Competition & Markets Authority

Retail banking market investigation

Provisional findings report

Notified: 22 October 2015

The Competition and Markets Authority has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets.

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Summary

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

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

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

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

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

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

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

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

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

Background to the investigation

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

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

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

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

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

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

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

Industry background

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

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

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

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

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

RBSG/Ulster, Danske, BoI and AIB account for over 80% of active BCAs in NI in 2014.

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

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

Regulation of banks

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

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

New entry

21. There has been new entry into retail banking in recent years. Metro Bank (PCA and SME) was the first organic entrant to the UK banking market in more than 100 years when it received its banking licence in March 2010. Aldermore Bank (primarily SME but not BCA) entered in 2009. Several other

new entrants have their roots in ancillary financial/retail services such as Tesco Bank (PCA 2014), the Post Office (PCA 2013/14), Virgin Money (PCA 2014), and Marks & Spencer Bank (M&S Bank) (PCA 2012). Handelsbanken (PCA and SME) has also significantly extended its UK operations more recently almost doubling its network between 2011 and 2015.

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

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

Financial crisis and subsequent initiatives

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

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

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

27. The prolonged economic downturn in which the central bank interest rate has been held at a very low level (0.5%) since March 2009 has reduced the opportunity costs to personal and SME customers of holding credit balances in PCAs and BCAs while banks have sought to attract new PCA customers in particular by offering interest-bearing PCAs.

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

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

Future developments

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

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

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

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

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

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

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

Financial performance of retail banks

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

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

Market definition

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

- *(a)* PCAs, including PCAs both with and without overdraft facilities;
- *(b)* BCAs, including BCAs both with and without overdraft facilities;
- *(c)* business loans, including both short-term and medium/long-term business loans, with or without collateral; and
- *(d)* business deposit accounts, whether instant-access or long-term.

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

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

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

Competition in PCAs

Introduction

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

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

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

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

PCA market structure

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

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

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

Pricing, quality and innovation in PCAs

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

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

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

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

Customer engagement in PCA markets

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

Levels of customer engagement

48. Our consumer survey found that in 2014:

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

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

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

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

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

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

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

Barriers to engagement, searching and switching

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

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

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

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

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

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

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

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

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

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

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

Factors increasing customer engagement in PCAs

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

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

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

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

Banks' incentives to compete in PCAs

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

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

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

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

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

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

Provisional finding in the provision of PCAs

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

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

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

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

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

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

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

Competition in SME banking

Introduction

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

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

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

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

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

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

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

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

SME banking market structure

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

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

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

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

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

Pricing, quality and innovation in SME banking

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

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

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

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

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

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

SME engagement in BCA markets

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

Levels of engagement in BCAs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Banks' incentives to compete in BCAs

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

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

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

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

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

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

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

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

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

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

Provisional findings in the provision of BCAs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Banks' incentives on SME lending

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

Provisional findings in SME lending

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

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

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

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

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

Barriers to entry and expansion

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

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

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

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

Regulatory barriers

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

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

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

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

Natural or intrinsic barriers

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

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

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

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

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

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

Strategic/first mover advantages

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Provisional findings

1. Introduction

1.1 On 6 November 2014 the Competition and Markets Authority (CMA) board, in exercise of its power under sections 131 and 133 of the Enterprise Act 2002 (EA02) made a reference for a market investigation into the supply of retail banking services to personal current account (PCA) customers and to small and medium-sized enterprises (SMEs) in the UK. The terms of reference for our investigation are provided in Appendix 1.1.

1.2 On 10 November 2014, the CMA appointed from its panel a group of five independent members for the investigation.[5]

1.3 This document sets out the CMA's provisional findings from this investigation based on the evidence we have reviewed and the analysis we have carried out to date. We are required to publish our final report by 5 May 2016.

Our statutory task

1.4 Section 134(1) of EA02 requires the CMA to decide whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom'. If the CMA, acting through a group of independent members, decides that there is such a feature or combination of features, then there is an adverse effect on competition (AEC).[6]

1.5 Under section 131(2) of EA02, a 'feature' of the market refers to:

(a) the structure of the market concerned or any aspect of that structure;

(b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or

(c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

1.6 If the CMA finds that there is an AEC, it is required under section 134(4) of EA02 to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying,

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[5] Details of the members of the group are on our website.
[6] EA02, section 134(2).

mitigating or preventing the AEC, or any detrimental effect on customers[7] so far as it has resulted from, or may be expected to result from, the AEC; and, if so, what action should be taken and what is to be remedied, mitigated or prevented. EA02 requires the CMA 'to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effects on customers so far resulting from the AEC'.[8] In considering remedies, the CMA may take into account any relevant consumer benefits, as defined in EA02, arising from the feature or features of the market.[9]

1.7 In the remainder of this section, we set out *(a)* the background to the reference; *(b)* our conduct of the investigation to date; and *(c)* the structure of these provisional findings.

