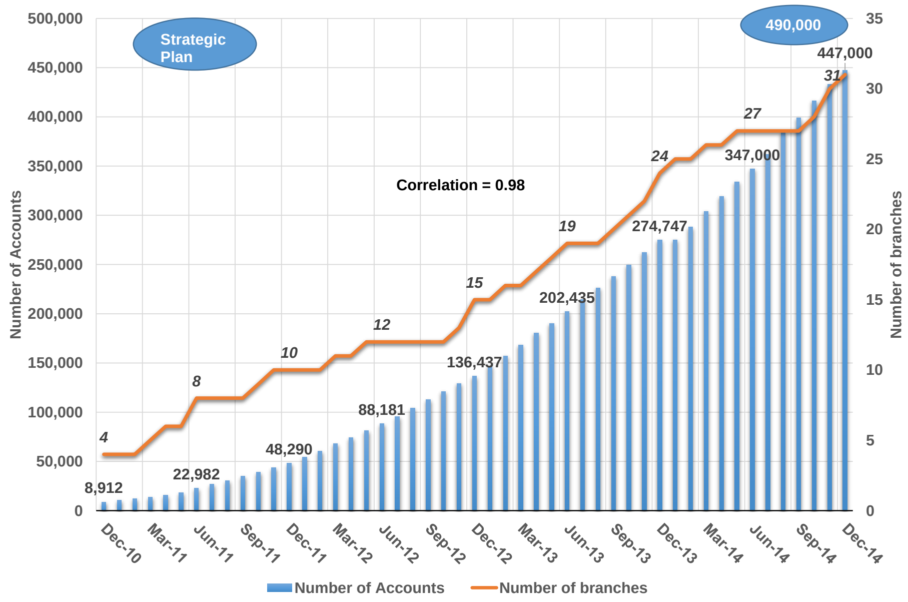


Source: Collated from Metro's website and documents.

33. Figure 5 shows that Metro has been able to rapidly grow its number of accounts since it launched in 2010. The total number of accounts increased from 8,912 in 2010 to 447,000 in 2014 – a compound annual growth rate (CAGR) of 166%. The figure also illustrates that the increase in the number of accounts has been in line with the growth in Metro's branches during this period (correlation of 0.98) reinforcing the importance of branches to its business model. The number of accounts at the end of 2014 was slightly behind its Strategic Plan of 490,000.

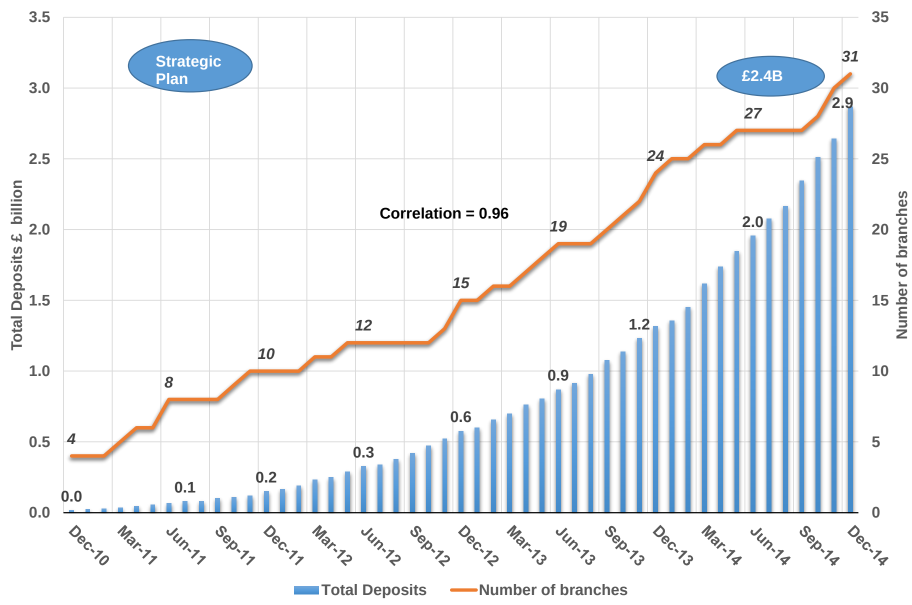
34. A similar trend is seen in Figure 6 which shows that Metro's deposits have grown at a fast pace – CAGR of 256% between 2010 and 2014. Total deposits stood at £2.9 billion at the end of 2014, higher than the Strategic Plan of £2.4 billion. The growth in Metro's deposits also closely follows the growth in its number of branches (correlation of 0.96).

Figure 5: Evolution of number of accounts and branches



Source: Collated from Metro's documents.

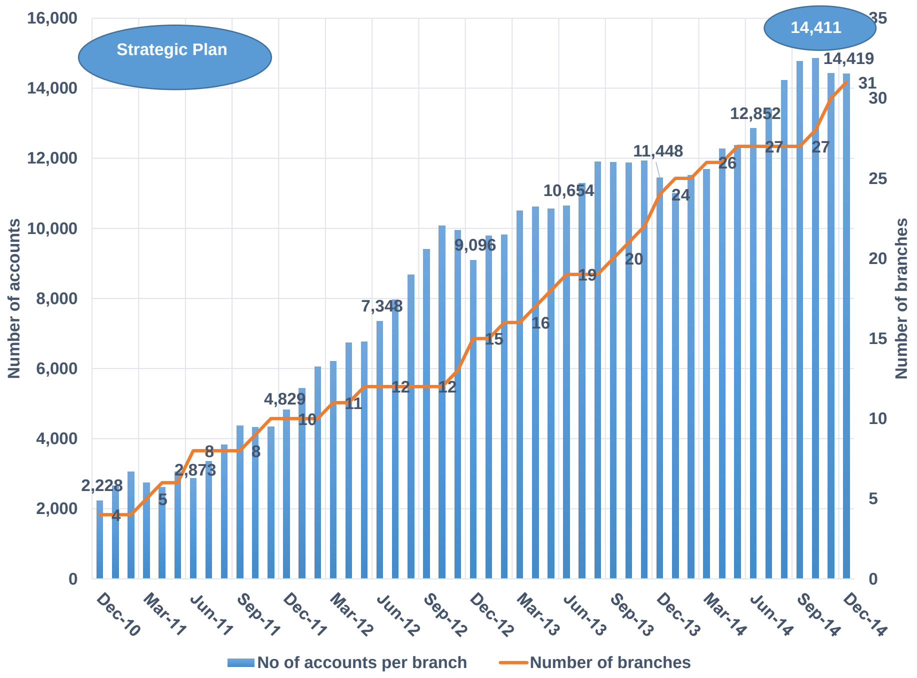
Figure 6: Evolution of deposits and number of branches



Source: Collated from Metro's documents.

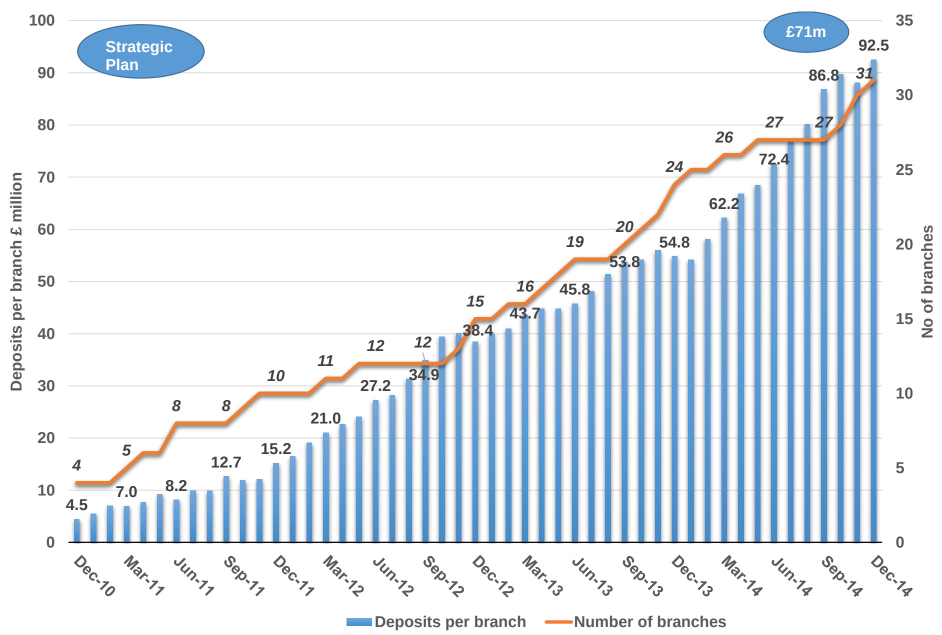
35. Figures 7 and 8 show the growth in Metro's number of accounts and deposits per branch. The number of accounts per branch has grown rapidly to 14,419 at the end of 2014 (CAGR of 59% since 2010) – close to what was assumed in the Strategic Plan. Similarly, average deposit per branch has also grown consistently over the last four years (CAGR of 113%) and was £92.5 million at the end of 2014, higher than what was assumed in the Strategic Plan (£71 million).

Figure 7: Evolution of number of accounts per branch



Source: Collated from Metro's documents.

Figure 8: Evolution of deposits per branch



Source: Collated from Metro's documents.

36. Figure 9 shows that Metro's number of PCAs has also grown rapidly and between 2011 and 2014 saw a CAGR of [✄]. At the end of 2014, Metro had over [✄] PCAs, and plans to grow these to over [✄] by the end of 2015. In 2014, the PCAs accounted for about [✄]% of its customer accounts, and applying this percentage to Metro's Strategic Plan of [✄] million total number of accounts, it could potentially have over [✄] PCAs by 2020.

Figure 9: Growth in the number of PCAs

[✂]

Source: Metro.

37. Similarly, Figure 10 shows that Metro's BCAs grew at a CAGR of [✂] between 2011 and 2014. At the end of 2014, Metro had about [✂] BCAs which it plans to almost double in 2015.

Figure 10: Growth in the number of BCAs

[✂]

Source: Metro.

38. In 2014, of about [✂] new PCAs added, Metro is aware of the sources of customers switching to it for about [✂] customers, which are shown in Table 1. Although this data on switching is only for a small subset of new PCAs added, it shows that customers are switching to Metro from many major banks, with Barclays, Santander, HSBC, Lloyds and Natwest accounting for [✂]% of those switching in.

Table 1: Sources of switchers to Metro in 2014

	Number of PCAs	*%*
Barclays	[✂]	[✂]
Santander	[✂]	[✂]
HSBC	[✂]	[✂]
Lloyds	[✂]	[✂]
Natwest	[✂]	[✂]
Halifax	[✂]	[✂]
Nationwide	[✂]	[✂]
All other	[✂]	[✂]
Total	[✂]	[✂]

Source: Metro.

39. In its 2015 annual road map for retail proposition, Metro mentioned that although its business model offering superior service and convenience had proved popular, [✂] Metro believes that it needs to continue to innovate to maintain itself as a customer focused banking brand. Regarding its SME business, Metro's focus for 2015 is [✂].

40. Metro's CFO Michael Brierley believes that the bank is on track to make a profit in 2015/16 and stated that 'We will generate a greater long-term profit if we continue to invest in our infrastructure, IT and people.[20,21]

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[20] Interview with Metro CFO Michael Brierley. *Financial Director,* 19 September 2014.
[21] While releasing its 2014 full-year results, Metro announced that its deposits had increased to £2.9 billion (annual increase of 118%) out of which deposits from business customers represented 64% or £1.9 billion. Total loans grew to £1.6 billion (an annual increase of 112%) with loans to business customers making up almost half

Barriers to entry and expansion

Authorisation process

41. Metro told us that the authorisation process it went through to get a banking licence was a challenging one mainly because a new bank had not been authorised in the UK in over a century. Metro stated that it 'navigated the process slowly but successfully alongside the Financial Services Authority'. It also noted the FCA's subsequent work on streamlining the authorisation process, and hoped that it facilitated more new banks to enter the market.[22]

42. In March 2013, the FSA and the Bank of England (BoE) published a review of the requirements for firms entering or expanding into the banking sector which set out reforms to the authorisation process to make it easier for the new applicants. These reforms were designed to provide firms with greater clarity about the information required to be submitted to facilitate authorisation as rapidly as possible and, to provide firms clear milestones along the path to authorisation, with the possibility of authorisation before they committed major resources to infrastructure investments.[23]

43. Another report of the Prudential Regulation Authority (PRA) and the FCA, published in July 2014 provided an update on progress in implementing these changes and clarified some issues that had arisen following the original review. Some of the developments mentioned in this follow-up report included the following:[24]

    (a) Increase in the level of pre-application support to the new applicants by the PRA and the FCA.

    (b) Streamlining of the application pack.

    (c) A new 'mobilisation' option – where authorisation was granted when a firm had met essential elements but with a restriction on its activities due to some areas needing to be completed (for example, investment in IT systems).

44. Overall, the authorisation process does not appear to have been a significant obstacle for Metro to enter retail banking in the UK.

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of total lending. The number of customers increased to 447,000, up 63% from last year. Metro Bank 2014 results announcement, 21 January 2015.

[22] The FCA replaced the FSA from 1 April 2013.

[23] BoE/FSA (March 2013), *A review of requirements for firms entering into or expanding in the banking sector.*

[24] BoE/PRA (July 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*. pp 5–8.

Capital requirements

45. Metro stated that it was currently required to hold around six to ten times more capital than the big banks and building societies when securing a mortgage for a customer, even if it was for the same customer, with the same deposit, on the same property – a situation which did not reflect a level playing field.

46. To elaborate this point, Metro told us that as a new entrant to the market, it had to use the standardised approach (SA) to credit risk when calculating capital requirements, while the larger banks were permitted to use an internal ratings based approach (IRB). Metro indicated that the IRB approach was based on many years of data, and enabled certain institutions to significantly reduce the value of their risk-weighted assets.

47. Similarly, in its submission to the PCBS, Metro had mentioned that:

> The business plan we put together [at the time of its authorisation application] had a significant capital requirement in there because it seemed proportionate and appropriate that, as a start-up bank, we had that … it is about how over time the capital requirement should reduce, as the risk of running an organisation reduces with longevity, and it is about the proportionality that is applied by a prudential approach that needed to be seen over time.[25]

48. Metro pointed out to the CMA the difference between the SA and IRB by using an example of a low loan-to-value residential mortgage. Metro stated that such a mortgage carried the same risk profile regardless of the lending institution but the challenger banks risk weight these particular assets at 35% compared with 3 to 6% for the larger banks.

49. Metro suggested to us that there should be tighter bands for capital requirements for standard product sets, rather than allowing for the current wide differentiation in the market. It also mentioned that the approaches used by many existing banks allowed for too much variability in capital in order to promote a truly fair and competitive market. And, in order to promote a truly fair and competitive market, capital requirements for all product sets should be brought in line with each other using industry-wide indicators set by the regulators.

50. In March 2013, the FSA and the BoE announced a shift in approach to the prudential regulation of banking start-ups whereby the additional requirements (known as ‘add-ons and scalars’) previously applied to reflect the

[25] Craig Donaldson’s oral evidence to PCBS, 13 November 2012. Answer to Q3.

uncertainties inherent in start-ups were no longer to be applied. These requirements according to the two regulators often resulted in capital and liquidity requirements for start-ups being higher than for existing banks.[26]

51. In a follow-up review, the PRA and FCA referred to the IRB approach to calculating credit risk versus the SA (the default position) for all new and existing banks and noted that 'The PRA has taken steps to address underestimation of risks that can result from applying the IRB approach to certain types of exposures.'[27] According to this review, the PRA was to continue to consider the impact of its policies on competition as required by its competitive objective with a caveat that the regulatory capital requirements were to a large extent determined by the relevant EU legislation over which PRA had little or no discretion.[28]

52. Metro mentioned in its Offer for Subscription in 2014 to investors that its capital and liquidity requirements had been further reduced reflecting the greater maturity of the company. However, it believed that as a new bank, it was required to hold disproportionately higher capital than an old, established bank. Metro's view was that capital requirements for all product sets should be brought closely in line with each other using industry-wide indicators set by the regulator. Metro told us that the way capital rules differed between larger banks and challenger banks made expansion and growth expensive.

53. The capital requirements did not prevent Metro from entering the UK retail banking market, and do not seem to have prevented it from growing at a fast pace so far. However, according to Metro, the requirement to hold higher capital than the larger banks may affect its expansion in the future.

Access to payment systems

54. Metro told us that access to payment systems continued to be a barrier for challenger banks, and the current payments infrastructure did not promote effective competition where small and new banks were heavily dependent on their competitors, to serve their customers.

55. Metro stated that the cost of developing and maintaining membership of one of the payment systems meant that any new bank wishing to provide a transactional service, such as direct debits or faster payments, had to accept an

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[26] BoE/FSA, *A review of requirements for firms entering into or expanding in the banking sector.*
[27] BoE/PRA, *A review of requirements for firms entering into or expanding in the banking sector: one year on*, paragraph 40.
[28] Ibid, paragraph 41.

‘agency banking arrangement’, essentially contracting an existing bank to provide its payment infrastructure.

56. According to Metro, this arrangement was anti-competitive since it meant that banks without their own clearing capacities were subject to the service levels and payment structures of existing players, and could be forced to provide the same or worse service to their customers. Metro pointed out that it had experienced many outages with some of the payment systems, which were not due to the payment systems but because of IT issues at one of the banks through which it accessed those systems.[29]

57. Metro informed the CMA that at the start of its relationship with its clearing bank supplier, it was paying £[✂] per outgoing Faster Payment, and given its growth over the last four years this had reduced to £[✂]. Metro told us that the corresponding cost for the members of the Faster Payment Scheme was £[✂] per transaction, and this ‘imposes a high cost on all small challenger banks, who may not be direct members, while acting as a clear and significant source of profit for the large larger clearing banks.’

58. Metro’s submission to PCBS regarding payment systems made the point that:

> If you look at the banking industry across the world, different models are applied, where you would have payments as a utility that banks link into. Therefore, everybody was starting from a level playing field and could then differentiate themselves, based on the proposition they wanted to offer customers, rather than having to rely on the proposition that the big banks wanted to offer customer. If we genuinely want competition, we need to create the level playing field, almost like a utility play, rather than forcing challenger banks to go to the lowest common denominator.[30]

59. Metro suggested to us that the CMA, in conjunction with the Payment Systems Regulator, should investigate the possibility of an independently run, licensed ‘Plug and Play’ payments platform with the same service levels for all banks, which could be funded according to volume.[31]

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[29] Metro provided a specific example illustrating the effect of accessing payment systems through another banks on its customer service. It cited the outage of its Faster Payment functionality using the Direct Corporate Access (DCA) between 08:00 and 20:00 on 29 November 2014, during which time outbound DCA payments were rejected and payments were not stored.

[30] Craig Donaldson’s oral evidence to PCBS, 13 November 2012. Answer to Q6.

[31] According to Metro, elsewhere in the world, such as in the USA, banking payment systems are run independently by a central organisation (such as the USA’s Clearing House Interbank Payment System).

60. Metro's experience suggests that it has to rely on larger banks, ie its competitors, for accessing payment systems, which may have both cost and quality implications. Metro's business model relies on high-quality service to its customers, but it cannot directly control the quality of the service of the payment systems since it accesses them through other banks.

IT system

61. Metro told the Treasury Select Committee that the biggest barrier to being a new bank in Britain was IT. It said that in the USA there were outsourced providers who were ready to put you in business almost immediately, while in the UK one had to build IT from scratch.[32]

62. Metro's IT strategy was intended to minimise the size of initial capital outlay and manage the bank's cash flow and profitability.[33] Metro chose to work with Temenos, which provided it with an IT platform with a single customer view that underpins its banking services. It selected Temenos because it offered an integrated IT solution which 'lowered the entry barriers by offering a flexible and massively scalable delivery model which reduced capital outlay and operating costs to a bare minimum.'[34] The implementation period for Metro's IT system was also relatively short at nine months.[35]

63. According to a report by Temenos,[36] it was able to offer the T24 IT[37] platform to Metro on a Software as a Service (SaaS) model – where a vendor (in this case using a third party) hosts an application on behalf of a customer and provides access through the internet, normally in exchange for a monthly or quarterly rental.

64. A recent report by Temenos concluded that in the UK, computer systems may put larger banks at a disadvantage.[38] Another report by Deloitte and Temenos has found that over the past five years, banks using third party banking applications have enjoyed on average a 19% higher return on assets, a 28% higher return on equity and a 6.5 percentage point lower cost-to-income ratio than banks running legacy applications.[39]

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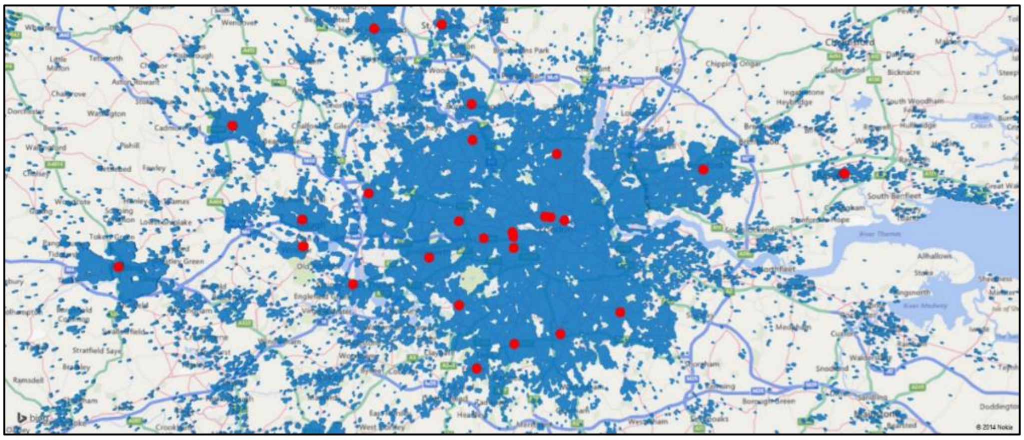
[32] House of Commons Treasury Select Committee. Vernon Hill's oral evidence, 14 December 2010. Answer to Question 460.
[33] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise, p15.
[34] ibid, p15.
[35] ibid.
[36] Ibid, p15.
[37] Temenos T24 (T24) is a front- to back-office, Customer Relation Management and product life cycle management software platform that powers core banking operations.
[38] Succeeding through the digital revolution. Lessons from Banking Industry Disruptors. White paper 2014. Temenos. pp13 & 20.
[39] Temenos and Deloitte. Restoring Profitability in the Digital Age. 2014.

65. Metro seems to have overcome many of the scale advantages enjoyed by the large banks by deploying an integrated IT solution. It has taken the application on a hosted pay-per-use basis minimising the level of upfront IT investment needed and rendering IT as a variable cost.[40] Since Metro has focused on growing organically, it has not been burdened by legacy IT systems, and its IT system appears to be a key competitive advantage.[41]

Need for branch network and availability of suitable sites

66. Metro's submission to the Treasury Select Committee pointed out the importance of a branch network to its business model: 'as a retailer, we know the more stores we put in the same market, the better those stores all do.'[42] Metro told us that its customers' feedback was that branches were important to them. It also made the point that, 'Our customers tend to be based in the areas and communities surrounding our stores, as new customers have to open their first account in a store', thus reinforcing the importance of its branches to its business model (see Figure 11 below).[43]

Figure 11: Metro's branches and customers (November 2014)



Legend: Red – Metro Bank branch. Blue – Metro Bank customer.

Source: Metro bank.

[40] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise, p1.
[41] According to Temenos case study on Metro '…lower absolute technology spending as result of having a modern, integrated system offers Metro Bank not just the opportunity to achieve a minimum efficient level of scale with lower volumes, but also a source of enduring economies of scale and competitive advantage - which it could choose to invest in higher deposit rates. Temenos Metro Bank case Study: Breaking the Mould but Breaking the Malaise, p19.
[42] House of Commons Treasury Select Committee, Vernon Hill's oral evidence, 14 December 2010. Answer to Question 461.
[43] Subsequent accounts can be opened online.

67. Although having branches was important, Metro stated that they made up only one part of its all-channel offering. As Metro mentioned in its response to the CMA's issue statement:

> … competition should be about banks offering different models to customers; some will take an all-channel approach (like us) and others will choose different strategies. As a result, we do not think that a branch network should act as a barrier to competition – banks must choose models that suit them and their customers, concentrating on differences and choice rather than more of the same.[44]

Planning permission

68. Metro stated that prior to April 2014, the majority of prime sites on the UK's high streets and in retail outlets were classified as A1 retail uses, while the Use Classes Order (1987) classified banks as well as other financial and professional service providers, as A2 users. This meant that in order to open a bank in a prime retail location, significant time and money had to be spent applying for planning consent from local authorities for a change of use (from A1 to A2 use). Metro told the CMA that this had a significant impact on its ability to grow branch numbers, since in many cases, planning permission could take six to nine months.

69. Metro informed the CMA that in April 2014, the Department for Communities and Local Government changed the rules to allow greater flexibility for change of use. Under the new rules, Metro (categorised as an A2 Financial and Professional services use), no longer needs planning consent to take an existing shop (or an A1 Retail use) and convert it to a bank. Metro stated that it had benefitted from the change in planning rules, and as a result, was able to acquire eight new branches in 2014 without the need for a planning application.

70. Metro also informed the CMA that following a consultation carried out in 2014, the government proposed further amendments to the planning process that would effectively merge use classes A1 and A2. According to Metro, should these changes fail to take place, it would continue to encounter the following problems in acquiring suitable sites for opening branches:

[44] Metro's response to the issues statement.

(a) Where a new property was developed and a planning consent granted for A1 retail use, it was not possible to utilise it as a bank until it had first been used as a retail space.

(b) Some properties had restrictive planning conditions which limited their use to A1 retail uses only, despite the changes to the rules in April 2014.

71. In its Offer for Subscription in 2014 for raising additional capital, Metro mentioned its ability to acquire suitable sites for its branches as a business risk. It said that ‘A cornerstone of Metro Bank’s business strategy is prime locations for its stores … any future inability to obtain additional properties could have a material adverse effect on Metro Bank’s business, financial condition, performance, results of operations and/or prospects.’

72. It appears that the changes to planning rules that took place in April 2014 removed an impediment to Metro’s ability to acquire suitable retail sites for its branches. Further changes to planning rules – for example, merging A1 and A2 user classes – can help Metro further in its ability to acquire suitable sites to grow its branch network. Since Metro plans to grow its branch network organically, if it cannot open new branches quickly enough, this may affect its ability to acquire customers and reach a certain scale.

Customer acquisition and advertising

73. Metro does not spend significantly on product marketing, sales incentives or introductory incentive offers, and does not make use of acquisition costs per customer or lifetime value per customer metrics. Metro stated that it relied more on word of mouth than advertising to attract and retain customers.[45]

74. Metro stated that it did not target a particular customer segment. In its evidence to the Treasury Select Committee, Metro had stated that ‘We do not believe there is such a thing as a high-profit customer or a low-profit customer … We believe every customer has real value. They may have low value when they are students and they may have higher value over time but we're out to serve as wide a market as we can get, from wealthy people to students.’[46]

75. Regarding the current account switch service (CASS), Metro’s view was that its effect on switching would be limited until there was more competition and choice in the market. Although Metro viewed CASS as a helpful utility, it did

[45] Metro mentioned that, ‘By keeping customers happy, building stores and surprising and delighting them, we create real advocacy….As a result, they [customers] will recommend us to their friends, and in our opinion this is much more powerful, and effective, rather than advertising.’ Metro’s response to CMA case study.
[46] House of Commons Treasury Select Committee, Vernon Hill’s oral evidence, 14 December 2010. Answer to Question 460.

not view it as a factor actively influencing its customers in their decision to switch.

76. Metro's decision not to advertise does not appear to have affected its ability to acquire customers and expand so far. This may be due to its decision to invest in a branch-based business model. It does not use retention as a measure of satisfaction, but pointed out to the CMA that many more people were joining rather than leaving Metro, and that its customers were switching to it from all the major high street banks.

Access to funding and capital

77. Metro stated that larger banks often competed unfairly with introductory switching bonuses and 'free banking', and they could do so due to cross-subsidy from small subsets of existing back book customers who paid significant fees on overdrafts.

78. Metro pointed out that the larger banks used the savings they made from offering lower interest rates to existing customers to cross-subsidise new customers, which effectively provided them with cheap deposit funding from their less active loyal customers. Metro stated that this created a barrier to entry in the market since the larger banks were able to use this cheap source of funding to drive down their cost of lending. Metro stated that the 'challenger' banks, with higher funding costs, were forced to compete at an unfair price for lending, and in some cases assumed higher-risk lending in order to compete.

79. Metro also told us that since it funded lending through customer deposits rather than through wholesale funding, it was adversely affected by the ability of large banks to drive up its cost of funds by being able to offer higher rates on deposits to new customers.[47,48]

80. Metro suggested to us that 'In the interests of transparency and treating customers fairly, banks should be obliged to give existing customers the same favourable rates and products offered to new customers.' It also added that 'Banks should also be obliged to keep fee structures simple, let customers

[47] PCAs and BCAs represent an important element of Metro's funding representing [✂] and [✂] of its deposits as at December 2014. Metro stated that it had never cut a variable interest rate for an existing customer or offered a bonus rate to a new customer – because it does not consider that to be fair treatment of its customers.
[48] Retail funding refers to the various types of deposits that households and small companies keep with a bank while wholesale funding is from external sources including other banks, large corporates, pension funds, insurance companies. 'Bank funding costs: what are they, what determines them and why do they matter?' Bank of England *Quarterly Bulletin*, Q4 2014.

know personally about every rate change and inform customers of any better suited products available to them.'

81. Despite this potential barrier, Metro has been able to rapidly grow its deposits to support its funding requirements. Metro has also been able to raise equity capital to fund its expansion, it appears, without any difficulties. So far, Metro has raised £641 million as equity capital from private investors, as is shown in Table 2 below:

Table 2: Equity capital raised by Metro

	Equity capital raised £m	*Comments*
2010	75	Initial equity capital
2010	51	Additional equity capital
2012	128	
2013	287	
2014	100	
Total	641	

Source: Metro's website.

Conclusions

82. Metro successfully overcame what obstacles it encountered in launching as a new high street bank, and has grown well so far. Its IT system appears to be a competitive advantage.

83. It considers capital holding requirements, the larger banks' ability to subsidise new customers and indirect access to payment systems to be key impediments to its further expansion. Metro has chosen to focus on expanding in the South East around the London commuter belt. Metro has also adopted a branch-based business model to promote itself and acquire customers. However, if it cannot open new branches quickly enough in these areas, this may affect its ability to acquire customers and reach a certain scale.

Nationwide Building Society's business current account

84. This case study focuses on the experience of Nationwide in considering the provision of a BCA and additional SME banking services.

85. In 2010, Nationwide was starting to explore diversification opportunities that would provide an improved experience for its members and an acceptable return on capital. Despite the poor macroeconomic conditions, Nationwide believed that the SME banking market was relatively resilient and appeared to be attractive (particularly given the perceived political support and apparent ease of leveraging Nationwide's existing personal banking infrastructure).

86. The intended operating model was [✂]. This would be targeted at [✂] to minimise the impact on the existing Nationwide branch network.

87. However, additional work in early 2013 revealed that providing a credible entry into the SME market through the provision of a BCA product would require significant further and sunk capital investment in IT. It was concluded that the project offered insufficient returns on this capital in a reasonable time period and could potentially impact other projects which were perceived as a higher priority for Nationwide.

88. Despite what Nationwide saw as the continued attractiveness of the SME market for an incumbent business, the decision was made not to enter organically with the launch of a BCA, [✂].

89. [✂]

90. Our preliminary assessment is that Nationwide's decision not to enter the SME market was primarily on the basis of capital prioritisation. Based on [✂], there was a relatively long time period needed to build scale with only modest profits being made even at maturity. Hence this proposition appeared relatively unattractive compared with other opportunities to invest in Nationwide's retail operations. There were also risks associated with entry, primarily regarding integration of new IT systems, and the impact on Nationwide's branch network.

Introduction

91. In this case study we examine the analysis which Nationwide conducted when assessing whether to launch a BCA and additional SME banking services. We consider in detail the process by which Nationwide identified the opportunity and why it ultimately took the decision to put this work on hold.

92. In 2012, Nationwide launched a business savings product available to SMEs, although this represents a very small line of business.

Overview of Nationwide

Origins and development

93. Nationwide claims to be the world's largest building society, tracing its beginnings to 1846 when Provident Union Building Society was founded.[49] It subsequently underwent many mergers and acquisitions with other building societies, most notably with Anglia (1987), Portman (2007), and Derbyshire (2008) and Cheshire (2008) building societies.

94. As a mutual, Nationwide is owned by its members, primarily made up of its financial services customers (borrowers and savers[50]) who are given voting rights for the election of directors as well as voting on resolutions, operating on a one-member one-vote system.

95. Nationwide told us that prior to 1987 it largely offered savings and mortgages to personal customers. It subsequently introduced PCAs and a number of other products to personal and business customers. Nationwide now offers a range of financial products, including:[51]

(a) personal products: residential mortgages, personal savings, personal financial planning, insurance products, personal lending, and other general personal banking services; and

(b) other products: commercial lending.

96. In 2007 Nationwide launched a major IT investment programme ('Project Voyager') to update its digital infrastructure. The aim was to facilitate the launch of new products, but also to replace its PCA back-end systems with an SAP[52] solution. This cost about £[✂], and was completed in 2012.

97. Nationwide has grown its customer base and product offerings describes itself as 'a meaningful alternative to the established banks.' In 2014 it generated a profit before tax of £677 million, and highlighted its performance in three specific areas:[53]

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[49] NBS Background.
[50] Generally requires a minimum of £100 savings or deposits as well as being aged 18 or over, NBS Membership Criteria.
[51] NBS Financial Products.
[52] SAP
[53] 2014 Annual Report, with quoted profit levels given as statuary profit before tax.

(a) £130.5 billion of member deposit balances;

(b) £166.6 billion of loans and advances to customers (Including £145.7 billion of residential lending through 1.5 million mortgage accounts); and

(c) 5.5 million current accounts.

Business description

98. Nationwide's core business is providing personal financial services to more than 14 million of its members. Its strategic agenda is focused on increasing its share of the personal banking market, with a specific target of achieving a 10% share of PCAs. In addition to this core focus, it said that its activities include specialist lending in both the commercial real estate and buy-to-let sectors as well as deposit-taking from SMEs. It does not currently offer a BCA or complementary SME banking services. It told us that this model is not expected to alter significantly in the short term.

99. Nationwide states that many of its existing members owned/operated SMEs but are unable to carry out their business banking with Nationwide. It told us that it recognises this gap in its offering and regularly reviews how it could best support SMEs.

100. Historically, Nationwide has sourced its funding from the personal savings and wholesale funding markets. In March 2012, it fully launched (ie available to new customers) simple business savings accounts to both meet its members' needs and to diversify its funding base. These catered to SME needs but were relatively simple, being postal-only.

101. By 2014, these business savings accounts amounted to £[✂].[54] Nationwide said that it intended to grow its business savings to £[✂] by [✂]. However, [✂] given that Nationwide's total funding[55] at 30 September 2014 was £185 billion.

Initial views on Nationwide's BCA project

102. In this section we consider Nationwide's reasons for delaying its BCA project.

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54 [✂]

55 According to NBS's 2014 Annual Report, 'Funding' includes customer deposits (72%), wholesale funding (20%), reserves (6%), other (2%).

103. Nationwide has consistently stated a number of reasons for entering the SME market through the launch of a BCA. Entering the SME market would:

(a) provide a better service offering to its members;

(b) diversify its business model (in terms of both revenue and funding);

(c) allow it to further leverage its brand; and

(d) provide an opportunity to cross-sell products between personal and business (eg using existing personal base as an entry point).

104. Nationwide chose to prioritise its investment in other projects ahead of developing its SME proposition. Four other factors caused Nationwide to de-prioritise entering the SME market once Nationwide had investigated in more detail, specifically:

(a) Developing the IT systems necessary to offer banking services to SMEs is complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. The original assumed ability to leverage existing IT investments from personal banking (ie Project Voyager) and thus minimise capital costs, was proved incorrect. Refined estimates indicated that an additional £[✂] would be required.

(b) Based on the anticipated levels of switching and growth, the business plan illustrated modest returns for many years making the investment horizon long term (delivering low returns on capital) and unlikely to add any diversification benefit to its existing business model.

(c) The distribution requirements and, in particular, the use of branch space potentially conflicting with retail requirements, ie some of Nationwide's branches are currently too small or too busy to accommodate SME service requirements. This is expected to become less of an issue as more transactions are done through mobile and digital channels, but there is still a risk that counter service for personal customers would be impacted by servicing [✂] SME customers [✂].

(d) Nationwide has limited SME expertise particularly in origination, service and risk management. IN Nationwide's view, this risk could be substantially reduced through [✂].

105. Although the SME market remained attractive after additional research, the level of synergy that could be achieved with existing assets was determined to be significantly lower than initially believed. This implied much higher capex requirements to enter, and hence a significantly worse return on capital

employed. Nationwide acknowledges that as its analysis progressed, the scale of the challenges faced by new entrants to the SME market became apparent.

106. [✄]:

(a) [✄];

(b) [✄]; and

(c) [✄].

107. Nationwide did not rule out a potential acquisition in the future, but considered that it would be dependent on an attractive target becoming available, and external market developments such as the CMA investigation.

Details on specific barriers

108. Nationwide told us that the primary reason it put its SME project team on hold was that its board took the view that investment in personal banking products and services must take priority over attempts to develop SME banking. The scale of change taking place in Nationwide's personal banking business made it unfeasible for it to develop the required SME capabilities in parallel. Its analysis had shown that for successful entry to take place, the following costs/ complexities would need to be overcome:

Set-up/capital costs

109. Nationwide concluded that developing the IT systems necessary to offer banking services to SMEs was complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. It also required significant technology management resource and expertise.

(a) The Nationwide board believed 'the Society could not afford to invest c.£[✄] million at this time at the expense of other projects.'

(b) At the point this statement was made (2013), SME banking appeared to be the lowest priority of the three 'discretionary' projects discussed.

Low financial returns

110. Based on the anticipated levels of switching and growth, the indicative business plan illustrated modest returns for many years making the investment horizon long term and unlikely to add any diversification benefit to the existing business model.

111. In 2014, the Nationwide board were ‘generally supportive [of SME proposal] particularly from a diversification perspective although some concern was expressed that given the relatively small forecast financial contribution by years 5 and 10 a stronger consideration was the “member needs” argument’.

Distribution concerns

112. The distribution requirements and, in particular, the use of branch space potentially conflicted with personal requirements, ie some of Nationwide’s branches were currently too small or too busy to accommodate SME service requirements.

- *(a)* [✂]
- *(b)* [✂]
- *(c)* Nationwide analysis has, however, suggested that this concern may become less important in the future as SMEs increasingly adopt digital banking solutions such as online and mobile. [✂]

Limited expertise and risks

113. Nationwide was concerned that as a personal financial service provider it did not have sufficient SME expertise in the fields of origination, service and risk management and would thus need to recruit and establish these areas of specialisation.

- *(a)* Although identified by Nationwide as being an area of concern early on in the process, [✂] appears to have given Nationwide sufficient confidence that it would be able to build a credible offering.
- *(b)* [✂]

Awareness of opportunities for inorganic growth

114. [✂]

115. [✂]

- *(a)* [✂]
- *(b)* [✂]
- *(c)* [✂]
- *(d)* [✂]

External communications and regulatory pressures

116. [✄]

(a) [✄]

(b) [✄]

(c) [✄]

(d) [✄]

(e) [✄]

117. In August 2013, the *Financial Times* reported that Nationwide had:

> Put on hold its plans to start offering loans to small- and medium-sized enterprises as it battles to meet tougher capital requirements set out by the financial regulator earlier this year […] after the Prudential Regulation Authority revealed that Nationwide would have to strengthen its capital position after it fell short of the required 3 per cent leverage ratio.[56]

118. The CMA notes that later in the same month *The Guardian* reported that the Bank of England (BoE) 'rejected any suggestion that Nationwide's decision to hold off from a launch into the SME sector was due to its demands on capital strength', quoting a BoE spokesman as saying 'the plan agreed with Nationwide to meet the 3% leverage ratio in 2015 will not result in them restricting lending to the real economy. Therefore it is wrong to blame their SME decision on the regulator'.[57]

119. Nationwide subsequently confirmed to us that the capital holding requirement was not one of the primary reasons for its decision to put its investigation of entry into the SME market on hold.

Tesco Bank's personal current account

120. This case study examines Tesco Bank's launch of a PCA in 2014.

121. Tesco Bank has its origin in a joint venture (the JV) between Tesco and The Royal Bank of Scotland (RBS), which was formed in 1997. This JV offered various personal banking products such as credit cards and loans to its customers but not a PCA. After purchasing RBS's share of the JV in 2008,

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[56] *Financial Times* report, 26 August 2013.
[57] *Guardian* report, 27 August 2013.

Tesco Bank established a stand-alone IT system and migrated its customers to this platform. In 2010, when most of this migration activity was complete, it began initial research on a PCA proposition with the objective of filling this gap in its banking portfolio.

122. After researching the market and enhancing its IT platform, Tesco Bank launched a PCA in June 2014. Tesco Bank's PCA is a direct, predominantly online product, and its main target market are existing Tesco Bank customers whom it plans to attract by emphasising the loyalty based rewards such as Tesco Clubcard points. Tesco Bank believes that its online proposition, coupled with providing basic transactions in some of Tesco's retail stores, is sufficient for it to succeed as a PCA provider, but it remains open-minded to assessing demand for different business models to meet customers' needs.

123. Tesco Bank did not face any significant regulatory hurdle to launch a PCA since it already had a bank licence which the JV had obtained in 1998. The main challenge it faced was the cost and complexity of developing an integrated IT platform to support its PCA offering. This took almost three years and [✂] investment of about £[✂] million. Tesco Bank also incurred £[✂] million on user acceptance testing of the IT system, other programme costs, and developing and building business capability to run the product. Tesco Bank decided to spend heavily to promote its PCA at launch and may do so on an ongoing basis; it expects its marketing budget to normalise around £[✂] million per year. It believes that it will take [✂] before its PCA becomes profitable on a stand-alone basis, but expects to gain by selling other banking and non-banking products to its PCA customers.

124. According to Tesco Bank, factors that may inhibit its plans to expand include access to payment systems both in respect of quality of service and costs, the prevailing free-if-in-credit PCA model, and the larger banks' access to low-cost funding.

125. It is too early to judge if Tesco Bank will be able to grow its PCA business in line with its plans. That said, with its long-term plan of having [✂], it is not clear if Tesco Bank will pose a major challenge to the larger banks in the near to medium term.

Introduction and background

126. This case study focuses on Tesco Bank's launch of a PCA in 2014 in Great Britain.[58] The case study begins with a brief history of Tesco Bank and the

[58] Tesco Bank stated that the Northern Ireland PCA Banking Market Investigation Order 2008 ('NI Order') which was introduced by the then Competition Commission, provided specific rules governing the switching process of

background to the launch of its PCA. Next, it discusses Tesco Bank's business model and strategy in relation to its PCA business, including an analysis of its growth since launch. Finally, the case study considers the extent to which Tesco Bank's experience suggests the presence of barriers to entry or expansion into UK retail banking.

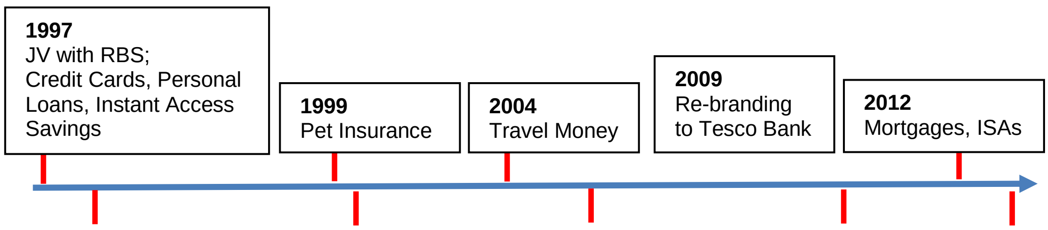
127. Tesco Bank is the trading name of Tesco Personal Finance PLC (TPF), a wholly owned subsidiary of Tesco Personal Finance Group Limited (a holding company) which, in turn, is wholly owned by Tesco PLC. TPF was formed in 1997 as a JV between RBS and Tesco PLC, and obtained its banking licence in June 1998, having operated under RBS's until then. The JV initially offered various financial products including a credit card, personal loans but not a PCA.

128. In December 2008, Tesco PLC acquired RBS's 50% shareholding in TPF. In order to continue servicing its customers without the support of RBS, it had to establish the necessary business functions (including finance, risk management, treasury, etc), and acquire the required physical infrastructure (eg buildings for its operational teams). In October 2009, TPF was rebranded and changed its trading name to Tesco Bank.

129. To remove its dependency on RBS, Tesco Bank needed to build a stand-alone IT infrastructure, before embarking on a major customer migration project. This process took three and a half years and cost £[✂]. The migration project was staged in three parts: general insurance followed by savings and loans and concluded with credit cards (in May 2012).

130. Tesco Bank launched a PCA in June 2014 which added to its range of other banking and insurance products for personal customers in the UK. Figure 12 shows Tesco Bank's main products with launch dates, as well as key events since 1997.

Figure 12: Tesco Bank – product launches and key events



PCAs. This included, for example: suppressing interest and charges for three months following the opening of a new PCA and annual reminders to how customers can switch. Due to the additional time required to achieve compliance with the NI Order, a decision was taken by Tesco not to include Northern Ireland in the initial launch.

1998 JV gets its own bank licence; Home Insurance	**2000** Motor Insurance	**2008** Tesco Bank buy-out of RBS' share in JV	**2010** Third Party Gift Cards Fixed Rate Saver	**2014** PCA

Source: Tesco Bank.

131. Since 2009, Tesco Bank's strategic direction was to be a bank which provided customers with a full range of personal banking services, and the development of a PCA was seen as the key element of this strategy. Given its focus on personal banking, it stated that offering banking services to SMEs was not part of its long-term plan.

132. At the end of the financial year 2013/14, Tesco Bank reported assets of £[✂] and customer deposits of £[✂] (Table 3).