Background to the reference and parallel reviews

1.8 The two separate market studies[10] leading to this investigation focused on the supply of PCAs, and on the supply of banking services to SMEs (together 'the Market Studies'). The CMA found that there were reasonable grounds for suspecting that a feature, or combination of features, of the markets for the provision of PCAs and SME banking services prevents, restricts or distorts competition in the UK. The CMA decided that both PCAs and the supply of banking services to SMEs should be incorporated into a single market investigation into the supply of retail banking services.

1.9 In addition, the CMA also decided to review the undertakings that were put in place following the 2002 CC investigation into SME banking[11] ('the 2002 SME Undertakings'). While the 2002 SME Undertakings review is separate to the market investigation, given that there is significant commonality of analysis between the market investigation and the review of the 2002 SME Undertakings, we are running the two projects concurrently, with the same group of members.

[7] A detrimental effect on customers (including future customers) is defined in section 134(5) of EA02 as one taking the form of: *(a)* higher prices, lower quality or less choice of goods or services in any market(s) in the UK (whether or not the market to which the feature or features concerned relate); or *(b)* less innovation in relation to such goods or services.
[8] EA02, section 134(6).
[9] EA02, section 134(7).
[10] The personal current accounts study ('the PCA Market Study') and personal current accounts and banking services to small and medium-sized enterprises study ('the SME Market Study').
[11] Nine banks originally provided these undertakings in 2002. These were: AIB Group (UK) plc (known as First Trust Bank); Bank of Ireland; Barclays Bank plc (Barclays); Clydesdale Bank PLC; HBOS plc (now part of LBG); HSBC Bank plc (HSBC); Lloyds TSB Bank plc (now part of LBG); Northern Bank Limited (now known as Danske Bank); and The Royal Bank of Scotland Group plc (which also includes Ulster Bank Ltd in NI) ('RBSG'). The nine banks became eight following the acquisition of HBOS plc by LBG in 2009.

1.10 The Northern Ireland PCA Banking Market Investigation Order 2008 ('NI Order') was put in place following an investigation by the CC into the PCA banking market in NI. The NI Order was then reviewed and varied in 2011. Under the NI Order banks are required to comply with information and switching requirements. The CMA consulted on reviewing the NI Order on 20 May 2015. Following responses to this consultation, the CMA launched a review on 28 August 2015 and, like the review of the 2002 SME Undertakings, the review of the NI Order is being undertaken concurrently with the market investigation with the same members forming the remedy group. Further details can be found on the review page.

1.11 Under the terms of reference, PCA services comprise the provision of an account marketed to individuals rather than businesses, offering facilities to hold deposits, to receive and make payments by cheque and/or debit card, to use ATM facilities and to make regular payments by direct debit and/or standing order. Many PCAs also offer overdraft facilities, whether arranged or unarranged, which enable account holders to withdraw cash beyond the amount held in the account up to a specified amount. However, as set out in the terms of reference, PCA services do not include for the purposes of this investigation:

(a) an account in which money is held on deposit in a currency other than the official currency of the UK; or

(b) a current account mortgage, ie a single account comprising both a PCA and a mortgage, which is regulated and marketed principally as a mortgage.[12]

1.12 The terms of reference define an SME as a business that has annual sales revenues (excluding VAT and other turnover-related taxes) not exceeding £25 million. The provision of retail banking services to SMEs, as defined in the terms of reference, includes, but is not limited to, the provision of general purpose business loans, deposit accounts, BCAs and overdrafts. However, for the purposes of this investigation such services exclude other non-lending products such as insurance products, merchant acquiring, hedging services and foreign exchange services.

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[12] Where products marketed as 'offset accounts' comprise two separate accounts, a mortgage and a PCA with credit interest on the PCA being credited to the mortgage account, the mortgage account falls outside the terms of reference and the PCA falls within, even though the two products are linked for the purposes of interest calculations.

Conduct of the investigation

1.13 The following paragraphs provide an overview of the process we have followed in our investigation and how we have analysed the evidence, data and information we received. Further details can be found in Appendix 1.1.

1.14 We published an issues statement on 12 November 2014 taking into account the Market Studies. The issues statement identified three hypotheses or theories of harm to help frame the conduct of the investigation. These broad hypotheses encompassed the broad range of issues identified by the Market Studies which formed the basis for the market investigation reference.

1.15 Throughout the investigation to date we have had contact with and/or received submissions from a number of interested parties including banks,[13] consumer and SME representative groups, financial service providers, IT providers, government departments including in the devolved nations, regulators, academics, consumers, SMEs and trade associations.