Table 3**: Assets and deposits (2013/14)**

[✂]

Source: Tesco Bank.

Tesco Bank's PCA launch

133. Tesco Bank viewed a PCA to be the key relationship product for customers, and its decision to launch a PCA was driven by the natural progression of its business to meet the full financial needs of Tesco Bank customers. It stated that:

> A major step towards delivering banking credibility for Tesco Bank will be established when we successfully launch current accounts and are able to provide a fuller banking relationship to Tesco loyals … Current account provides a deeper understanding of a customers['] financial situation – allowing the provider to produce better risk analysis, more informed decisions about a customers' suitability for other products and ultimately wider product holding.

134. Tesco Bank had commenced initial research to understand the customer expectations of a PCA while its JV with RBS still existed. Tesco Bank said that once the initial products were launched by the JV, consideration was given to offering a PCA, but the long-term investment required at the time when RBS already had more than 20% of the PCA market share did not make it a priority over other opportunities. In 2010, once the banking IT platforms and operations were fully controlled by Tesco Bank, and most of the data migration from RBS was complete, a new focus was established on what Tesco Bank could offer to customers in the PCA market.

135. Tesco Bank’s objectives for offering a PCA were:

(a) to prove to loyal Tesco shoppers that Tesco Bank was a credible choice for a PCA and wider financial services products;

(b) to build momentum over time as it established a PCA reputation for excellent service and rewarding loyalty;

(c) to provide its customers with high-quality online, telephone and mobile banking services and to offer basic deposit and withdrawal services in Tesco stores; and

(d) to generate income to offset the cost of running its operation and rewarding loyalty.

136. Tesco Bank made the point that [✂] there were tangible benefits of a PCA to the Tesco Bank and the Tesco Group, which included the following:

(a) Broadening the appeal of Tesco Bank by providing a more inclusive choice in terms of how Tesco customers wished to shop at Tesco and earn and benefit from Clubcard rewards.

(b) Issuance of Clubcard points for debit card spend anywhere which was likely to lead to increased spend in Tesco stores when customers used their vouchers.

(c) Incremental sales uplift in stores [✂] from PCA customers.

(d) Net debit interchange benefit of PCA customers paying with a Tesco Bank debit card [✂].

(e) Lower likelihood for customers to lapse in-store loyalty as their engagement increased through ownership of bank products and services.

(f) Greater affinity of transactional (PCA) customers with other retail services, [✂].

137. Tesco Bank also stated that the incremental value to the Tesco group to be generated from cross-selling was in the range of £[✂] cumulative [✂] year contribution.

138. While considering whether to launch a PCA, Tesco Bank considered the product’s contribution at three levels:

(a) Stand-alone value where a PCA would enable it to participate in a large market, and be an anchor product for its customer relationships.

(b) Synergy value to Tesco Bank whereby a PCA could help to establish it as a 'real bank' in customers' minds. A PCA was also seen to help in increasing the potential for multiple product holdings, and improve the customer experience on other product journeys.

(c) Synergy value to the Tesco group by creating increased customer loyalty and increased spending in stores and reduced transaction costs as more transactions moved to contactless payments.

139. The Tesco Bank PCA was launched in June 2014 in Great Britain with the following main features:[59]

(a) Clubcard points on debit card spend;

(b) 3% AER interest on credit balances up to £3,000;

(c) £5 monthly fee, but only if customers deposit less than £750 per month;[60]

(d) online and mobile banking;

(e) UK-based customer service centres which were open 24 hours a day, seven days a week; and

(f) ability to make deposits and withdrawals at 305 Tesco stores.

140. Table 4 shows that [✂].

Table 4: Tesco Bank PCA – forecast and long-term plan (LTP)

[✂]

Source: Tesco Bank.

141. Figure 13 shows that [✂]

Figure 13: Depreciation expense projections

[✂]

Source: Tesco Bank.

142. Tesco Bank estimates the net present value (NPV) of an individual PCA to be [✂], but expects other benefits from the product in the form of lower cost of funds and cross-sell opportunities, and plans to review its forecast NPV per account as it acquires more customers. Tesco Bank stated that given the

[59] More details of Tesco Bank's PCA are provided in Annex F.
[60] Tesco Bank announced removal of £5 monthly account fee with effect from 17 September 2015. Source: Tesco Bank website.

scale of (sunk) investment (mainly IT and promotion costs) required to launch and promote its PCA, it expects to break-even [✂] after launch [✂].

Strategy and business model

143. Tesco Bank told us that its strategy was to be the bank for Tesco customers where it rewarded their loyalty and earned their trust. Tesco Clubcard is central to how Tesco recognises and rewards loyalty: it offers points on debit and credit card spend, mortgage repayments, and discounted pricing for Clubcard customers on Car and Home Insurance.

144. Tesco Bank told us that it had designed its PCA strategy and product offering to appeal to those customers:

   (a) who were happy not to have a face-to-face relationship with their bank since it determined that there was a sizeable customer appetite for a direct (branchless) proposition;

   (b) who wanted a simple and transparent product, providing the payment and account servicing capability that were 'hygiene factors' for a current account, whilst allowing customers to take control and self-service where possible;[61]

   (c) who wanted to be in control of their finances, avoid excessive charges and receive texts or emails to let them know when they needed to pay in or to confirm action taken on their account; and

   (d) who wanted their bank to recognise them with ongoing rewards for doing their everyday banking.

145. Tesco Bank's research indicated that customers' overriding requirement of a current account was that it 'just worked'. This meant that customers did not want to spend time on their banking and wanted to be confident that their bank would take care of their money management needs.

146. Tesco Bank's research also found that there was a high level of 'emotional trust' (belief that a bank will do the right thing) in Tesco Bank but that customers had a 'higher transactional trust' (belief that a bank can do things right) in the existing banks. This made it challenging to persuade customers to move their PCA to Tesco Bank even if they did not feel valued or rewarded by their existing bank.

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[61] The term 'hygiene factors' is usually used to refer to factors which do not give positive satisfaction but if absent can cause dissatisfaction.

147. Tesco Bank stated that the differentiation and appeal of its PCA was the provision of points for the loyalty of its customers. As it put it:

> The target proposition is a fully functioning Tesco Bank current account that rewards ongoing loyalty, has a simpler approach to fees and charges and offers feature rich servicing options … The proposition is differentiated in areas that hold significant appeal to Tesco loyal customers and are difficult for our competitors to replicate, in particular the areas of convenience and reward.

148. Tesco Bank told us that its PCA was designed to fit with its strategy 'to be the bank for Tesco Bank customers'. It also mentioned that 'The customer segments and target market for the Tesco Bank current account proposition are young adults, young families and older families, typically those who are poorly served by current competitor offerings and have demonstrated a strong affinity to our proposition.' Tesco Bank believed that those customers who already had other banking services (eg credit card) with them would be more receptive to its PCA than non-Tesco Bank customers.

149. Accordingly, Tesco Bank developed a targeting model to identify which Tesco Bank customers should be targeted based on the customer insights described above. [✂] Tesco's defined target market is shown in Figure 14.

Figure 14: Target market

[✂]

Source: Tesco Bank.

150. Based on the expected rate of PCA take-up from this target market, Tesco Bank's initial expectations were to gain about [✂] PCA customers ([✂]).

151. Tesco Bank's primary channels from a (PCA) customer acquisition perspective are as follows:

   (a) Above-the-line (television, outdoor and press) marketing: to reach out to customers in the switcher market that could be overlooked by direct channels.

   (b) In-store: Tesco Bank leverages the large store network primarily to raise consumer awareness of its PCA among Tesco shoppers.

   (c) Direct: Tesco Bank uses targeted mailing to Tesco Clubcard holders and Tesco customers using its insight and segmentation models.

   (d) Online: Tesco Bank has invested in search engine optimisation and implemented high-quality, easily accessible information on its website.

(e) Mobile Banking App: which can be used to send messages, and be a customer servicing platform.

(f) Public Relations: From January 2014 onwards, Tesco Bank engaged in a dialogue with journalists in the lead up to the PCA launch.

152. Tesco Bank stated that although its existing customers were always going to be its primary target market segment, with more than 20 million Tesco customers to reach, above the line – particularly television advertising – was the most effective and wide-reaching channel for building awareness of a new product with this customer group. Tesco Bank also made the point that whilst its PCA was designed with the needs of Tesco shoppers in mind, it expected the product to have a broader appeal, especially as it further developed its PCA product range.

Performance so far

153. Figure 15 shows growth in the number of Tesco PCAs since launch. [✂]

Figure 15: Number of PCAs

[✂]

Source: Tesco Bank.

154. Tesco's forecast and actual performance for PCA applications, new accounts and costs per account opened in the first year is shown in Table 5.

Table 5: Key performance indicators – Year 1

[✂]

Source: Tesco Bank.

155. [✂]

156. Tesco Bank stated that based on the experience gained since the launch of its PCA, it was planning to make improvements to the application and account opening process in order to enhance the customer experience. It was also planning to review its product range to serve more customers. Tesco Bank mentioned that:

> As such, our future product map will consist of a broader suite of products which will more than likely be segmented to meet the needs and desires of a wider range of customer, from lower affluence through to a more value adding higher affluences segment type.

157. As per Tesco Bank's latest PCA forecast shown in Figure 16, it expects to have about [✂] PCAs by year [✂].

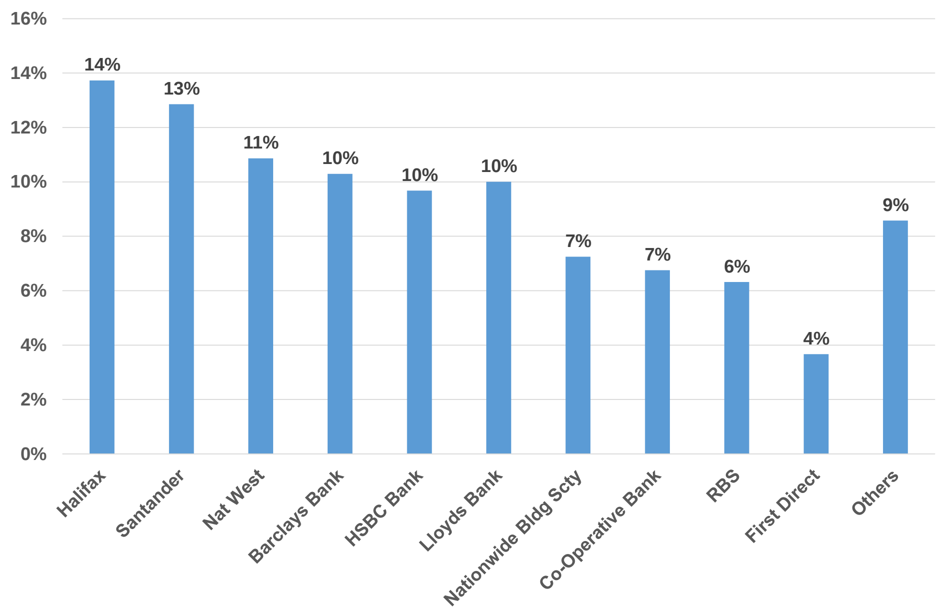
Figure 16: Forecast – PCA stock

[✂]

Source: Tesco Bank.

158. Tesco Bank told us that it was too soon to determine reliably particular customer characteristics, demographics and the source of its new accounts. Some of the new accounts (around [✂]%) included a full or partial switch via the current account switch service (CASS), which provided it with some information on the source of new customers. It stated however that it could not yet draw any firm conclusions from this data and its ongoing analysis would help to determine any notable trends. Tesco Bank's analysis of customers switching via CASS for the period July 2014 to January 2015 is given in Figure 17 which shows that it is gaining customers from many established PCA providers.

Figure 17: Tesco Bank PCA – sources of switchers



Source: Tesco Bank.

Barriers to entry and expansion

Regulatory requirements

159. Tesco Bank obtained its banking licence in June 1998 under the JV with RBS, and does not consider that the hurdles to get this licence were overly burdensome. It was not required to become authorised to launch a PCA since it already had the required permissions in place. Tesco Bank said that as part

of launching the PCA, it held a number of discussions and engagements with the regulators, but did not face any significant regulatory obstacles.

160. Tesco Bank had to hold £[✂] million in additional capital against the risks associated with the launch of its PCA. [✂][62]

161. Tesco Bank stated that during the development of its PCA offering, there were a number of regulatory changes which impacted the complexity and cost of the product development, and also led to a modest delay in Tesco Bank's launch of a PCA. As examples, it cited the introduction of CASS and the transfer of consumer credit regulation from the OFT to the Financial Conduct Authority (FCA), but did not consider these as significant competitive disadvantages.

Access to payment systems

162. Tesco Bank is an indirect (agency) member of the interbank payments schemes (such as Bacs, CHAPS, Faster Payments Service (FPS)), and the Cheque and Credit Clearing Company (C&CC)) through [✂]. It made the point that its ability to offer the same level of service as banks directly accessing the payment systems could be limited. As Tesco Bank put it: 'In practice, connecting to the UK interbank payment systems through a competitor means that the payments services we offer customers can be no better than our sponsor bank and, as we have experienced, a lesser offering in a number of instances'.

163. Tesco Bank told us that while the introduction of faster payments had been beneficial for its customers, agency banks were unable to process payments in real-time 24x7, making them less responsive to the customers' needs than banks with direct access to the payment networks. It also stated that this situation was exacerbated by the development of additional 'overlay' services utilising the faster payments infrastructure – such as Paym[63] – which further exploited the asymmetry in real-time payments processing capability between agency banks and those accessing the UK interbank payment systems directly.[64]

164. Tesco Bank stated that the direct members of the interbank payment schemes were notified in the event of either scheme-wide issues or in the

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[62] [✂]
[63] Paym allows customers to make payments to account holders of other participating banks or building societies using their mobile number.
[64] Tesco Bank provided an example where its sponsor bank used Swift NET to transmit payments and since Swift gateways were closed for maintenance between 16:00 Saturday and 06:00 Sunday, no faster payments to/from Tesco Bank could be transmitted during this time. This, according to Tesco is an example of situations where it is unable to provide services, which other sponsor banks may be able to offer to their customers.

case that a particular scheme member experienced difficulty. For FPS, this notification was supported by real-time Unsolicited Messages (USMs). Tesco Bank told us that being an indirect member, it did not receive notification directly from the scheme and could not receive USMs, and was therefore reliant upon its sponsor bank for such notifications.

165. Regarding the costs of accessing payment systems, Tesco Bank told us that it paid a cost premium for accessing payment systems through the agency relationship. [✂]

166. Tesco Bank also made the point that direct members paid for the direct costs of running the interbank payment systems. These included the scheme operators' infrastructure, staff and administration costs, which were apportioned according to the direct member's share of transactions. It stated that Agency banking, on the other hand, was a commercial service, and the providers of these services recovered direct costs and generated a commercial return from providing such services.

167. Tesco Bank believed that the prices being charged of the agency banks reflected the concentrated nature of the service provision within the market and the high costs of switching provider.

IT systems

168. Tesco Bank told us that the development of IT infrastructure necessary to support its PCA offering was both complex and costly. At the point of taking full control of the business from RBS in 2008, Tesco Bank had none of its own IT infrastructure or applications to support its banking products. In order to remove its dependency on RBS, it acquired and built a number of IT components before migrating the existing customer base to its own system.

169. To develop a PCA platform on top of its existing IT infrastructure, Tesco Bank needed to enhance and extend the capability of many internal and external applications, and build and acquire a number of new infrastructure components.

170. Tesco Bank said that the transactional nature of a PCA (compared with, say, savings and loans book) meant that it had to substantially increase the processing speeds for a number of different payment types.[65] In order to minimise the disruption to existing customers of Tesco Bank, an extensive process was required to implement the new processes as part of its IT

[65] For example, card transactions processing were uplifted to process 30 times more transactions than Tesco Bank was processing pre-PCAs, and BACS payments 70 times faster.

systems. In summary, the development of Tesco Bank's PCA IT infrastructure involved:

(a) approximately 15,000 man-days on design and build;

(b) 5,218 requirements being met;

(c) 89 detailed design packs written and delivered;

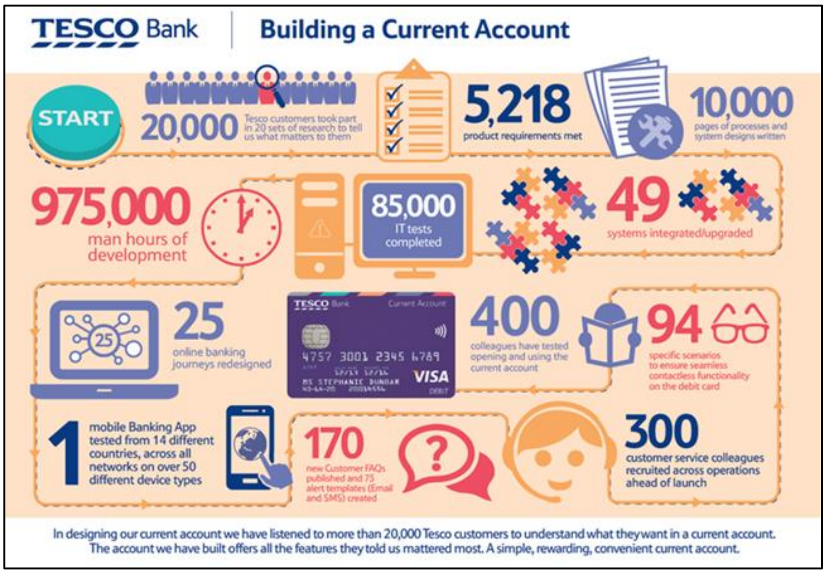
(d) 49 systems integrated/upgraded;

(e) 67,388 system integration tests completed; and

(f) 3,300 user acceptance tests completed.

171. Figure 18 illustrates the scale of the effort involved in building Tesco Bank's PCA.

Figure 18: Development of Tesco Bank's PCA



Source: Tesco Bank.

172. The development of Tesco Bank's PCA programme required investment of £[✂] million over [✂] years. [✂][66] Tables 6 and 7 show the details of the investment to support Tesco Bank's PCA development, by spend category and by functional work streams.

Table 6: PCA programme costs by year and major category

[✂]

Source: Tesco Bank.

[66] Tesco Bank told us that during the design, build and testing of the PCA proposition, resources and spending were not limited to the PCA in isolation. Much of the testing was to ensure enterprise wide reliability for existing customers while a range of deliverables included in the PCA launch had a benefit beyond purely the PCA.

Table 7: PCA programme costs by business and IT work streams

[✄]

Source: Tesco Bank.

173. Tesco Bank stated that in addition to the above programme costs, an additional £[✄] million per year had been added to its existing IT support costs as a result of launching the PCA. Tesco Bank told us that the complexity (and the cost) of developing the IT infrastructure to support its PCA was compounded due to the need for the IT platform to be placed on top of an existing set of systems, and the need for it to also support Tesco Bank's other products and customers rather than being built in isolation.

174. Tesco Bank made the point that it would be an easier task and would require less investment for a new bank with no existing products, customers and systems to put in place the necessary capabilities and IT system to launch a PCA with robust online, mobile and telephone banking propositions and services.

Need for branch network

175. Tesco Bank's PCA is mainly an online offering but it told us that it had also experimented (pre-PCA launch) with different in-store branch formats and locations with little consumer usage, and remained open minded to assessing customer demand for different models.[67]

176. Tesco Bank told the OFT in 2013 that 'Given our stores' footprint and their customer footfall, we have no interest in branch networks for sale or emulating those buying them. The overwhelming feedback from our customers is that they want a banking service which is convenient, easy to use and is available when it most suits them.' In a similar message, Tesco Bank said, in its response to the CMA's consultation on a potential market investigation reference for retail banking, that 'We believe [however], that the historically strong correlation between the number of branches a provider has and their PCA market share is breaking down'.[68]

177. Tesco Bank believed that whilst a branch network might still be important for a certain market segment, there continued to be a migration away from branches and towards digital channels. Tesco Bank stated that it had achieved considerable scale in certain products – such as credit cards and

[67] Tesco Bank told the CMA that its PCA was developed while taking consideration of the shift in customer behaviour towards digital channels, and it had not conducted research into alternative business models.
[68] Tesco's Bank's response to the CMA's consultation, 2014, Answer 1d.

personal loans – by pursuing an online and telephone-based strategy, and while developing its PCA proposition, it determined that there was a sizeable customer appetite for a direct (branchless) proposition that was only likely to grow.

178. Tesco Bank stated that as it developed its PCA offering, it recognised that some customers valued the convenience of being able to deposit and withdraw funds face-to-face. It has provided the facility to PCA customers to take advantage of the deposit and withdrawal functionality at some of its stores across the UK.[69] However, Tesco Bank stores do not in general, operate like a bank branch, and it mainly makes use of the Tesco store network to raise consumer awareness about its banking products. In-store deposit and withdrawal capability for bank products is limited to its PCA and Instant Access Savings Accounts, and to only 305 of Tesco's 3,378 UK stores (see the map in Annex E).

179. Tesco Bank also operates three bank branches at its stores in Edinburgh, Coventry and West Durrington.[70] However, the technological capability in these branches is limited, and there is no connectivity to back office systems. The service in these branches mirrors the online customer experience but with staff available to support customers. Tesco Bank told us that most customers visited these branches to purchase foreign currency.

180. Tesco Bank made the point that its PCA was very much a direct, predominantly online account. Therefore, its limited in-store facilities were not intended to be a like-for-like offering with a branch network. Tesco Bank believed that its strong digital capabilities, coupled with some basic deposit and withdrawal facilities in store, would allow it to provide a strong service offering to its customers which would also be cost-effective. However, it planned to continue to assess whether its PCA proposition met its customers' needs, and review the offering and servicing channels accordingly.

181. Tesco Bank noted that the benefits of a branch network were heavily influenced by a bank's starting point: while for larger banks with an extensive physical estate, closing branches reduced cost significantly, for new entrants, opening branches added significant costs to their expense base. Similarly, Tesco Bank stated that any existing bank with a large customer user base that closed a traditional branch to open a smaller physical space in a retail

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[69] Tesco Bank told us that these stores were predominately larger format stores with the exception of small formats in outlying geographical locations.
[70] Tesco Bank stated that this was part of it testing approaches to in-store banking. These were selected based on their location, size, customer demographic as well as the availability of space in these stores. The services available at these branches are: account opening, deposit and withdrawal facilities for cheque and cash and account enquiries.

environment would be reducing its operational costs. Tesco Bank believed that given the direction of travel in the market, its approach of offering primarily an online PCA was an appropriate starting point.

Brand awareness and advertising

182. Tesco Bank told us that its consumer research had referred to two types of trust in a brand: ‘transactional trust’ – the belief that the account would do what it said it would, and ‘emotional trust’ – the belief that a provider would act in the interests of its customers. It believed that the nature of a PCA was such that transactional trust was paramount and therefore customers favoured established brands with scale and experience in this market.

183. Tesco Bank made the point that it had been able to establish itself in financial services by leveraging the strength of its brand. It believed that for a new entrant without any existing customers or brand recognition, it would be more difficult to enter the PCA market and gain consumer acceptance.

184. Tesco Bank also stated that new entrants into the PCA market needed to make significant investment in marketing and promotion in order to grow brand awareness and consideration.

185. To grow its share of brand awareness and consideration, Tesco Bank decided to support the launch of its PCA by giving more weight to above the line (mainly through TV) promotional strategy for the short to medium term.[71] Table 8 shows the distribution of Tesco Bank’s Year 1 PCA marketing budget across different marketing channels.

Table 8: Year 1 PCA marketing budget by channel

[✄]

Source: Tesco Bank.

186. Tesco Bank told us that its approach towards marketing and promotional spend and the primacy of above the line advertising was largely in line with the approach taken by other PCA providers in the market, as is shown in Figure 19.

Figure 19: Spend on PCA marketing

[✄]

Source: Tesco Bank.

[71] Above-the-line promotion involves the use of advertising to reach a mass audience. It uses media such as television, cinema, radio, print to promote brands or convey a specific offer.

187. Despite having a well-known brand name, Tesco Bank believed that it needed to invest in building awareness of its PCA proposition and capabilities. The need to promote the PCA appeared to reflect the challenges it anticipates to overcome the 'transactional trust' barrier which means that established brands dominate. Tesco Bank expected its PCA marketing budget to normalise around £[✂] million per year.

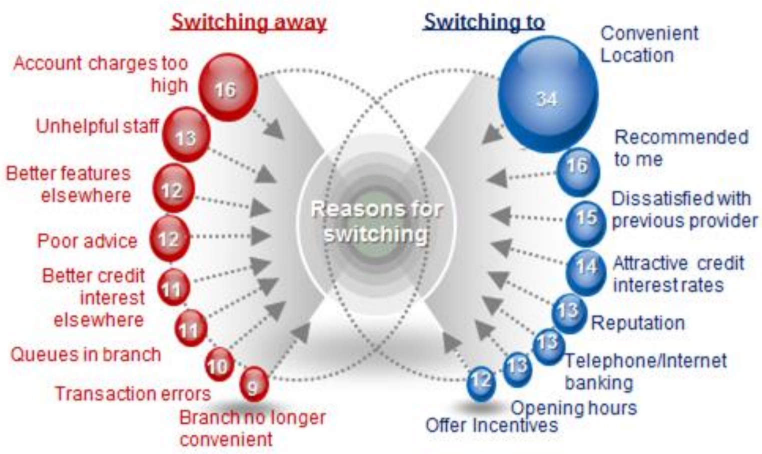
Customer acquisition and retention

188. Tesco Bank pointed out that that its market insights drew out a linkage between customer satisfaction, service quality, and retention (see Figure 20):

(a) For those who do switch, 'push' rather than 'pull' factors dominate.

(b) Not feeling valued, high charges and poor customer service are the most frequent triggers for leaving a provider.

Figure 20: Factors facilitating switching



Source: Tesco Bank.

189. Tesco Bank mentioned the following challenges faced by it as a new entrant, in trying to acquire customers:

(a) Lack of transparency and comparability in the market – Tesco Bank believed that there were issues with transparency, complexity and comparability of PCA product offerings making it harder for customers to shop around.

(b) Use of loss-leading pricing and incentives, which could be used by larger banks to grow market share, usually in combination with aggressive marketing investment.

(c) 'Free if-in-credit' model – Tesco Bank believed that this model created a barrier to entry which was very difficult for new entrants not to conform to,

in order to compete. It had made a similar point in its response to the CMA's consultation on a potential market investigation reference for PCA and SME banking services stating that, '…the perception that your PCA is "free" is a key contributing factor to the lack of customer engagement in assessing the value they derive from their account.'[72] Tesco Bank stated that this barrier was heightened by larger banks which were able to support competitive new business offerings at the expense of their existing customers. Tesco Bank [✂] decided to enter the market with a £5 monthly fee which is waived if a customer deposited £750 a month.[73]

(d) Lower cost of funds for larger banks: Tesco Bank mentioned that larger banks paying high rates of credit interest on new business had significant current account and savings deposits in place that they were paying little or no interest on. This, according to Tesco Bank, meant that the larger banks' cost of funds mix would be lower than for new entrants, which did not have such back books.[74]

190. Tesco Bank noted that whilst initiatives such as CASS were starting to make an impact, the scale was still modest. It believed that more needed to be done to promote the service, and without additional promotional investment, it was unlikely that CASS would achieve its full potential as an enabler of competition in the PCA market.

191. Tesco Bank did not anticipate any customer retention issues since it believed that its PCA had been designed to meet customer needs, and offered an all-round proposition including credit interest, Clubcard rewards and a convenient account.

Conclusions

192. It appears that the development of an IT infrastructure was the main obstacle to Tesco Bank's launch of a PCA. It took about three years and a significant investment for Tesco Bank to build a PCA IT platform on top of an existing IT system.

193. Although Tesco Bank has launched a PCA, [✂] it is uncertain if it will be able to challenge the larger banks in the near future. The main factors identified for this limited scale are customer acquisition costs and inertia. As Benny Higgins, Tesco Bank's Chief Executive, recently remarked: 'I think that we can

[72] Tesco Bank's response to the CMA's consultation, 2014. Answer 1c.
[73] [✂]
[74] Tesco Bank pointed out that over time, as base rates climbed, this dynamic would alter as easy access savings rates became more competitive against current accounts.

aspire to be a significant player but I think the nature of the market means it will take time … I think the current account is going to be a long burner.'[75]

TSB's experience of entry

194. The TSB Banking Group plc (TSB) business comprised assets divested from Lloyds Banking Group (LBG) as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS.

195. When it entered the market in 2013, TSB possessed assets that other entrants did not: it owned over 600 branches (a 6.1% share of all UK bank branches), had 4.1% of the personal current account (PCA) market and retained access to the LBG IT platform. However, it faced the same potential barriers to expansion as other banks, in particular customer acquisition, including by persuading customers of other banks to switch to it.

196. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of market flow[76] and added over 200,000 PCAs to its stock. We considered that this indicated TSB had not encountered insuperable barriers to expansion.

197. However, TSB put it to us that its performance in 2014 does not necessarily equate to it having a meaningful and lasting impact on the competitive dynamics of the sector in the future as:

    (a) rising costs resulting from the terms of its arrangements with LBG, in particular regarding the cost of the shared IT platform and the ongoing reduction of other, temporary profitability enhancements put in place following the recommendations of the OFT in September 2013 could constrain the amount it could afford to invest in customer acquisition in subsequent years; and

    (b) PCA customers that TSB acquires from other banks may take several years to become profitable.

198. Subsequent to these submissions TSB reached an agreement on an offer from Banco de Sabadell to buy all of the shares in TSB Banking Group plc. Should the transaction complete it is Sabadell's intention to migrate TSB customers across to its own proprietary in-house IT platform which it

[75] Reuters (11 February 2015), Tesco Bank to grow current accounts market share – CEO.
[76] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock'.

anticipates would deliver £160 million per annum in cost savings in the third full year following completion of the acquisition.

Introduction

199. In our statement of issues we set out three hypotheses, or 'theories of harm,' for investigation. Our third theory of harm was that there may be barriers to entry or expansion in the retail banking market leading to worse outcomes for consumers. We said that our analysis will in the first instance look at a selection of case studies of past entry and expansion (successful and unsuccessful). Here we examine TSB's experience of entry and expansion into retail banking, with a particular focus on its PCA products.[77]

200. At the time the business was launched TSB possessed assets the absence of which have been considered in past investigations to constitute barriers to entry or expansion and which other subjects of our case studies lacked. TSB owned around 6% of the UK banking branch network, had the authorisations and licences necessary to carry out a banking business and had an established and familiar brand name. It also began life with a share of the PCA market of just over 4%.

201. On the other hand it lacked advantages enjoyed by other entrants, such as a purpose built, modern IT platform, and it faced the same potential obstacles as all new entrants: in particular a low propensity of consumers to switch PCAs, sometimes characterised as 'consumer inertia'.

202. The main purpose of this case study is to set out and assess the relative importance of these factors in shaping TSB's performance in the PCA market and the extent to which they can be considered barriers to entry or expansion.

203. We begin by explaining the circumstances that led to TSB's launch. We then describe its PCA strategy, how this fitted into its overall business strategy, how successful TSB has been in acquiring and retaining PCA customers and the reasons for this. Finally we consider the extent to which TSB's experience suggests the presence of barriers to entry or expansion in the retail banking market.

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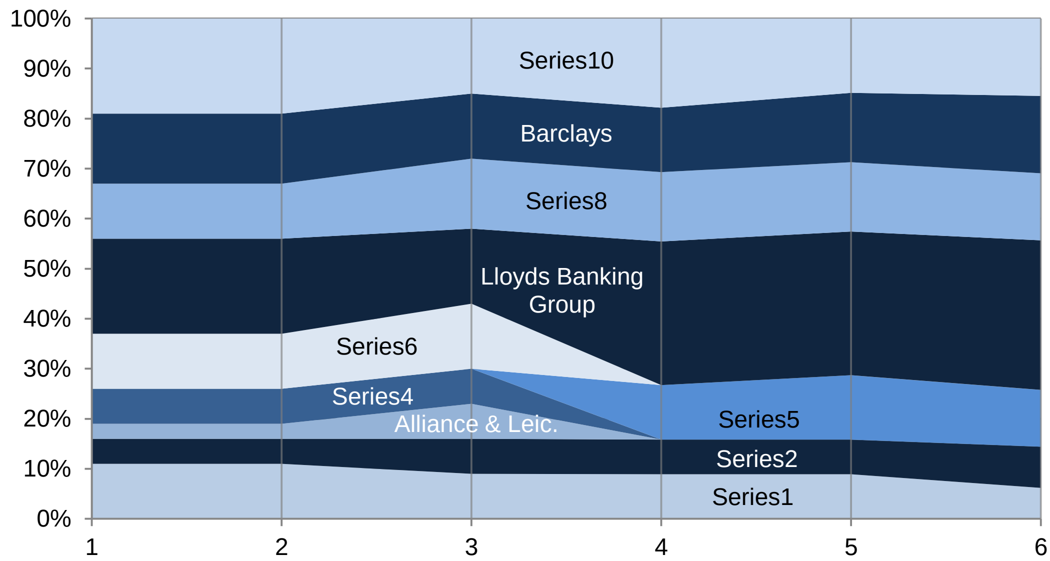
[77]TSB told us that the main focus of its business strategy was the consumer sector and growth of the business current account business was not seen as a strategic priority. It said that the profile of its SME customers was weighted towards the smaller end of the segment with sole traders representing 40% of its business customers and clubs and charities almost 30%. Reflecting this it said that its share of the business lending market was less than 1%. (Response to SME questionnaire, Q5).

Background

The Lloyds TSB divestiture

204. The TSB business comprised assets divested from LBG as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS. The merger's effect on concentration in the retail banking market, and the combined entity's relative share, can be seen in the chart below.

Figure 21: Market shares for the largest PCA providers, 2007 to 2012, Great Britain



Source: Office of Fair Trading (OFT), State Aid Divestments by LBG and RBSG, Economic Advice, paragraph 49.

205. Lloyds TSB and HBOS, already large banking institutions, merged amid serious concerns that HBOS would collapse without some form of external support. In the event, even this merger proved insufficient and the enlarged banking group required an injection of £20.6 billion[78] in taxpayer funds. This intervention gave rise to EU concerns as regards state aid and its impact on competition.[79]

206. In its analysis the European Commission noted that the combined entity had a large market share of PCAs (20 to 30%[80]) and that in Scotland it was even

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[78] State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 178.
[79] TSB submitted that these concerns were limited to addressing the distortions to competition brought about by the UK government's support for LBG and that it was not the Commission's intention to create a scale challenger which would provide a disruptive competitive presence in the market. We do not agree entirely with TSB's analysis since we consider that the EC did take account of the fact that LBG had eliminated a 'challenger bank' and that the objective of the divestiture was to recreate 'a viable business in the future that can compete in the retail banking business in the UK' (paragraph 185).
[80] The non-confidential, version of the Commission's analysis used ranges to indicate market shares.

larger (40 to 50%). It said that Lloyds TSB's share of the PCA and mortgage markets had been strongly reinforced by the acquisition of HBOS, which had had a share of 10 to 20% and 20 to 30% of these markets respectively.[81] In addition, the Commission noted that not only had the acquisition allowed LBG to increase its market share, particularly in PCAs, it had also allowed it to 'eliminate a challenger in particular on certain segments of the market which were already concentrated and featured low switching rates among customers.[82] Consequently, measures are necessary in order to remedy this distortion of competition which had been created by the aid'.[83]

207. To address the Commission's concerns LBG was required to create and divest a ring-fenced business entity (code-named 'Verde') with assets of between £51 billion and £70 billion.

208. Verde was to consist of:[84]

(a) the TSB brand;

(b) the banking licence of Lloyds TSB Scotland;

(c) the Intelligent Finance business and brand;[85]

(d) the branches, including the banking business associated with all customers and all branch employees, of Lloyds TSB Scotland;

(e) the Cheltenham and Gloucester (C&G) branches and branch employees, all C&G savings accounts and those C&G mortgages associated with branch-based customers;

(f) supplementary branches and their branch business, selected by LBG, which:

(i) numbered at least 600;

(ii) together with the other branches and their business comprised at least a 4.6%[86] share of the PCA market;

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[81] State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 179.
[82] ibid, paragraph 181. A footnote makes clear this refers to the PCA market.
[83] ibid, paragraph 181. It concluded that absent the state aid, the merger would not have taken place and that, consequently, measures were necessary in order to remedy this distortion of competition created by the aid as well as the moral hazard created. See paragraph 182).
[84] As set out in European Commission, 2009, State Aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group. Further detail on the package was contained in the Term Sheet setting out the commitments of the UK authorities (paragraph 97, ibid).
[85] An online and telephone bank offering current account, mortgage and savings customers.
[86] The EU originally envisaged a divesture package equivalent to a 10% market share but this was opposed by HM Treasury, which argued that on the basis of previous OFT investigations, a 5% share would be a sufficient

(iii) resulted in the average retail income per retail customer being not less than the average retail income of LBG;

(iv) had a ‘reach’ of at least 43%;[87]

(v) resulted in the average gross ground floor space of all branches in the divested business being at least 220m^2.

209. LBG, in pursuit of a trade sale, committed to approaching potentially interested and suitable[88] buyers by 30 November 2011 and to completing the divestiture by 30 November 2013. If the disposal through a trade sale had not been completed by that date, the government said it would appoint a divestiture trustee to oversee the sale at no minimum price. LBG was also permitted to dispose of the business through an initial public offering (IPO).

Responses to the proposed divestiture

210. The Independent Commission on Banking (ICB)[89] expressed concerns over the size and nature of the Verde package. Its report concluded that a substantial enhancement of the proposed LBG divestiture provided the best opportunity to improve the structure of the PCA market and was the most cost-effective way available to ensure the emergence of a strong new challenger. It said this should be effected by ensuring that the entity resulting from the divestiture had a strong funding position and sufficient scale.[90]

211. On the former, it said that a strong challenger required a sound funding position, both in terms of the amount of wholesale funding it needed to raise, and the price at which it could access such funds. With a weak funding position relative to its peers a bank would be unable to be a strong challenger because:

(a) it would have an incentive to shed loans in order to reduce its reliance on wholesale markets, rather than competing hard to lend; and

(b) its cost of funding would be higher, making its customer offerings more expensive generally.

212. The ICB said that to be considered as having a stronger funding position, Verde’s loan-to-deposit ratio should be better than its, then, 200% and

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opening base for a challenger and that a 10% share could reduce the incentive of the new entity to acquire new customers aggressively. (HM Treasury, *Effective Challengers in UK Retail Banking*, 8 September 2009.)

[87] ‘Reach’ was defined as the proportion of the GB population that lived within 2 miles of a branch.

[88] The buyer was to have no more than 14% of the PCA market after acquiring the divestiture, for example. See State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 190.

[89] For the background to the establishment of the ICB or ‘Vickers’ Commission see GOV.UK.

[90] *Independent Commission on Banking. Final Report* (2011), paragraph 8.13.

comparable with particular banks it listed in its report, which varied between 98 and 148%.[91]

213. As regards scale, it said that to have the best possible chance of becoming a strong, effective challenger, the entity resulting from the divestment should have at least a 6% share of the PCA market.[92]

214. Evidence from the previous decade, it said, showed that small banks (below 5% PCA market share) on average had grown only slowly, with an average annual growth in market share of 0.07%. Banks with a PCA market share of between 5% and 12%, it said, grew significantly more quickly, with an average annual growth in market share of 0.34%, though it noted that given the relatively small number of challengers, this number was drawn from a small sample. Above 12%, banks begin to act as incumbents as their incentives changed with their market shares.

215. It said that with a PCA market share of 4.6% Verde was on the borderline of sub-scale banks that had failed to grow significantly in the past and was smaller than most previous challengers over the past decade, as measured by PCA market share.[93]

216. Finally, the ICB noted that this enhancement in PCA share could either be achieved by the acquisition of Verde by a bank whose existing PCA share would bring the new entity's total share to above 6% or, were Verde to be sold via an IPO, increasing the number of PCA accounts divested by LBG. The former scenario seemed possible at this time as a bank, the Co-operative Banking Group (CBG), whose acquisition of Verde would take the combined entity's share of the PCA market to 7%,[94] had emerged as a bidder.

The Co-operative Banking Group bid

217. Following discussions between LBG, CBG and the European Commission, the European Commission indicated in September 2012 that, because of the emerging difficulty in funding the business, it would agree to a reduction in the balance sheet of the divestment business to £23 billion. This compared with the balance sheet implied by the original perimeter of £53–£71 billion, the £71 billion in the Information Memorandum and the reduction to £36 billion agreed by the European Commission in March 2012.[95] Although under the

[91] ibid, Table 8.2, p209.
[92] LBG argued to the ICB that the 6% threshold was inappropriate (Competition Slides for ICB Private Hearing, 20 July 2011). Similar data was presented to the OFT in the context of its advice to the Chancellor on the Verde package (Annexes 4 and 5).
[93] ICB, paragraph 8.22.
[94] House of Commons Treasury Select Committee Report on Project Verde, paragraph 300.
[95] TSB site visit presentation, 5 February 2015, p13.

original perimeter the business met the tests set down by the European Commission to demonstrate profitability, once LBG had entered into exclusive discussions with CBG, CBG sought further profitability enhancements through, in particular, the removal of: high loan-to-value, relatively low yielding mortgage assets; relatively expensive fixed rate deposits; and the Intelligent Finance online and telephone banking business – such that the Verde business's PCA market share fell by 0.3% to 4.3%. Changes to the cost of IT and systems support services from LBG were also discussed, although at this point they were not included in the amended divestment package.[96]

218. However, in April 2013 the CBG withdrew from the process[97] and LBG proceeded to prepare for, with the approval of the European Commission, an IPO of the Verde package.[98] The Verde package, as we have seen, was originally designed to be consolidated with an existing retail bank rather than floated as a free-standing entity. It comprised a smaller share of the PCA market than the original package and fell significantly short of the 6% referenced by the ICB or the 10% originally contemplated by the European Commission. The Chancellor of the Exchequer asked the OFT for its advice on the impact of the divestment on competition in retail and SME banking and whether anything could be done to strengthen competition through enhancing the divestiture package.

The Office of Fair Trading's advice

219. The OFT provided its advice to the Chancellor of the Exchequer on the impact on competition of the LBG (and RBS) divestitures in September 2013.[99] Regarding the scale of the divestitures being contemplated it referred to its own work on PCAs which it said identified effective competitor banks as occupying a market share of roughly 5 to 14% and having a network of around 700 or more branches. It said that such scale enabled banks to offset certain costs and maintain their incentive to compete because of the number of marginal customers they were likely to have.

220. It made a number of recommendations:

[96] TSB Case Study submission, B8.
[97] For a description of the events leading up to the withdrawal of CBG see the House of Commons Treasury Select Committee report on Project Verde.
[98] See: http://ec.europa.eu/competition/state_aid/cases/252285/252285_1558448_89_2.pdf
[99] Letter dated 11 September 2013.

(a) Steps should be taken to ensure that the service agreement (TSA) with LBG, under which it provided TSB with an IT platform, did not allow it to influence TSB's competitive behaviour or impair its profitability.[100]

(b) Measures to provide TSB with a higher income to enable it to invest in its legacy C&G network, possibly through a direct capital injection.

(c) TSB's PCA opening market share should be increased to at least that level foreseen in the original package (4.6%) within two years of the divestment or IPO.

221. HM Treasury and LBG broadly[101] agreed the changes recommended by the OFT.[102] The European Commission indicated in May 2014 that proposals by the UK authorities to amend conditions for the divestment of LBG's UK retail business, in the context of LBG's restructuring plan, were in line with EU state aid rules.[103] On 9 June 2014, the IPO completed with the listing of an initial 38.5% of TSB's shares. TSB was now an independently managed, stand-alone 'challenger' bank,[104] with 4.5 million retail customers,[105] 8,600 staff, 631 branches, £23 billion of customer lending and deposits of £23.3 billion.[106] A further tranche of 11.5% was sold in September 2014 such that LBG owned 50.001% of TSB.[107]

222. We next set out TSB's entry strategy, the extent of its achievements so far and, where relevant, the presence of factors which may have hindered its progress.

TSB's entry and expansion strategy

223. Growing its share of the PCA market was one of three strategic priorities for TSB. Its aim, as set out in the IPO Prospectus,[108] was to grow its share of PCA 'market flow'[109] to at least its share of branches, which was then around 6%, including the C&G branches which were part of the Verde package.

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[100] Internal TSB Presentation, Creating a standalone competitor bank, Anthony Thompson, April 2014, slide 5.
[101] TSB's share of the PCA market was not enhanced to a level closer to 6%, a move which had been strongly opposed by LBG. However, the annual charge for IT platform support was cut by 10% and a monitoring trustee was installed to maintain oversight of the arrangements with LBG. TSB's profitability was enhanced by the transfer of a £200 million mortgage bond and the provision of a £40 million customer acquisition fund. (Source TSB presentation April 2014.)
[102] See news story, 'Office of Fair Trading reports to government on Lloyds and RBS divestments'.
[103] See European Commission press release.
[104] Albeit having a continuing link with LBG via the shared IT platform.
[105] Plus 110,000 'micro' SME customers.
[106] TSB Overview of growth strategy, Presentation prepared for the CMA, 2 December 2014.
[107] In March 2015 LBG agreed to sell 9.99% of its remaining shareholding to Banco de Sabadell, and entered into an irrevocable undertaking in respect of the remaining 40.01%.
[108] P90.
[109] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.' Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.

Capturing 6% of PCA market flow would, it argued, eventually translate into a 6% share of the PCA market overall.

224. The Prospectus noted that the main driver of TSB's growth, along with its re-entry into the mortgage intermediary channel, was its share of PCA flow and associated cross-sales of savings accounts and unsecured lending products to these PCA customers. It said that not only was PCA growth an important enabler of medium-term profit growth it was also a critical enabler of long-term value as PCAs provided a key source of low-risk, low cost liabilities. In addition, the relatively high level of transactions associated with current accounts provided an opportunity to develop the customer relationship and over time meet more of their other banking needs.[110] PCAs, therefore, were both a 'gateway' product, enabling cross-sales of other products, and a low-cost and low-risk source of funding.

225. Its Customer Plan[111] for the PCA market set out its strategy in more detail. It said that while the PCA market was reaching maturity, with around 70 million accounts being held, consumers opened some 5.7 million new accounts each year and these consumers were its target. TSB estimated that switchers (2 million) represented the largest single segment within this group.[112]

226. The plan noted that customers increasingly expected to be rewarded for their loyalty and that just over 11% of current account holders had accounts that paid interest on their credit balances, up from 8% in 2013. It said that one-off incentives such as cashback had been successful but that long-term rewards, such as credit interest, were also becoming more popular.[113] Spend incentives, it said, were becoming more prevalent but their value to individuals was not always clear.[114]

227. TSB stressed the importance of the branch network in executing its plan and we consider its reasoning and the evidence underlying it in the next section of the case study.

The TSB branch network

228. The size and composition of the branch network inherited by TSB, which, as was noted earlier, accounted for about 6% of all retail bank branches in the UK,[115] is shown in the table below. It comprised a total of 631 branches, 164

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[110] TSB Medium Term Plan Narrative, 2014–2018, p12.
[111] TSB Customer Plans – PCA, June 2014.
[112] These comprised both customers using CASS and those switching without using CASS.
[113] The TSB Classic Plus account would offer 5% interest on balances up to £2,000 but, unlike Santander's 1-2-3 account, for example, not cashback on payments.
[114] Customer Plans – PCA, slide 4.
[115] IPO Prospectus, p100.

of which were formerly branded Cheltenham and Gloucester, 185 of which were formerly operated by TSB Scotland and 282 former Lloyds TSB branches in England and Wales.[116]

Table 9: TSB's branch network

Heritage	*Number of branches (freehold)*	*(leasehold)*
Cheltenham & Gloucester	13	151
Lloyds TSB (Scotland)	80	105
Lloyds TSB (England and Wales)	67	215
Total	**160**	**471**

Source: TSB IPO Prospectus, p77.

229. The importance of the branch network in generating PCA sales and the existence of a relationship between its share of branches and its share of the PCA market is a recurring theme in TSB's policy documents.[117] An example of its analysis of this relationship is shown in the table below which suggests an association between TSB's share of branches and its share of flow[118] by country or region. As can be seen, TSB's share of flow was highest in Scotland ([✂]%), where it had its highest share of branches ([✂]%) but lower, and roughly in proportion to its share of branches, elsewhere.[119]

Table 10: PCA and branch share

CACI region	*TSB share of flow*	*TSB share of branches (w/0 C&G)*	*%* *TSB share of total branches*
Scotland	[✂]	[✂]	[✂]
West Midlands	[✂]	[✂]	[✂]
Northern	[✂]	[✂]	[✂]
North West	[✂]	[✂]	[✂]
Yorks & Humber	[✂]	[✂]	[✂]
East Midlands	[✂]	[✂]	[✂]
East Anglia	[✂]	[✂]	[✂]
Greater London	[✂]	[✂]	[✂]
Wales	[✂]	[✂]	[✂]
South West	[✂]	[✂]	[✂]
South East	[✂]	[✂]	[✂]
Northern Ireland	[✂]	[✂]	[✂]

Source: TSB.

230. The underlying reasoning here was that as the majority of new PCAs were sold/opened in TSB branches and as [✂]% of switchers to TSB came through a branch, the higher share of branches TSB had the more likely it was to win

[116] TSB has no branches in Northern Ireland.
[117] Other banks also told us there was a correlation between PCA share and share of branches. See, for example, Nationwide's response to the issues statement, paragraph 2.2(iii).
[118] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.' Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.
[119] The association between total TSB branches and its share of flow is slightly less evident in the South West, for example, where a higher proportion of branches were originally C&G and C&G did not provide PCAs.

the locally available PCA business. Whilst online and mobile were growing in usage, the branch remained the most important channel for opening new accounts and servicing customers.

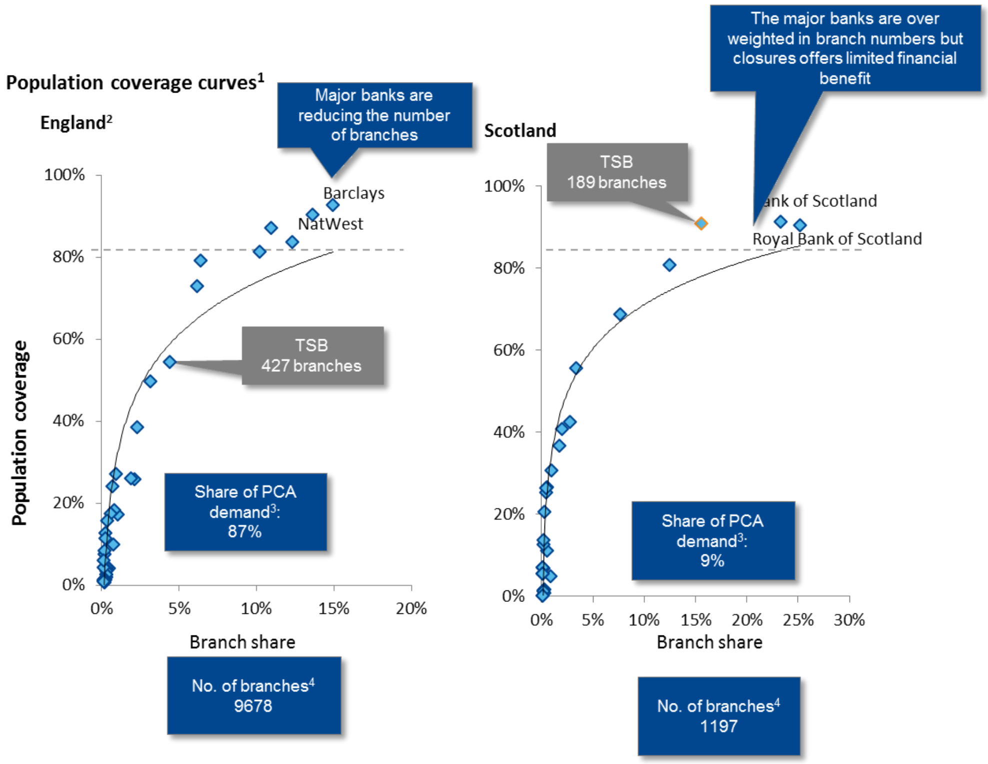
231. Further, as was shown in TSB's consumer research, branch location was an important consideration for consumers who were planning to switch bank accounts. While consumers (other than Lloyds customers) who had decided to switch from their current provider did so mainly (44%) because of bad service, the main reason they gave for switching to TSB (51%) was 'convenient branches'. 60% of switchers from Lloyds cited convenient branches as the reason for switching to TSB.

232. TSB's analysis indicated that the same factors operated as regards traffic the other way: TSB customers (ie those originally transferred to Verde from LBG) switching back to Lloyds. It found that overall just [✂]% of TSB customers who also had an account at Lloyds had switched (back) to Lloyds. However, where a customer's accounts were split between Lloyds and TSB, and the nearest TSB branch was more than 10 miles away and where the customer used a local branch on average once a month, the rate of switching back to Lloyds was ten times higher, over [✂]%.

233. TSB's analysis suggested, however, that the relationship between a bank's share of branches and the proportion of the population that the branch sales channel could address (its 'reach') was not linear: above a certain point the increase in reach achieved by an increase in share of branches began to diminish.

234. In Scotland, for example, TSB said that increasing its reach would require a disproportionate increase in its share of branches. Conversely, a reduction in its share of branches would result in a less than commensurate fall in population coverage. In England, increasing reach would be less costly in terms of growing share of branches. The charts below show TSB's and its competitors' branch market shares in England and Scotland together with the reach of their branches.

Figure 22: Branch share, population coverage and PCA share



Source: TSB.

235. An internal TSB presentation assessed the potential for branch expansion in London and the South East, where it said switching rates were higher and where there were several catchment areas currently unserved by TSB branches. The presentation stated that it would be necessary to open new branches in some areas as 'powering up' the legacy C&G branches would not on its own be sufficient to address the business potential identified. Nonetheless, because of the size of the catchment areas concerned, a comparatively large increase in reach could be accomplished by a relatively limited expansion of the network in Greater London, as illustrated below.

Figure 23: Branch expansion in Greater London

[✂]

Source: TSB.

236. Having considered TSB's strategy we now examine the extent to which it was successful in increasing its share of the PCA market.

TSB's strategy implementation and results

Results overall

237. Between October 2013 and October 2014 TSB achieved a share of flow of around 8%, representing a net gain of around [✂] PCAs, growing its account base by [✂]%. However, because the annual flow represents such a small proportion of the overall PCA stock, this translated into an increase in its share of the PCA market of 0.3%: from 4.0% to 4.3%.

238. These net figures conceal quite large inflows and outflows, with total gains of around [✂] and losses of just under [✂] in the period between October 2013 and October 2014. Early on, TSB suffered losses arising from the departure of customers it had acquired from Lloyds, later on gaining new customers for its interest-bearing PCA. We show the overall pattern of gains and losses in Figure 24.

Figure 24: PCA accounts opened and closed, 2013 to 2014

[✂]

Source: TSB.

239. We next looked at data on the origin and destination of customers who switched either to or away from TSB in 2014, where this was known, and these are shown in full in the table below and for the largest movements in or out in the chart following it (Figure 25).

Table 11: Switchers in and out of TSB, 2014

	Switched in	*Switched out*	*Net*
Lloyds Bank plc	[✂]	[✂]	[✂]
Halifax	[✂]	[✂]	[✂]
Santander	[✂]	[✂]	[✂]
HSBC Bank	[✂]	[✂]	[✂]
Nationwide Building Society	[✂]	[✂]	[✂]
Nat West Bank plc	[✂]	[✂]	[✂]
Bank of Scotland plc	[✂]	[✂]	[✂]
Barclays Bank plc	[✂]	[✂]	[✂]
Royal Bank of Scotland	[✂]	[✂]	[✂]
Co-operative Bank	[✂]	[✂]	[✂]
Clydesdale	[✂]	[✂]	[✂]
Metro Bank	[✂]	[✂]	[✂]
Yorkshire Bank	[✂]	[✂]	[✂]
Tesco Bank	[✂]	[✂]	[✂]
Cumberland Building Society	[✂]	[✂]	[✂]
Handelsbanken	[✂]	[✂]	[✂]
Secure Trust	[✂]	[✂]	[✂]
Bank of Ireland	[✂]	[✂]	[✂]
Lloyds International	[✂]	[✂]	[✂]
NBL T/A Danske Bank	[✂]	[✂]	[✂]
Ulster Bank Limited	[✂]	[✂]	[✂]
Isle of Man Bank Ltd	[✂]	[✂]	[✂]
Reliance Bank	[✂]	[✂]	[✂]
First Trust Bank	[✂]	[✂]	[✂]
C Hoare & Co	[✂]	[✂]	[✂]
RBS One Account	[✂]	[✂]	[✂]
Coutts	[✂]	[✂]	[✂]
Lloyds Private Bank	[✂]	[✂]	[✂]
Adam & Company	[✂]	[✂]	[✂]
Virgin Money plc	[✂]	[✂]	[✂]
JP Morgan Europe Ltd	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

Source: TSB.

240. As can be seen, TSB made its biggest net losses to two LBG banking brands (Lloyds and Halifax)[120] and Santander, all three of which offered PCAs incorporating rewards, for example interest on balances and/or cash on signing up. Halifax and Santander were also major sources of PCA customers for TSB but its largest net source of PCA customers was Barclays, which did not offer an interest-bearing PCA. TSB was also a net gainer from the two other major banks, NatWest and HSBC, neither of which offered an interest-bearing PCA.

Figure 25: TSB main PCA account gains and losses by bank, 2014

[✂]

Source: TSB.

Customer acquisition

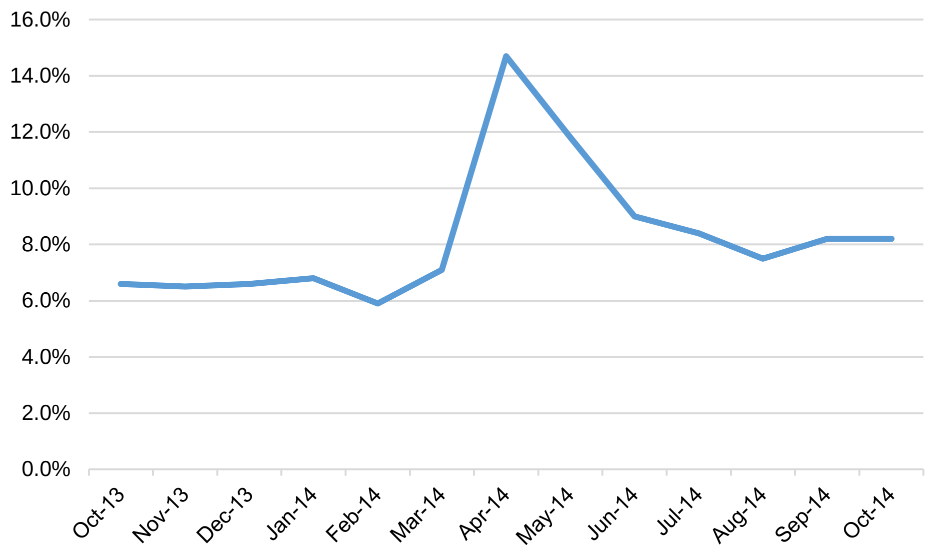
241. In April/May 2014 TSB acquired new customers in large numbers. Monthly volumes peaked at over [✂] in April, driven by the launch of the advertising

[120] Its position versus Bank of Scotland was virtually neutral.

campaign for TSB's Classic Plus product, settling at around [✄] subsequently.[121]

242. The impact of its Classic Plus campaign in April/May 2014 can also be seen in TSB's share of flow. Prior to the campaign, TSB's share of flow was, at around 6%, roughly in line with its plan (and with its share of branches). However, its share of flow more than doubled (to +14%) in April and May, then fell back to around 8%, still considerably higher than its share of the overall retail banking market: TSB was indeed 'punching above its weight.'

Figure 26: TSB share of PCA flow

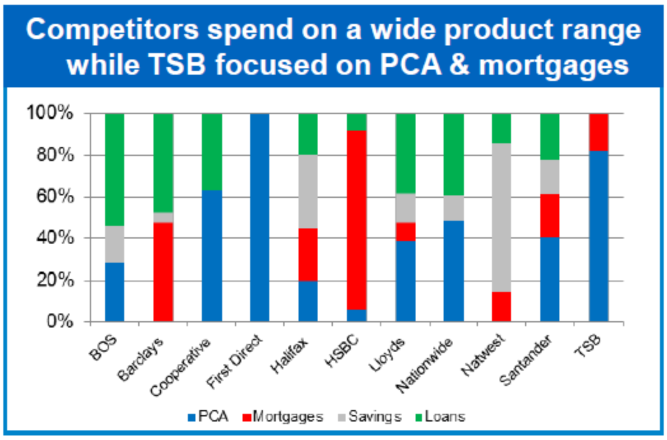


Source: TSB.

243. TSB allocated a substantial advertising budget to this campaign. Its 'share of voice'[122] (SoV) in PCA advertising specifically was very high indeed and almost the same as its much larger rivals whose total advertising expenditure was about double TSB's.[123] In the first half of 2014 TSB spent £[✄] on PCA advertising compared with Santander and Lloyds, which each spent about £8.5 million on advertising their PCAs but which spent twice as much on advertising as TSB overall.

[121] This offered customers 5% interest on balances of up to £2,000.
[122] TSB's expenditure on advertising as a proportion of the sum of its rivals'.
[123] The acceleration and then decline in weekly PCA sales volumes appears to coincide with TSB's television, press and outdoor advertising campaigns which commenced in April and ended in the last week of May.

Figure 27: TSB and competitors' advertising spend by product, January to June 2014



Source: TSB.

Figure 28: Total advertising spend of TSB and other banks, H1 2014

[✂]

Source: BEC Week 1 Update, Marketing and Communications, 5 August 2014.

Customer retention

244. In July 2014, at the same time that its new sales were stabilising, the number of non-Lloyds' switchers out of TSB increased, particularly those switching to Santander and Halifax, LBG's 'challenger bank'.[124]

Figure 29: PCA account holder switching away from TSB, May to October 2014

[✂]

Source: TSB.

245. TSB attributed this to three main factors:

(a) The end of co-servicing in Lloyds' branches in August 2014, which could have disrupted customers transferred from LBG to TSB but who habitually used a Lloyds branch.

(b) The increasing awareness of CASS.

(c) Competitor activity.

246. Research conducted by TSB among switchers to Lloyds, Santander and Halifax revealed quite different reasons for switching among the three groups of consumers. Those switching to Lloyds did so primarily[125] because of

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[124] LBG positions Halifax as 'The UK's number one challenger bank.'
[125] 42% of switchers to Lloyds gave this as their trigger compared with 14% of Halifax and 4% of Santander switchers.

branch location, because the Lloyds branch they had been using whilst co-servicing was available was more conveniently located than the nearest TSB branch. The research indicated that references to lack of convenience increased somewhat at a distance of 4 miles from branch but increased appreciably if the relevant branch was further than 8 miles away.

247. Switchers to Halifax, which offered a £100 bonus to new account holders, cited 'financial incentives' as their main reason for switching while most switchers to Santander said they thought the Santander product was better than TSB's.[126]

248. It also appears that the offers being made by these three banks varied in their appeal to customers depending upon the size of the balances that they carried in their current account prior to switching. For accounts with average incoming payments of £500 per month, switchers to Santander held the highest average balance (£[✄]), switchers to the Halifax the lowest (£[✄]) and those switching to Lloyds a level between the two (£[✄]).

249. That said, there is some evidence that the switchers that TSB researched had one factor in common: a higher propensity to switch between other providers of services. 34% of TSB current account holders who switched to Santander and 30% of those who switched to Halifax had switched energy providers in the last 12 months, for example, which is roughly double the national average rate of switching.[127]

Barriers to entry and expansion faced by TSB

250. We now consider whether TSB's experience suggests that there are features of the retail banking market which constitute barriers to entry or expansion. We look first at TSB's results to date and then at its submission that its future growth may be constrained by falling profitability of the business. Finally we set out our tentative assessment of the evidence we have seen so far.

TSB's results to date

251. Since its launch as an independently managed bank TSB has added, net, over 200,000 PCAs, increasing its account base by 6.5% and, at its peak, was securing 14% of PCA flow. It has done so despite the quite significant loss of

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[126] The Santander account offered 5% interest on balances between £3,000 and £20,000 whereas TSB's Classic Plus offered 5% interest on balances up to £2,000. The report also noted (slide 17) the importance of Santander's 1-2-3 television advertising as a driver of switching to Santander.
[127] See CMA (July 2014), *Personal current accounts: Market study update*, p92.

customers back to LBG and in the face of competition for flow from larger rivals such as Lloyds and Santander.

252. The launch of its Classic Plus product in April/May 2014 in particular allowed TSB to grow its PCA sales, driven forward by an advertising campaign with a budget comparable to those of much larger banks.

TSB's submission on rising costs and new customer profitability

253. TSB has submitted that its progress as witnessed to date may not be sustainable in the future for two reasons:

(a) Rising costs, as a result of its arrangements with LBG and the ongoing reduction of other temporary profitability enhancements put in place following the recommendations of the OFT in September 2013, may constrain its ability in future to invest in new customer acquisition and this will make its position as a challenger bank les effective.

(b) The PCA customers that TSB is likely to acquire from other banks may take several years to become profitable.

254. We set out and consider both arguments below.

Rising costs

255. TSB told us that the marketing campaign which had driven its sales in 2014 had been funded in large part by the reduction in the cost of its IT services agreed by LBG for the initial years of its operations and the enhancements to profitability which were put in place following the recommendations of the OFT in September 2013.[128] It said that without that funding TSB would not have been able to invest to the same extent in attracting new customers. It said that if these profitability enhancements were excluded, TSB's underlying profitability would be significantly reduced: in the nine months to October 2014, if reductions in the cost of the IT services under the transitional arrangements with LBG and the benefit of the mortgage enhancement are excluded, TSB would have [✂].

[128] The long-term service agreement, which is due to operate from 2017, is expected to increase TSB's cost base by more than £100 million a year. In addition, TSB received, with effect from February 2014, the benefit of a £3.4 billion portfolio of mortgage loans which was assigned to it by LBG. This was designed to enhance TSB's profitability by a cumulative £230 million over approximately five years. This portfolio is subject to a call option exercisable by LBG after the £230 million profit target has been achieved. (TSB Preliminary Results Announcement 2014, p7). LBG also provided TSB with an additional £40 million capital to enable future customer acquisition and develop its branch network.

256. Furthermore, it said that these profitability enhancements were temporary and would decline year-on-year. As a result of the make-up of the mortgage portfolio, the annual income was greatest in the first year and then reduced year-on-year as the portfolio ran off. This decline in mortgage income coincided with the step up in the costs of its IT services from LBG in 2017.

257. In summary, it said that TSB's credentials as a disruptive competitive force had been fundamentally affected by a period of low profitability in its early years as a result of both the changes made to the business during the attempted Verde trade sale which saw the bank's balance sheet reduced without a commensurate reduction in its cost base and an economic environment with low interest rates, contrary to expectations at the time of the bank's design. It said that these changes had introduced a drag on TSB's underlying profitability and may reduce the business's potential to be a sustained disruptive force in the market against the large incumbent banks once the benefits of the various profit enhancements had ended.

New customer profitability

258. TSB told us that, in general terms, [✂]% of a bank's customers generated around [✂]% of its income and that its analysis indicated that these customers were half as likely to switch as others. It told us that the reason for this was that these high-value customers were most likely to be overdraft users but would be less likely to switch banks because they considered, probably correctly, that a new bank might be unwilling to provide them with equivalent facilities without the depth of customer history held by their current provider. TSB customers who did decide to switch were, therefore, likely to be less profitable. It inferred that the same was true for other banks' customers.

259. It pointed out that the less valuable customers who did switch would not become profitable for some time and this would be even more marked where a cash incentive had been offered as an inducement to switch. It said that in these circumstances it could be several years before a customer acquired through switching became profitable. It illustrated this model in the figure below.

Figure 30: Customer profitability model where cash inducement is provided

[✂]

Source: TSB.

Our assessment of TSB's submission

Rising costs

260. Clearly, a lack of sufficient funds to invest in customer acquisition would handicap a potential entrant but this would not constitute a market feature unless other potential entrants were faced by the same prospect. We considered whether TSB's arguments as to the sustainability of its status as a challenger bank were specific to the Verde divestiture arrangements or whether they could have wider application.

261. We noted that the cost of creating or acquiring an IT platform capable of supporting a PCA could, in theory, constitute a barrier to entry or expansion but we did not consider that we had sufficient evidence to conclude that all entrants would be similarly handicapped. On the other hand, it may be that despite such a (hypothetical) barrier, new entrants could, or have been able to, identify and adopt strategies which would overcome this obstacle, for example by offering fewer service channels or by focusing on a particular market niche.[129]

Falling customer profitability

262. PCA customers switching to a new provider may be unprofitable either because they generate less value for the bank than it costs it to service them or because they leave the bank before they have become profitable. We considered what evidence was available to assess both these possibilities.

Customer value

263. TSB argued that lower-value customers were more likely to switch PCA providers and that, generally, these would be customers who did not make use of overdraft facilities.[130] Challenger banks would therefore, if this were the case, acquire relatively lower-value customers, leaving incumbents with the more profitable ones.

264. We noted that it is certainly plausible that customers with existing overdrafts might be reluctant or even unable to switch banks if they were required to repay their debt on doing so. Further, for the reasons suggested by TSB,

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[129] Outsourcing may also be possible and some newer banks appear to be considering this as an option. See PRA and FCA (July 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*, paragraphs 69–77. See also FCA (July 2014), *Considerations for firms thinking of using third party technology*.
[130] We note that PCA customers may, by holding money in their accounts, also generate value by providing a bank with a low-cost source of funds.

customers considering switching in anticipation of securing an overdraft may refrain from doing so because they realise that their creditworthiness will be unclear to their new bank. Equally, a customer may switch and then be unable to borrow (because the new bank will not have sight of their credit history) and thus fail to generate revenue for the new bank.

265. That said, we also noted that one incumbent bank had concluded the opposite and that it was its higher-value customers whom it was most in danger of losing.

266. Data from LBG on the characteristics and value[131] of customers it had lost to rivals does not tend to support TSB's argument that higher-value customers were less likely to switch than others. LBG's concern was that it was losing customers with higher credit turnover (CTO) and balances to rivals, [✂]. It illustrated the relative propensity of its customers to switch to [✂] in the matrix reproduced below.

Figure 31: Characteristics of account holders switching from LBG to Santander

[✂]

Source: LBG.

267. This suggested that switching [✂] became more likely as a customer's CTO increased and that there was also a positive association, albeit less clear, between switching propensity and the size of account balances.[132]

268. [✂]

Figure 32: Net switching behaviour of Lloyds' higher-value customers

[✂]

Source: [✂]

269. We note that propensity to switch may depend on the salience of the offer to particular customer groups.[133] The Santander 1-2-3 offer, for example, which pays relatively high rates of interest on credit balances of between £3,000 and £20,000, may have appealed in particular to LBG's higher-value customers since the segmentation used above is based on a combination of a customer's CTO (as a proxy for income); and investable deposits and home

[131] LBG's categorisation takes account both of a customer's use of its credit facilities and how much money they keep in their current account.
[132] LBG had a retention strategy which aimed to predict which of its customers might be at risk of switching and to target them with pre-emptive retention activity.
[133] Salience may be determined not just by the monetary rewards on offer but also by the quality of service provided.

value (both as a proxy for wealth). We hope that our survey of PCA customers will shed further light on this.

Customer lifetime

270. The 'lifetime value' of customers will depend partly on how much income they generate for the bank and on how long they stay with it. We considered it plausible that customers who have switched bank accounts previously may have a higher propensity to switch subsequently if, for example, a more attractive offer became available.[134] Customers switching early in their 'life' may, therefore, never become profitable and, clearly, the higher their acquisition cost[135] the more likely this would be. Again, while we cannot know what TSB's retention rates will be in the coming years, our survey research and modelling will indicate whether propensity to switch PCAs is affected by previous switching behaviour, including between banks.

TSB – preliminary assessment of barriers to entry

271. Because it entered through divestiture rather than organic growth, TSB possessed assets from the outset that other entrants did not. It owned around 6% of the UK banking branch network, had the authorisations and licences necessary to carry out a banking business and began life with a share of the PCA market of just over 4%.

272. On the other hand TSB lacked advantages enjoyed by other entrants, such as a purpose-built, modern IT platform, and it faced the same potential obstacles as all new entrants: in particular, a low propensity of consumers to switch PCAs, sometimes characterised as 'consumer inertia'.

273. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of flow[136] and added over 200,000 PCAs to its stock.

274. It is not yet clear whether TSB's growth is sustainable or whether the issues that it has drawn to our attention that it claims may threaten its sustainability, in particular the cost of an IT platform, would similarly constrain other firms seeking to enter or expand in this market.

275. Finally, we note that in March 2015 TSB reached an agreement on an offer from Banco de Sabadell to buy all of the shares in TSB Banking Group plc. Should the transaction complete it is Sabadell's intention to migrate TSB

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[134] This behaviour is sometimes described as 'rate chasing'.
[135] In terms of marketing spend per customer acquired and any reward offered on joining.
[136] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock'.

customers across to its own proprietary in-house IT platform, which it anticipates would deliver £160 million a year in cost savings in the third full year following completion of Sabadell's acquisition[137] and remove TSB's dependence on the LBG platform. Such savings would help mitigate the impact of the rising costs to which TSB drew our attention.[138]

Virgin Money's personal current account

276. This case study focuses on Virgin Money's launch of its personal current account (PCA) in the UK.

277. Virgin Money acquired Northern Rock plc (NR) in January 2012, which transformed it from being a comparatively small online bank to having a high street banking presence with 75 branches.

278. Thereafter, Virgin Money considered a number of different strategic alternatives, and launched its first PCA, its 'Essential Current Account' (ECA) – a type of basic bank account (BBA), in Scotland and Northern Ireland in July 2014, and in the rest of the UK in March 2015.[139,140] It [✂] considers this launch to be the first step towards offering more PCA products in the future.

279. Although Virgin Money has launched its ECA, and has plans to offer a wider range of PCA products, it does not intend to substantially grow its current account business in the near future. It told us that it faced some impediments to further expansion. These included: the free-if-in-credit PCA model, a lack of product diversity in the market, perceived difficulties of account switching, and the competitiveness of payment systems.

280. Developing a suitable IT platform was not considered to be an impediment by Virgin Money to enter the PCA market because it acquired much of the required capability with NR. However, it told us that further investment in IT would be required if it sought to create a 'me-too' PCA product and compete

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[137] Recommended Cash Offer by Banco de Sabadell, S.A. for TSB Banking Group plc Offer document, p14.
[138] For example, limitations resulting from its current branch network, the levels of switching, the scale advantage of the biggest banks (which have a larger stock of existing customers over which to spread their fixed cost base and from which to fund competition for new customer acquisition), and the time taken for new customers to become profitable.
[139] A BBA is a PCA that does not have an overdraft facility but allows the customer to receive payments, pay in cheques, withdraw money, and set up a direct debit or standing order. It does not carry a monthly fee, does not usually offer any in-credit interest but may provide the customer with a debit card. Money advice service; British Bankers' Association.
[140] An agreement was announced in December 2014 between the UK government and the banking industry to establish new BBAs under which customers will not incur bank charges if a direct debit or standing order fails. Nine high street banks have agreed to offer such accounts to customers. See HM Treasury news story New basic fee-free bank accounts to help millions manage their money.

directly with the larger banks. It does not consider its limited network of 75 branches to be an obstacle to its further expansion.

281. Through its launch of its ECA, Virgin Money appears to have adopted a cautious and phased approach towards offering PCAs, and has attempted to identify areas where it considers it will not face head-on competition from the major PCA providers. Its PCA strategy appears to be driven by a desire to limit the scale of its investment (for example in customer acquisition and IT platform) and therefore risk, due to its belief that it is difficult to achieve the required scale to recover these costs.

282. Virgin Money told us that in light of its views on the current market and regulatory environment, it does not expect to become a major PCA provider in the near future, and is likely to remain predominantly a retail-funded mortgage bank.

Introduction and background

283. This case study focuses on Virgin Money's launch of its ECA in the UK. The case study begins with a brief background of its businesses, which is followed by a chronological analysis of events leading up to the launch of its ECA, including Virgin Money's strategy and business model. Finally, the case study considers the extent to which Virgin Money's experience suggests the presence of barriers to entry or expansion.

284. Virgin Money is a UK-based retail bank, which was established in 1995.[141] It initially offered a personal equity plan, the forerunner of its personal savings accounts, and investment plans. It added credit cards and personal loans in 2002, car and home insurance in 2004 and life insurance a year later to its portfolio, but did not have a PCA offering. In 2010, with the acquisition of Church House Trust plc, Virgin Money acquired a UK banking licence.[142]

285. Virgin Money acquired NR in 2012, which transformed it from being a comparatively small online bank to having a high street banking presence. This acquisition included 75 branches, one million customers, £14 billion mortgage book, £16 billion retail deposit book and 2,100 employees.[143] Virgin Money also acquired around 100,000 NR PCA customers, an IT platform, and access to relevant UK payment systems.

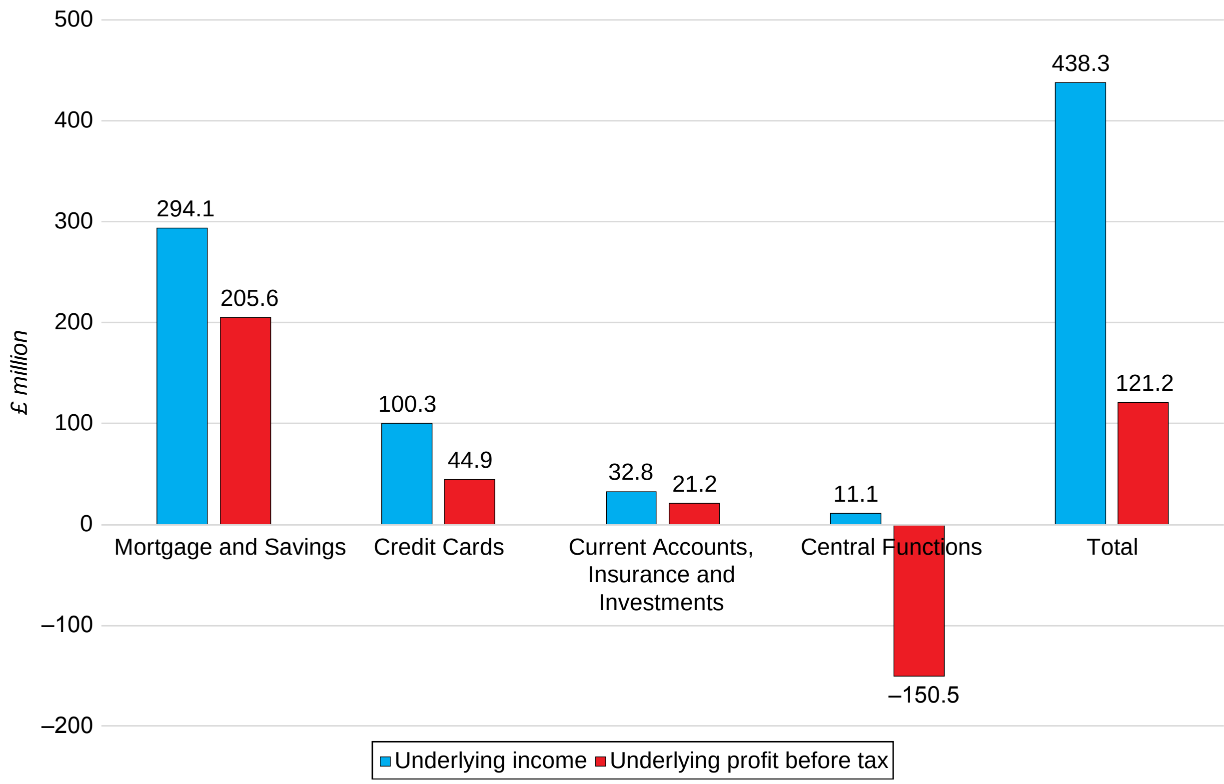
[141] Virgin Money is part of the Virgin family of companies which have businesses in sectors ranging from mobile telephony, travel, financial services, leisure, music, holidays, and health and wellness. Virgin Money website.
[142] BBC News (17 November 2011), Virgin Money looks to join the mainstream.
[143] Virgin Money completes the acquisition of Northern Rock.

286. At the end of 2014, Virgin Money had 2.8 million customers which it serviced through a range of channels, including online and mobile, and a network of 75 branches and five customer centres (which it terms 'Lounges').[144,145]

287. Virgin Money operates exclusively in the UK with the exception of wholesale funding and liquidity management activities which it undertakes both in the UK and in limited overseas markets. Its operations are broken down into three business units: Mortgages and Savings; Credit Cards; and Current Accounts, Insurance and Investments, all of which are supported by its Central Functions unit which provides support services to these business units.[146]

288. Figure 33 shows the underlying income and profits of Virgin Money's business units in 2014.[147] As can be seen, Mortgage and Savings is its largest business unit, accounting for 69% of underlying income and 76% of underlying profit before tax in 2014.[148]

Figure 33: Income and underlying profit of Virgin Money business units



Source: Based on data in Virgin Money Group Annual Report 2014, p27.

144 Virgin Money Group Annual Report 2014, p20.
145 The location map of Virgin Money's branches (called stores) is provided in Appendix A.
146 Virgin Money Group Annual Report 2014, p27.
147 Further details of Virgin Money's financial performance during 2011–2014 are provided in Appendix B.
148 Excluding Central Functions.

289. Virgin Money believes that its business model positions it well for cost-effective growth in an increasingly digital world.[149] It considers its brand, customer-focused culture, financial strength and the fact that it is unburdened by legacy as key enablers in providing a distinctive customer proposition.[150] According to Virgin Money, its ability to grow has been enhanced by a successful listing on the London Stock Exchange following an Initial Public Offering (IPO) in November 2014.[151]

290. In its IPO prospectus, Virgin Money stated that its strategy was focused on:

(a) continuing strong growth in its core mortgages, savings and credit cards businesses, along with further product extensions over time;

(b) maintaining high asset quality and a low cost of risk through a robust risk management approach; and

(c) delivering strong returns by increasing net interest margins, driving operating leverage, growing non-interest income and optimising capital efficiency.

291. In the IPO prospectus, Virgin Money also stated that it was targeting a return on tangible equity in the mid-teens range by the end of 2016, and expected to deliver continued improvement on this measure beyond 2016.

Launch of Essential Current Account (ECA)

292. In its submission to the House of Commons Treasury Select Committee ('Select Committee') in 2010, Virgin Money referred to the difficulty of launching a PCA; it stated that since PCA switching rates were low, it would take some time for a new entrant to achieve scale – during which time the incumbent banks could respond to threats from new entrants.[152] It began exploring its options to launch a PCA after its acquisition of NR in January 2012, since it felt that as a mass consumer brand, it should make clear its intention to become a competitor in the wider PCA market.

293. Virgin Money launched its ECA in Scotland and Northern Ireland in July 2014, and in the rest of the UK in March 2015. Its strategy has been evolving since it acquired NR, and currently includes plans to launch more PCA products in the future that will be fee paying, have more digital functionalities, and cater to a wider target market including customers who use overdrafts, mortgages, and

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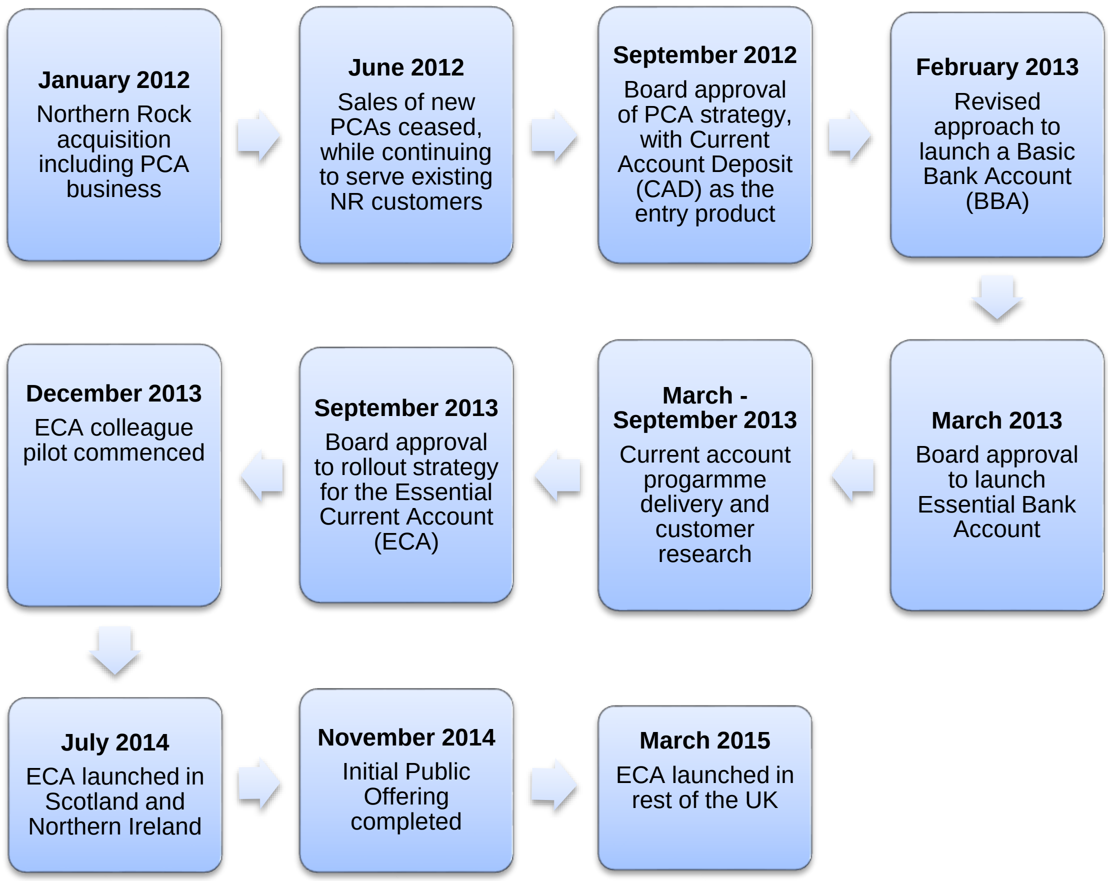
[149] Virgin Money Group Annual Report 2014, p20.
[150] Virgin Money Group Annual Report 2014, p20.
[151] Virgin Money Group Annual Report 2014, p12.
[152] House of Commons Treasury Select Committee. Competition and Choice in retail banking. Written evidence submitted by Virgin Money (September 2010), paragraph 3.6.

look to build their savings. Virgin Money told us that these plans are subject to it considering the regulatory landscape being favourable.

294. A chronological summary of key events leading up to Virgin Money's launch of its ECA is provided in Figure 34.

Figure 34: Launch of ECA – key events



Source: Collated by CMA based on information provided by Virgin Money.

Cessation of sales of NR current account, June 2012

295. After the NR acquisition, Virgin Money began a detailed evaluation of the acquired current account book and systems. Its assessment identified a number of challenges which led to a decision (in June 2012) to close the (NR) current account offering to new customers.[153] These challenges included a recognition that the NR PCA proposition lacked some basic functionalities (for example online capability), and a desire to avoid confusion in the market through the conflation of the Virgin Money and NR brands.

[153] While it ceased its sale of current accounts, it continued (and continues) to service the acquired NR customers.

296. Virgin Money stated that ceasing sales of the acquired NR PCA product to new customers also enabled it to devote efforts on improving its systems and processes, whilst building an enhanced PCA product proposition.

Board approval of PCA strategy with CAD as the entry product, September 2012

297. A board paper of September 2012 noted that:

> ‘We appear to be an inflexion point for the PCA market where the powerful incumbents may no longer be able to resist pressure for change. This will create an opportunity for new products and participants, but only if
>
> - Customer and regulators can be convinced the provision of basic banking is safe and reliable;
> - All observers can be assured of the transparency and fairness of charging;
> - The standards of service, including speed and reliability of switching, is high.’

298. Virgin Money believed that while the acquired NR PCA had been withdrawn in June 2012, it provided a foundation for building a future PCA product. At that time, it was considering launching a product called the Current Account Deposit (CAD) which combined its existing deposit capability with current account functionality, and which could be the first of a range of current account related products.

299. [✂]. Figure 35 illustrates [✂].

Figure 35: PCA programme

[✂]

Source: [✂].

300. [✂].

301. [✂].

Revised approach – to launch a BBA, February 2013

302. In February 2013, Virgin Money revised its strategy and proposed to launch a BBA, offering a ‘quicker and less risky’ launch, addressing the most

‘underserved’ part of the market and supporting its ‘Building Better Banking’ philosophy (see Figure 36).

303. It made the decision to launch a BBA ‘after considering a number of different strategic alternatives and discounting them on the basis of the scale of investment required in an unfavourable regulatory environment.’ The proposed BBA was a free product but was thought to support Virgin Money’s positioning on monthly fees for subsequent, more functionally rich PCA propositions when it considered the market and regulatory conditions to be favourable.

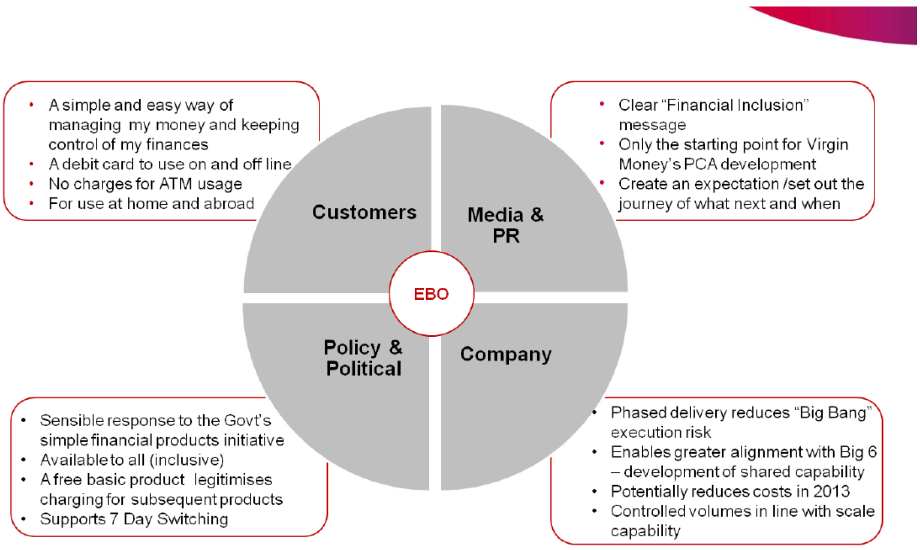
Figure 36: PCA strategy

[✄]

Source: [✄].

304. An internal strategy paper of February 2013 noted that alternative delivery options needed to be explored in order to get to the market more quickly and cheaply, whilst still making a sensible first step on the road map to a full PCA offering. Key to this revised strategy was the launch of a BBA, which was to help ‘reduce the execution risks’ and ‘enable a stronger Virgin narrative for customers, the media and the political environment.’ Figure 37 shows Virgin Money’s strategic rationale for proposing to launch a BBA.

Figure 37: Virgin Money BBA – strategic rationale



Source: Virgin Money.

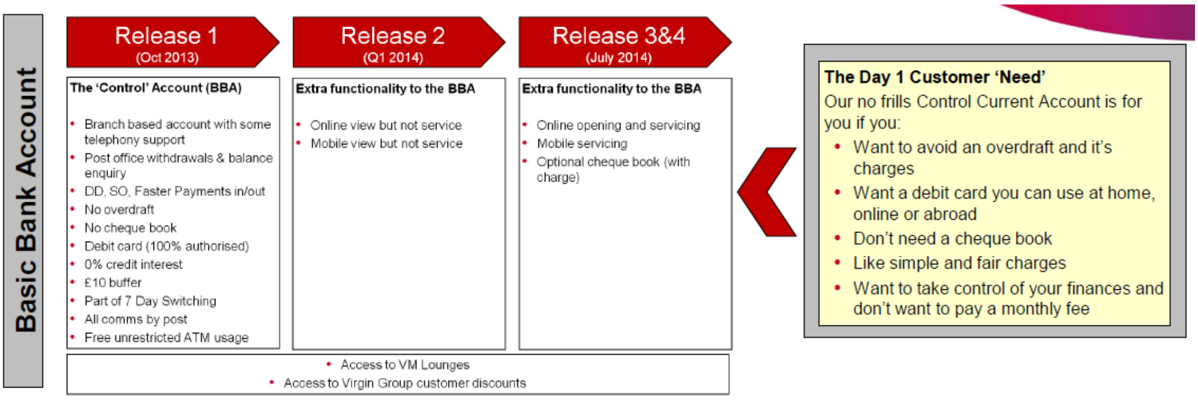
305. The strategy paper explained the background and purpose of a BBA as follows:

(a) A current account with limited functionality.

(b) Originally designed to cater for the financially excluded but then positioned as an account which enabled customers to take better control of their finances, since it did not offer an overdraft.

306. The strategy paper noted that a phased delivery of current account products de-risked the original CAD launch plan and enabled costs and resources to be re-planned. Figure 38 shows the proposed road map to Virgin Money's proposed phased delivery of PCAs, as well as how the different products were intended to meet the requirements of the target market segments.

Figure 38: Scope of PCA programme



[✂]

Source: Virgin Money.

307. The strategy paper also stated that the primary driver for Virgin Money's PCA programme was not profitability but rather enabling a broader customer relationship strategy. However, according to its estimates, the programme was expected to deliver a neutral to positive contribution in its own right – see Table 12.

Table 32: PCA programme – high level financial assessment

[✂]

Source: Virgin Money.

308. [✂].

Figure 39: Contribution comparison

[✂]

Source: Virgin Money.

Board approval of new strategy to launch the Essential Bank Account (later renamed the Essential Current Account (ECA), March 2013

309. A board paper of March 2013 set out the plan for launching Virgin Money's Essential Bank Account (EBA) in October 2013, which was to be a 'simple and free current account without an overdraft facility, for those who want convenience and control.' This product was not to offer credit interest, was to be sold only through Virgin Money branches, although it could also be operated through other channels – post offices, online and via mobile (view only), enabling careful control of volumes.

310. The paper pointed out that the EBA was the first step of Virgin Money's PCA road map, which was to deliver a range of fee-paying current accounts to savers, spenders and homeowners in the future – see Figure 40.

Figure 40: PCA road map

[✂]

Source: Virgin Money.

311. [✂].

Table 13: Indicative financials – PCA programme

[✂]

Source: Virgin Money.

312. [✂].

Current account programme delivery and customer research, March to September 2013

313. During March to September 2013, Virgin Money worked through its product proposition, design, process mapping etc, and carried out primary research to ensure that its offering was in line with the requirements of the target market.

Board approval to roll out strategy for the ECA with limits on volumes, September 2013

314. In a board update of September 2013, Virgin Money stated that it was ready to launch its ECA in November 2013. It mentioned that the ECA was being built on its existing infrastructure, thus ensuring a low risk of delivery, and would establish the engine for future product launches.

315. The update also stated that being a type of BBA, the ECA did not carry a monthly fee, and therefore posed a profitability challenge for Virgin Money.

316. As a mitigation measure, Virgin Money proposed an annual cap of 6,000 to 10,000 on ECA volumes which limited the negative contribution of the ECA to less than £[✂] million a year until 2017. Virgin Money 2014 Annual Report stated that ‘our current account offering will be extended, although we will carefully control volumes ahead of expected future market changes such as those that might be introduced following the decision of the CMA to refer the PCA market for a full market investigation’.[154]

317. An initial staff pilot during November and December 2013 was to be followed by a phased public roll-out of the ECA starting in Scotland and Northern Ireland in Quarter 1, 2014. The board update stated that ‘The ECA enables us to take a strong challenger position with a best of breed Basic Bank Account for a large but underserved part of the market.’ It went on to say that ‘entering the market with a brilliant Basic Bank Account strengthens our [Virgin Money’s] voice in the political debates about competition, switching and “free in credit” banking.’

318. The board update spelt out the benefits of launching the ECA, which included the following:

(a) It closed a product gap in its portfolio.

(b) It enabled low risk market entry.

(c) It was very hard to criticise.

(d) It helped to build future charging products.

319. Virgin Money believed that an ECA was likely to be the first bank account for customers, who were likely to manage their money closely checking their balance regularly.

320. Although Virgin Money expected its ECA to make a loss on a stand-alone basis (see Table 14), it expected the product to serve as a platform for the launch of its future PCA offerings. The annual running cost of ECA started at approximately £[✂] per account due to low volumes, and was expected to reach approximately £[✂] by 2020. [✂].

Table 14: Financials – Essential Current Account (ECA)

[✂]

Source: Virgin Money.

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[154] Virgin Money Group Annual Report 2014, p22.

321. The board update stated that the next step on Virgin Money's PCA strategy was the delivery of an account which was to charge a monthly fee and offer a richer functionality; this offering was expected to appeal to a broader range of customer groups including savers and spenders, and be the vehicle through which it planned to drive higher PCA volumes. [✄].

Figure 41: PCA strategy and roadmap

[✄]

Source: Virgin Money.

ECA launched – in Scotland and Northern Ireland, July 2014 and in the rest of the UK, March 2015

322. Virgin Money's ECA which was launched in Scotland and Northern Ireland in July 2014 and in the rest of the UK in March 2015,[155] has the following key features:[156]

(a) It can only be opened in a Virgin Money branch.

(b) It is designed to be managed through Virgin Money branches and at any post office, with some services available online and over the phone.

(c) It has no overdraft facility.

(d) It has free withdrawals at almost all high street cash machine.

(e) It has 1% gross (variable) interest on the balance held in the account.[157]

323. According to Virgin Money, launching an ECA enabled it to ensure that it had fully tested and had robust capability to drive its further expansion at an appropriate time. It told us that the ECA volumes so far had been in line with its expectations.

Barriers to entry and expansion

324. Although Virgin Money has launched an ECA, it does not plan to grow its current account portfolio at scale in the near future. It told us that it faced some impediments to further expansion. These related to:

[155] Virgin Money told us that the phased launch enabled it to manage PCA volumes and test its systems and processes.
[156] Virgin Money Essential Current Account, January 2015.
[157] According to Virgin Money, credit interest (currently 1%) was applied to all ECA balances without restriction. However, the maximum balance allowed under the ECA terms and conditions is £100,000. Virgin Money stated that where customers exceeded this limit, it continued to pay the interest on the total balance but insisted that the balance was brought down below £100,000 within a reasonable period.

(a) free-if-in-credit banking;

(b) a lack of product diversity in the market;

(c) the account switching process; and

(d) access to payment systems.

325. These impediments, in Virgin Money's view, had constrained the ability of the 'challenger' banks to compete with the incumbent banks. It said, 'despite our powerful brand and acquired systems capability, the cost and barriers to entry at scale into the full current account market would be prohibitive.'

Free-if-in-credit banking

326. Virgin Money believes that product cross-subsidisation is inconsistent with treating customers fairly. It said: 'We believe that cross-subsidisation within financial services has the potential to create conduct risk and consumer detriments, as has been shown by banks selling profitable PPI to subsidise personal loans with low interest rates.'

327. Virgin Money told us that larger banks derived cost and liquidity advantages from credit balances in PCAs especially since these tended to be stable and long term, and had lower costs than the other short-term sources of funding. This, according to Virgin Money incentivised the larger banks to maintain the status quo rather than to engage in innovation and competition, which might undermine their incumbency advantages.

328. According to Virgin Money, the above 'systemic' issues (related to product and customer cross-subsidy and cost and liquidity advantages for the larger banks) primarily arose from the free-if-in-credit banking model, which made it difficult for the 'challenger' banks to achieve scale in the provision of PCAs, since the cost of entry was high, and could not be recouped from a 'free' PCA offering.

329. It appears that Virgin Money's perceived disadvantages arising from the free-if-in-credit PCA model contributed to its cautious and phased approach towards developing its PCA proposition.

Lack of product diversity and account switching process

330. Virgin Money said that in its view, the main incumbent banks had not changed or improved their primary PCA offering for many years, PCAs were broadly indistinguishable between one bank and another. This had resulted in a static market where customers did not want to change their PCA provider, thus

providing the main incumbent banks with a source of stable funding, and driving their profitability.

331. Virgin Money considered that customers did not want to change their PCA provider because of a combination of perceived difficulties in switching, the lack of product differentiation, and the difficulty in assessing costs and benefits of different PCAs.[158]

Access to payment systems

332. Virgin Money stated that although having acquired NR,[159] gaining access to payment systems had not been an impediment to entering the PCA market, but it questioned if a system could be competitive and open to new providers with new ideas, when access to that system was 'controlled' by the main incumbent banks. It also pointed out that it was not clear if the fees charged by sponsor banks to agency banks like Virgin Money[160] for accessing payment systems was loading a 'penalty' on new entrants, thereby increasing the economic barriers to entry.[161]

333. In an internal note prepared in 2013, Virgin Money mentioned that for a new entrant, it was probably quicker, cheaper, easier and more practical to interface through a sponsor bank (agency banking) rather than building and maintaining costly infrastructure for lower volumes. However, it also elaborated issues which it thought were caused by agency banking relationships:

(a) Service standards whereby the agency bank could find it difficult to offer the same standard of service on payments as its sponsor bank.

(b) Potential brand damage which could result if payments were delayed.

(c) Delay in hearing about industry-wide issues since agency banks relied on their sponsor banks to keep them informed of any industry-wide issues.

(d) Project delays which could result due to reliance of agency banks on sponsor banks during a project life cycle.

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[158] To address the perceived difficulties of account switching, Virgin Money is in favour of the introduction of full account number portability.
[159] As a result of Virgin Money's NR acquisition, it obtained access to the UK payment systems.
[160] Further details on payment systems are set out at paragraphs 140 to 150 of our updated issues statement and are set out in our working paper on barriers to entry: regulation, IT systems and payment systems, and our provisional findings.
[161] Virgin Money stated that pricing differed between sponsor banks and is subject to individual negotiation.

(e) Inadequate new initiatives since these tended to be directed by sponsor banks, and therefore solutions could end up fitting the requirements of those banks.

334. In response to a query by the CMA, Virgin Money made the following comments regarding its indirect membership of the following payment systems:

(a) Faster Payments: Virgin Money stated that although it was happy with the service provided and did not feel that costs were egregious, some capability gaps existed since no payments were possible during weekly SWIFT outage (between Saturdays 3pm and Sunday 6am).[162] Further, indirect membership did not allow it to join Paym or Zapp.[163]

(b) Cheque and Credit: Virgin Money said that it was happy with the service provided, and the costs were reasonable.

(c) CHAPS: According to Virgin Money, costs and service were reasonable, and there were no proposition gaps by being an indirect member.

335. Thus, although Virgin Money pointed out potential difficulties for agency banks and potential issues arising from the ownership of payment systems by the main incumbent banks, in practice it did not appear to have any major concerns regarding the cost and quality of service of its indirect membership of payment systems.

IT systems

336. Virgin Money told us that developing a suitable IT platform had not been an impediment to its entering the PCA market, since it acquired much of the capability from its acquisition of NR in 2012. However, it told us that it had subsequently needed to spend approximately £[✂] million to support its PCA programme.[164]

337. Since Virgin Money did not have a PCA offering when it acquired NR, there were no integration costs per se. It stated that the need to integrate the NR IT platform with its IT systems was limited because its other major businesses – mortgages and savings – were also run on systems acquired from NR.

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162 SWIFT stands for Society for Worldwide InterBank Financial Telecommunications. It operates a network which facilitates the exchange of payment and other financial messages between financial institutions and eligible corporates throughout the world. A SWIFT payment message is an instruction to transfer funds; the exchange of funds takes place over a payment system or through correspondent bank relationships. KPMG (31 August 2014), *UK Payments Infrastructure: Exploring Opportunities*, p91.
163 Paym and Zapp are services that enable making payments using a mobile phone.
164 [✂]

338. Virgin Money said that further investment in IT (1.5 to 2 times the amount it had already invested) would be required if it sought to create a 'me-too' PCA product and compete directly with the larger banks (which according to Virgin Money was not the best approach for them). However, Virgin Money also stated that the obstacle was not the ability to fund this investment, but rather that the features of the PCA market did not justify making this investment.

Need for a branch network[165]

339. In its comments on the CMA's statement of issues, Virgin Money stated that while a branch network appeared to be important for a significant proportion of customers, it believed that this factor was of declining importance for many retail banking products, largely due to the growing popularity of alternative channels such as the internet.[166]

340. Virgin Money told us that in the future, customers would want to access its services through all available channels. It felt that although branches were important to enable some customers to build personal relationships, it expected the majority to want to access its services through digital and online technologies. It stated that in 2014, it had over 47 million interactions with customers, of which 38 million (81%) were via digital (website or email) channels. Similarly, 71% of its service interactions and 78% of its product sales took place through digital channels.

341. Virgin Money believes that through its 75 branches, it already has a good coverage of the major urban centres in the UK, and it was also working to provide more advanced digital banking capabilities to its customers.[167] Virgin Money stated that while it had considered different scenarios while finalising its PCA roadmap, an extension of the branch network had never been part of this strategy.

342. Virgin Money has no plans to expand its branch network in the near future, but it does not consider this to be an obstacle to its further expansion.

Capital requirements and regulatory barriers

343. Virgin Money told the Select Committee that:

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[165] Virgin Money does not currently use any advertising to promote itself, and instead relies on its branches and word of mouth to acquire customers.
[166] Virgin Money's response to the issues statement, paragraph 12.
[167] Virgin Money's ECA has been designed to be managed through Virgin Money branches and at any post office, with some services available online and over the phone.

> Given the riskiness of the business model of large banks, and the limitation of their risk models, our conclusion is that a level playing field should be achieved by requiring large banks to hold at least as much capital (proportionately) as new entrants- and perhaps more at some times in the economic cycle.[168]

344. It told us that capital requirements were not a major concern for PCAs, but it was something that larger banks could manage more optimally due to their greater experience/sophistication, with better historical data and models.[169]

345. Virgin Money stated that it had all regulatory approvals necessary to build on its current PCA capability.[170] Similarly, in its response to the CMA's statement of issues, it had stated that 'the [banking] authorisation process has been simplified and capital requirements for new banks have been reduced – which should have positive consequences in terms of barriers to entry and growth in the PCA market.'[171]

Conclusions

346. Virgin Money gained a bank licence in 2010, but began exploring its options to launch a PCA after its NR acquisition in 2012 which also included a PCA product, a pool of PCA customers, 75 branches, an IT platform and access to relevant payment systems. After closing the NR PCA offering to new customers, it considered a number of alternative strategies to enter the PCA market before deciding to launch its ECA in 2014.[172]

347. Although Virgin Money has launched its ECA, and has plans to offer a wider range of PCA products, it does not intend to substantially grow its current account business in the near future. It told us that impediments which stand in its way include the free-if-in-credit PCA model, a lack of product diversity, perceived difficulties of account switching, and the competitiveness of payment systems.

348. Although developing a suitable IT platform was not considered to be an impediment by Virgin Money to enter the PCA market, it told us that further

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[168] House of Commons Treasury Select Committee, Competition and Choice in retail banking. Written evidence submitted by Virgin Money, (September 2010), paragraph 3.27.
[169] After acquiring NR, Virgin Money uses the IRB approach for its capital requirements.
[170] Virgin Money did not need formal approval to launch a current account since it already had the necessary bank licence and current account permissions in place following its acquisition of NR.
[171] Virgin Money's response to the issues statement, paragraph 12. It went on to say (para 33) that 'retail banking is highly regulated, and the complexity of the regulations and costs of ensuring compliance with them may still form a barrier to entry and growth in retail banking.' Virgin Money clarified this comment by stating that regulation was not a PCA-specific issue but more generally something that was a challenge for smaller banks with less advanced risk management infrastructure to address.
[172] Its ECA was launched in Scotland and Northern Ireland in July 2014 and in the rest of the UK in March 2015.

investment in IT would be required if it sought to create a ‘me-too’ PCA product and compete directly with the larger banks. It does not consider its limited branch network to be an obstacle to its further expansion.

349. It appears that Virgin Money has chosen to target the BBA market segment, due to its belief that it would be difficult to succeed in directly competing with the larger, more established banks in the provision of non-BBA PCAs. It stated that ‘We aspire to be a major player in the PCA market, but only when market and regulatory conditions allow.’ Its strategy appears to be driven by a desire to limit the scale of its investment (for example in customer acquisition and IT platform) and therefore risk, due to its belief that it is difficult to achieve the required scale to recover these costs.

350. Virgin Money stated that in light of its views on the current market and regulatory environment, it does not expect to become a major PCA provider in the near future, and is likely to remain predominantly a retail-funded mortgage bank.

Potential new entrants

351. In the last two years there has been a sharp increase in the number of firms seeking authorisation to provide banking services. This case study describes, in tabular form, the experience of five prospective new entrants that are either in the process of seeking authorisation or that have recently been authorised. None of them has currently begun trading, limiting the level of detail available on performance.

352. The fact that new entry into the retail banking market appears to be accelerating should not be taken to indicate that there are no obstacles to entry in the sector. Clearly, entry and expansion demonstrate that there are no insurmountable barriers but there may well be features of a market that limit the scale, scope and speed of entry and expansion. We note that the companies whose experience we describe here appear to have altered their propositions and operating models to account for some of these features.

353. Based on the views of the companies included in this case study, along with our observations of where they have adapted their business model, there appear to be a number of potential barriers which they have encountered/expect to encounter:

(a) **Customer inertia:** The prospective entrants generally believe that this is largely down to a lack of differentiation in the existing offerings, which results in apathy from customers. However, even with their new models, the prospective entrants are aware of the risk from continued customer

inertia. Many have designed their customer acquisition strategy to address this; for example, Fidor intends to first build an online community of financially interested consumers, and then over time convert these individuals to customers. We also note that even the perception of customer inertia may be a sufficient impediment to deter some prospective entrants.

(b) **Physical presence/branches:** Launching a new branch network is acknowledged by some as prohibitively expensive, and none of the prospective entrants is doing so. However, they all acknowledge that cash/cheque handling is generally important (and vital for current accounts) so are relying on agency agreements with existing banks to use their branches. Alternatives do exist, for example the Post Office, but these appear to be considered inadequate due to issues with identifying customers and ability to handle larger cash sums.

(c) **Capital holdings requirements:** Respondents gave mixed opinions on whether capital holding requirements represented a barrier to entry, which we note may be related to the products they are intending to offer. The specific area mentioned regarded the methodology for risk-weighting assets (RWA). It is important to note that, even if the standard RWA methodology (which new entrants are required to use) and the internal risk based approach (IRB) result in similar holding requirements at a total level, any mismatch on specific products may present a barrier to entering these segments.

354. It is also interesting to note a number of specific areas which appear to present lower barriers than might be expected:

(a) **Access to payment systems:** The prospective entrants highlighted that access to Faster Payments (specifically) is often key for a compelling proposition and could potentially present a significant barrier. They believe that agency agreements have a number of issues, including cost, speed (real time vs near real time), and whether some information is stripped out. However, we note a recent announcement from Faster Payment Scheme Limited (FPSL) and the Payment Systems Regulator (PSR)[173] that it intends to develop an independent technical direct access solution. This would allow direct access for all market participants which may address the issues discussed, if it is implemented well.

(b) **Licence application process:** Recent changes to the licence application process including the introduction of the 'authorised with restrictions' have

[173] FPSL announcement, 11 May 2015.

greatly reduced the barriers to entry. The process is not without challenges, but most prospective entrants believe that this is proportionate to the level of responsibility necessary to be a bank.

(c) **IT platform:** IT costs for start-ups are substantially lower than they are for existing banks due to the latter's high costs of maintaining legacy systems. In addition to this, the introduction of off-the-shelf SaaS IT solutions has resulted in a lower proportion of fixed costs and higher levels of scalability. This results in relatively low barriers to entry for new start-up entrants.

355. Overall, prospective entrants are optimistic about their ability to enter the retail banking market. However, there are some concerns with regards to subsequent expansion; in particular, online-only banks' penetration of the market will be limited by the requirement of some customer segments for certain branch/counter services, especially the ability to deposit cash.

Company views on barriers

Table 15: Summary of views on barriers to entry for potential entrants

	Atom	*Fidor*	*Starling*	*OakNorth*	*CivilisedBank*
Brief description of company	Digitally led, full service for personal and SMEs	German-based bank offering online financial service platform (including PCAs), with other services through connected third party partners	Offering online PCAs only	SMEs (No BCA) focus, with a digital proposition extending across SMEs and personal deposits	Branchless, relationship-led (bank managers) for SMEs, including BCAs with small digital personal proposition
Potential barriers					
Customer inertia	Primary concern is consumer perception of the industry, which may be hard to change. However, novel propositions may help address this	Community-based model is intended to result in a conversion funnel over time	PCAs currently treated as commodities, so unsurprising customers don't switch as can only compete on price	Major potential barrier, particularly due to incumbents using current accounts to lock in customers, and propensity to buy or 'kill' any significant new competitors. Also, limited credit information compared with the incumbent bank who has current account data	Certainly a concern, particularly if incumbents are artificially increasing barriers to transfers (eg high costs for break clauses), although some anecdotes which imply may not be too hard to address
Physical presence (eg branches)	No concern as using a competitor to provide	The UK uses relatively little cash (vs Germany), so not intending to launch with any physical branches	Necessary for proposition, so using a competitor to provide	Believes barriers are vast to build your own, and reticent from partnering, so prevents OakNorth from offering a BCA (cash handling)	Necessary to handle cash and cheques, using a competitor to provide
Capital holding requirements (and RWAs)	RWA methodology may disadvantage new start-ups in some areas	No concern as meeting requirements in Germany already	Not mentioned	Capital requirements for operating risk charge is penal for new start-ups due to forward-looking 3 years calculation methodology	No concern

	Atom	***Fidor***	***Starling***	***OakNorth***	***CivilisedBank***
Access to payment systems	Have to use an agency agreement which results in inability to offer real-time processing	Takes time, and sponsor banks have understandably high compliance requirements even for 'safe' European regulated banks. Different from centralised continental Europe system	Very concerned previously due to cost and loss of information from using an agency agreement. Recent changes by PRS should address this	A major barrier to transactional banking	Access to Faster Payments is key and was a concern until the recent announcement. If this is successful, no concerns
Licence application	No concern with regulator, but very difficult to manage capital over an unclear timetable. Similarly, capital allocation becomes more difficult, particularly when needing to commit to third party suppliers	No concern as operating on EU passport. FCA and PRA were very helpful with this	No concern since improvements implemented	The costs, time, and uncertainty of the process is a barrier. However, the barrier is appropriate given retail deposits are being taken	Significant improvements made to process means fine so far, with slight concern it may become more opaque once submitting formal documents
IT systems	Had to find the right partner	No concern as using existing German platform	No concern – multiple options available. Starling is using a combination of package software and bespoke build for £[✂]	Regulatory concerns when using a new provider, particularly when proposing more innovative or recent developments (eg use of cloud computing)	No real concerns. Intending to spend [✂], which is significantly less than incumbents would need
Marketing costs	No concern, [✂]	No concern, as based on building a community then converting community members interested in retail banking products. [✂]	Business model requires scale, so allocating [✂]	Not mentioned	No concern as largely based on word of mouth via social media, with small amounts of central spend
Ongoing regulatory burdens	Not mentioned	Not mentioned	Not mentioned	Concerned about the next step of growth, in particular if political support of new entrants is withdrawn, then regulator could introduce severe ongoing burdens	Not mentioned
Staff recruitment	Not mentioned	No concern as London labour pool is entrepreneurial and well qualified	Not mentioned	Finding senior staff who have the start-up mentality is difficult, as people with experience have largely worked in large banks	No concern with finding bank managers for launch

	Atom	*Fidor*	*Starling*	*OakNorth*	*CivilisedBank*
Initial funding	Not mentioned	Not mentioned	Not mentioned	Not mentioned	Regulatory risk pre-application is difficult to manage, particular with PE/VC-type investors who are used to greater levels of control
KYC/AML	Not mentioned	No concern, and actually part of business model as ensures consumers are KYC/AML approved for its financial services partners	Not a concern, since incumbents' processes are not optimally implemented. More effective processes can be delivered using more customer friendly technology	Not mentioned	Not concerned, and investigating how detailed actually needs to be as incumbents may be overly stringent
Geographic coverage	No concern	Not mentioned	No concern	No concern	No concern as lack of geographical overhead allows a gradual rollout, testing new areas

Source: Interviews with companies, regulatory business plans, investor presentations and CMA analysis.

Annex A: List of Metro's branches at the end of 2014

No.	*Store location*	*Date of opening*
1	Holborn	Jul-10
2	Earl's Court	Sep-10
3	Borehamwood	Oct-10
4	Fulham Broadway	Oct-10
5	Tottenham Court Road	Mar-11
6	Kensington High Street	Apr-11
7	Bromley	Jun-11
8	Croydon	Jun-11
9	Uxbridge	Oct-11
10	Hounslow	Dec-11
11	High Wycombe	Mar-12
12	Chiswick	May-12
13	Reading	Nov-12
14	Hemel Hempstead	Dec-12
15	Romford	Dec-12
16	Sutton	Feb-13
17	Guildford	Apr-13
18	Slough	May-13
19	Ealing	Jun-13
20	Staines	Sep-13
21	Kingston	Oct-13
22	Cheapside	Nov-13
23	Edgware	Dec-13
24	Windsor	Dec-13
25	Milton Keynes	Jan-14
26	Epsom	Mar-14
27	Milton Keynes Oakgrove	May-14
28	Wood Green	Oct-14
29	Basildon	Nov-14
30	St Albans	Nov-14
31	Orpington	Dec-14

Source: Metro website.

Annex B: Metro's main products

Personal banking[174]

- Current Accounts
- Savings Accounts, eg ISAs, Young savers account
- Mortgages
- Borrowings – eg Credit card, Overdraft, Personal loans professional studies loan

Business banking[175]

- Business Bank Accounts
- Deposit accounts, eg Business Instant Access Deposit Account
- Borrowings, eg Small business loans
- Commercial Banking, eg Not-for-profit banking
- SME finance services, eg Invoice and Asset Finance
- Cash management services

Other

- Safe Deposit Boxes

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[174] www.metrobankonline.co.uk/Personal/.
[175] www.metrobankonline.co.uk/Commercial/.

Annex C: Timeline of events

1. A summary of the timelines is laid out in Figure 1 below, along with the key figures as they were presented to the executive committee/board:

Figure 1: Summary timeline of events

[✂]

Source: CMA analysis.

2010

2. At Nationwide's September 2010 Strategy Conference, an initial document assessing the prospects of Nationwide's entry into the provision of SME banking services (including BCAs) was presented to the board. This included an overview of the SME sector and the main competitors, a channel and product strategy, indicative financials and independent market research.

3. Specifically, the paper highlighted that entry into the market should be possible, based on a strategy of [✂]. It stated that [✂].

4. The overall recommendation of the paper was that a full business case should be developed for presentation to the board in early 2011.

5. The board sought further clarification on a number of areas including:

   (a) the size and nature of the target market;

   (b) the impact of the SME product suite on the Nationwide operating model including its branch network;

   (c) the impact on Nationwide's 'transformation agenda' (its IT platform, facilitating multi-channel service delivery);

   (d) the business case for parallel IT developments to support the SME business;

   (e) the credit process for SME customers; and

   (f) further refinement of the product proposition.

2011

6. The subsequent paper presented to the board in April 2011 sought to clarify these issues. It proposed that [✂]. It recommended a project team be

assembled ([✂]) and that the team work towards a pilot launch [✂] and a full launch [✂].

7. The paper explained that Nationwide [✂]. It considered that these businesses tended to [✂].

8. [✂]

9. The paper set out the breakdown of the [✂] market ([✂]).

Figure 2: [✂]

[✂]

Source: [✂].

10. [✂]

11. [✂]

12. The paper also concluded that [✂].

Figure 3: [✂]

[✂]

Source: [✂].

13. The proposed operating model for serving SME customers would utilise Nationwide's internet, branch, telephone and ATM channels. [✂]

14. The proposed SME products at this time were:

(a) [✂];

(b) [✂];

(c) [✂];

(d) [✂]; and

(e) [✂].

15. One of the questions highlighted by the board in response to the original proposition in 2010 concerned the distribution requirements associated with serving the SME market and, in particular, the use of branch space. This was of particular importance, since this board paper forecast that the SME customer base would grow to [✂]. Supporting analysis estimated that this could have potentially generated up to [✂] branch counter transactions a year. It stated that it was clear that entering the market with no controls could

place undue pressure on branches as SME customers could increase transaction levels by about [✂].

16. The board paper therefore set out the controls that it believed should be put in place from the outset:

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

17. Nationwide stated that the business case was based on an assumption that [✂]% of accounts would be opened in branch, about [✂]% of accounts would be opened online and about [✂]% through the telephone channel. As a new entrant in this sector Nationwide believed it would look to demonstrate continuously improving account opening capabilities through [✂] channels, so these opening percentages were viewed as conservative.

18. The paper stated that adopting this recommended approach, with its focus on attracting [✂], the forecasted transaction levels at Nationwide branches would rise by about [✂] and the number of branch-based customer representatives required to service this [✂]. It said that the cost of this (worst-case) scenario was included in the business case.

19. However, the paper estimated that [✂], so the argument was made that this cost (provision for which was made in the business case) might not have materialised since [✂].

20. The paper also stated that the proposition might require an additional [✂]. As with branch servicing, it stated that these costs were included in the business case but might not have materialised [✂].

21. The business case accompanying the board paper showed a £[✂] contribution by year 5 and a £[✂] contribution by year 10. This assumed an estimated set up cost of £[✂] and that it could grow to [✂] BCAs ([✂]) by year 5 and [✂] ([✂]) by year 10. The paper stated that it considered this achievable, considering that [✂].

22. The major areas of operating costs were forecast as:

(a) product costs ([✂]);

(b) channel costs ([✂]);

(c) attributed costs ([✂]); and

(d) provisions ([✂]).[176]

23. The Nationwide board agreed to support in principle entry, and approved the creation of the formal project team to further develop the business case. It raised a number of further questions and challenges including:

(a) the possibility of accelerating the launch date or initially launching an SME deposit account;

(b) the benefits of a large branch network with managers having a strong understanding of the business needs of the target market;

(c) differences in the training requirements relating to the product T&Cs; and

(d) cross-selling opportunities and the need to avoid value destructive activities.

2012

24. Another paper was presented to the executive committee in April 2012, and subsequently the board in May 2012, which provided an update on the SME project team's progress in assessing the options available to Nationwide. In particular, it discussed:

(a) an update on the market conditions which indicated that despite the economic downturn, the SME sector remained broadly stable;

(b) [✂]; and

(c) the assumption that the required SME IT infrastructure could be developed in parallel to the significant investment taking place to support Nationwide's personal banking operations.

25. The board also heard that within the SME market, the government had been actively encouraging competition and lending; and received information on the newly launched Commercial Deposits (business savings) accounts, which were piloted to existing Nationwide Commercial customers in 2011 and were launched to the external market for the first time in March 2012.

26. The paper included an updated business case based on the latest assumptions, which showed the [✂]. However, no additional details on the expected

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[176] See Annex D for the details of the business case.

set-up costs were provided. Nationwide highlighted the main changes in the business case assumptions as the following:

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

27. Nationwide provided us with an initial Experian presentation from November 2012 which supported previous size estimates and gave more detailed information regarding the make-up of the SME market.

28. The board paper shows that in this period Nationwide completed a programme of competitor benchmarking [✂]. It stated that [✂].

29. The paper stated that Nationwide [✂].

30. Nationwide designed a BCA product whose features included:[177]

(a) [✂];

(b) [✂];

(c) [✂];

(d) [✂];

(e) [✂];

(f) [✂]; and

(g) [✂].

31. During this period Nationwide was also aware of a number of inorganic entry options, [✂].

32. In October 2012, alternative IT solutions were proposed to support the delivery of an organic SME proposition:

(a) Option A (Original): [✂].

(b) Option B (Alternative): [✂].

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[177] The CMA notes that subsequent work was commissioned which questioned the feasibility of parts of this delivery model, and recognises that the exact proposition would likely evolve before reaching market.

2013

33. In 2013, after assessing these supporting IT options against a number of criteria including: strategic fit to the business and IT strategy; timeline to deliver; delivery and operating costs; risk profile of delivery, IT solution ‘Option B’ was adopted as the recommended solution should Nationwide decide to enter the SME market.

34. In 2013 it also became clear that developing the required business banking infrastructure would have an impact on the investment taking place in personal products and services as IT resource would need to be diverted.

35. In March 2013 Nationwide papers were presented to the executive committee and subsequently the board which showed that the latest business case estimated the programme cost as being significantly higher [✄]. Therefore what was anticipated to be a relatively modest investment of capital (£[✄]) and resource turned out to be more onerous. Most of this requirement was in the form of capital expenditure ([✄]), with the majority consisting of IT design and development, [✄]:

(a) [✄];

(b) [✄];

(c) [✄];

(d) [✄];

(e) [✄]; and

(f) [✄].

36. Although some board members expressed concern that Nationwide was missing an opportunity to broaden the services it offers to its members, it was agreed that Nationwide could not afford to invest around £[✄] at that time and at the expense of other projects.

37. The board considered that, due to the levels of profit at the time, some discretionary programmes would need to be deferred. [✄]:

(a) [✄]

(b) [✄]

(c) [✄]

38. It was agreed at the board meeting that [✂] should be progressed, and it was generally accepted that the preference would be to invest in [✂] ahead of SME banking. The SME proposition would be deferred and reviewed in 12 months' time.

39. The work of the SME project team was therefore put on hold, [✂].

2014

40. In June 2014, another board paper gave an updated overview of the SME market which showed the following:

(a) There were [✂] SMEs, [✂], of which [✂] used a BCA.

(b) The number of SMEs was expected to show steady growth over the next [✂] years.

(c) The BCA market was still 'dominated' by the major banks with 90% held by the Big 5.[178]

(d) There was no current tangible alternative to the Big 5, although there were a number of new smaller/niche players entering the market, for example Williams & Glyn, and TSB, which were looking to grow their market share. The paper specifically highlighted the levels of political support and the ongoing Office of Fair Trading investigation as factors which encouraged these entrants.

(e) SME customers were becoming more digitally active [✂].

(f) [✂]

41. The paper recommended that the preferred Nationwide proposition should be [✂]:

(a) [✂];

(b) [✂];

(c) [✂];

(d) [✂]; and

(e) [✂].

[178] Barclays, HSBCG, LBG, RBSG and Santander.

42. The recommendation to the board was that [✂].

43. [✂]

Figure 4: [✂]

[✂]

Source: [✂].

44. The Nationwide board reviewed the above, considering [✂] with regard to the appropriateness of developing a business banking offering in the context of their new 2014–2019 Corporate Plan.

45. The board was told that since the update in 2013, [✂]. The business plan predicted [✂].

46. [✂]

47. In conclusion, the board agreed that the SME market still represented a market opportunity in the medium term but [✂].

Latest statements

48. Nationwide has told us that developing an organic entry into the SME market remains an option and it is retaining the SME project team's deliverables, which provide insight into how to overcome key challenges such as maximising synergies from IT integration, distribution requirements and supplementing Nationwide's personal expertise with SME experts.

49. Nationwide estimated that the project had cost about £[✂] to reach this stage ([✂]) and the paper identifies [✂] based on incorporating the required bridging of gaps in Nationwide's IT functionality whilst also taking advantage of relevant existing IT infrastructure.

50. [✂]

   (a) [✂]

      (vi) [✂]

      (vii) [✂]

      (viii) [✂]

   (b) [✂]

      (ix) [✂]

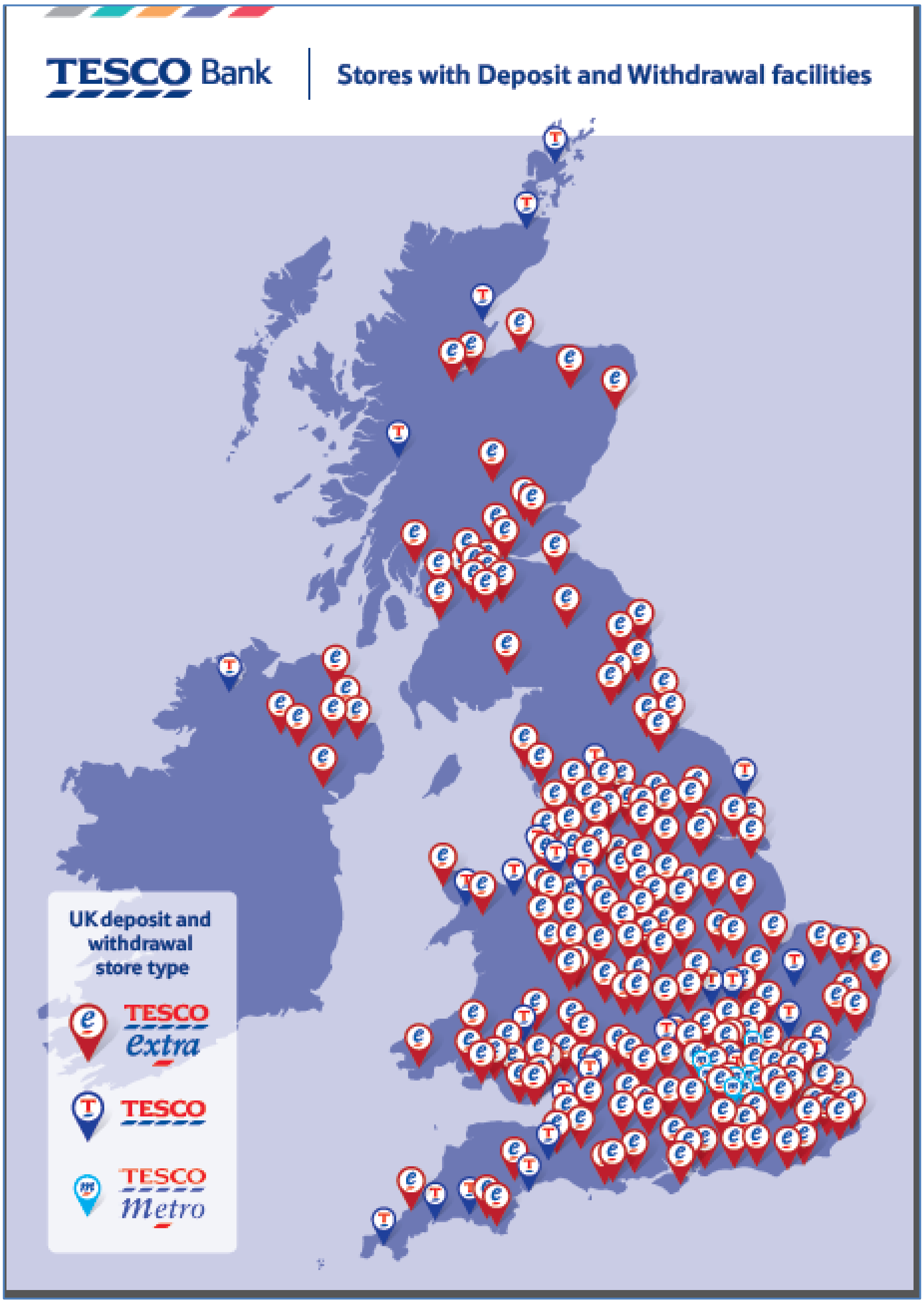
(x) [✂]

(xi) [✂]

Annex D: Nationwide - Details on 2011 business case modelling

[✂]

Annex E: Map of Tesco stores with (limited) personal current account services



Source: Tesco Bank.

Annex F: Features of Tesco personal current account

1. Tesco's PCA was launched with following key features:[179]

   (a) Clubcard points on Visa debit card spend both in and out of Tesco stores.

   (b) 3% AER interest on credit balances up to £3,000.

   (c) £5 monthly fee if customers deposit less than £750 per month. No monthly fee for customers who deposit more than £750 per month.

   (d) Free 'overdraft control' feature to make managing the account easier.

   (e) Automatic text and email alerts and extended grace period to help customers avoid unarranged transactions fees.

   (f) Variable EAR of 18.9% for customers who use an arranged overdraft facility (no fixed monthly fee).

   (g) A set £5 fee for payments made using an unarranged overdraft or if Tesco rejected a payment.

   (h) Capped charges for paid and unpaid transaction fees at £50 per month.

   (i) Online and mobile banking.

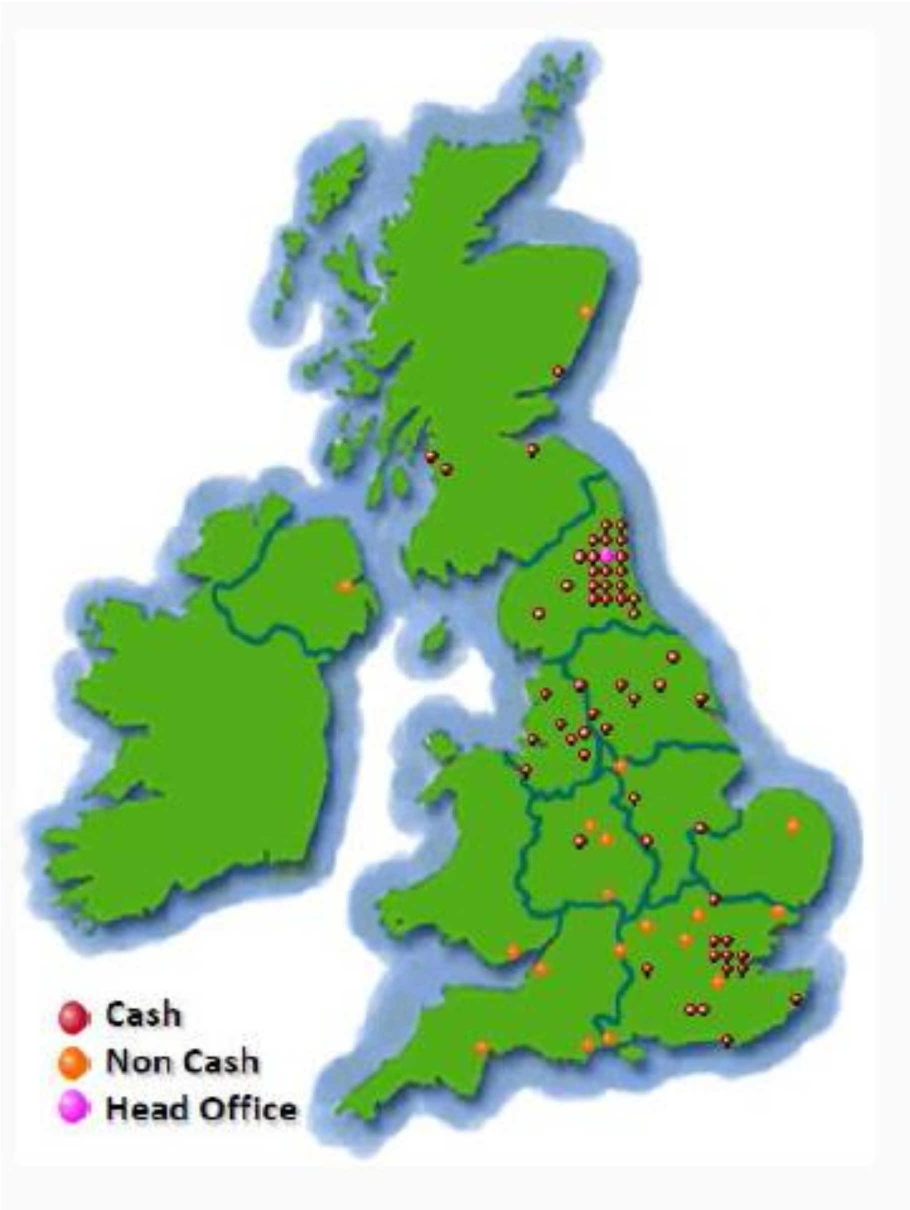
   (j) UK-based customer service centres which were open 24 hours a day, seven days a week.

   (k) Ability to make deposits at over 300 Tesco stores.

   (l) Contactless Visa debit card which doubled as a Clubcard.

[179] Tesco Bank's response to CMA information request – November 2014. Page 2.

Annex G: Location map of Virgin Money branches in the UK



Source: Follow-up information submitted by Virgin, 24 April 2015.

Annex H: Virgin Money 2011 to 2014 performance

Results 2011-14		2014	2013	2012	2011[1]
Growth					
Gross mortgage lending	£bn	5.8	5.6	4.9	3.7
Mortgage balances	£bn	21.9	19.6	16.8	13.9
Credit card balances	£bn	1.1	0.8	–	–
Deposit balances	£bn	22.4	21.1	18.0	16.2
Total assets	£bn	26.5	24.6	21.8	19.6
Quality					
Cost of risk[2]	%	0.11	0.15	0.02	–
Fully-loaded Common Equity Tier 1 capital ratio	%	19.0	15.5	15.5	18.7
Leverage ratio	%	4.1	3.8	3.6	4.0
Loan-to-deposit ratio	%	102.8	96.4	93.1	85.8
Returns					
Underlying total income	£m	438.2	361.5	234.6	161.7
Underlying profit/(loss) before tax	£m	121.2	53.4	(2.5)	(59.1)
Statutory profit before tax	£m	34.0	185.4	160.2	23.5
Underlying net interest margin	%	1.50	1.26	0.54	0.36
Underlying cost:income ratio	%	68.7	77.2	100.2	148.1
Underlying return on tangible equity	%	7.4	2.3	(1.1)	(5.2)
Underlying basic earnings per share	p	21.4	8.1	17.0	(33.9)

1 The 2011 results of Virgin Money Holdings (UK) plc have been presented as if Northern Rock plc had been part of the Group during 2011.

2 Cost of risk excludes benefit of debt sale of £8.9 million.

Source: Virgin Money Group Annual Report, p2.

Annex I: Cost to deliver the Virgin Money personal current account programme

[✄]

Source: Virgin Money.