1.16 A significant focus of our investigation has been on collecting and analysing data and other evidence from a large number of industry participants as well as regulators and other interested parties. We have consulted on our approach to key pieces of analysis including on our various surveys and qualitative research and analysis on profitability, pricing, switching and comparing perceived and actual behaviour of consumers.

1.17 On 21 May 2015, we published an updated issues statement (UIS) which set out our thinking based on the evidence received and the analyses we had undertaken by that time. The document highlighted those issues which we considered would be the focus of the investigation going forward and those issues which were of lesser concern. Between May and August 2015 we published a number of working papers.

1.18 We commissioned GfK NOP Ltd to conduct a customer survey and to undertake qualitative research into PCA customers, the results of which were published on our website in June.[14] We also commissioned Deloitte LLP (Deloitte) to investigate the impact of innovation in the UK retail banking market[15] and Research Works to carry out qualitative research into SME banking.[16] We acquired data held by Charterhouse Research

[13] For convenience we use the term 'bank' to refer to both banks and building societies throughout our provisional findings.
[14] GfK PCA consumer survey report.
[15] Deloitte (30 July 2015), *The impact of innovation in the UK retail banking market* ('Deloitte innovation report').
[16] Research Works (July 2015), *Small and medium enterprise customer research into the retail banking market: qualitative research report*.

(Charterhouse) from its Business Banking SME Surveys and also commissioned additional surveys from Charterhouse into SME banking. Our analysis of the Charterhouse data and the additional survey on NI have been put into a confidentiality ring and the other additional surveys we commissioned from Charterhouse were published on our website in August 2015.

1.19 We have published a number of documents on the CMA website. These include non-confidential versions of parties' written submissions, non-confidential versions of summaries of hearings held with parties, and parties' responses to our issues statement and updated issues statement. We have also published a number of updates to keep parties informed of progress of our investigation. Further details can be found in Appendix 1.1.

1.20 Between January and March 2015, members and staff attended 12 site visits to banks throughout the UK. In addition, a number of regulators and other parties attended meetings with members and staff at this time as part of our information gathering. Between June and August 2015 we held 14 hearings with interested parties, four of which were round-table hearings held with members of the British Bankers' Association 'challenger bank' group, the Welsh government and SME representatives in Wales, consumer organisations, and SME representative bodies respectively.

Structure of provisional findings

1.21 This document, together with its appendices, constitutes our provisional findings. It refers, where appropriate, to material published separately on the CMA website. The report, however, is self-contained and is designed to provide all material necessary for an understanding of our provisional findings. The accompanying Notice of Possible Remedies sets out details of remedies the CMA identified as possibly addressing the AECs effectively, and is the starting point for a discussion of remedies.

1.22 The remainder of these provisional findings is set out as follows:

- Section 2: Industry background.
- Section 3: The regulation of retail banking.
- Section 4: Market definition.
- Section 5: Structure and market outcomes for PCAs.
- Section 6: Structure and market outcomes for SME retail banking products.

- Section 7: PCAs.
- Section 8: Demand for SME retail banking services.
- Section 9: SME banking competition between banks.
- Section 10: Barriers to entry and expansion.
- Section 11: Market structure and market power
- Section 12: Provisional findings.
- Section 13: Review of 2002 SME banking undertaking.
- Section 14: Review of 2008 Northern Ireland PCA banking order.

1.23 Appendices supporting each section are numbered according to the first section where they are relevant and are listed in full in the table of contents at the beginning of this report.

1.24 Alongside this report we have also published:

- a summary of our provisional findings;
- a Notice of Provisional Findings in which we identify the features that we have provisionally found give rise to AECs in the supply of retail banking services to PCA customers and to SMEs in the UK; and
- a Notice of Possible Remedies in which we set out possible action that we may take to remedy, mitigate or prevent the AECs we have provisionally found or any resulting detrimental effects on customers.

2. Industry background

Introduction

2.1 In this section we provide an overview of the UK retail banking industry, focusing on:

(a) the macroeconomic environment and previous competition reviews;

(b) an overview of retail banking, including a brief description of PCAs and SME banking products, of customers and distribution channels, and a summary of the main banks and other market participants; and

(c) how retail banks generate income and profits, including an analysis of retail banking profitability.

2.2 The banking industry is highly regulated and this is considered in detail in Section 3.

Macroeconomic environment and previous reviews

Macroeconomic environment

2.3 We recognise that our market investigation is being carried out against a backdrop of highly unusual macroeconomic conditions following the global financial crisis in 2007/08 and the subsequent economic downturn. We have identified the following particularly relevant to our assessment:

(a) Very low central bank interest rates over a prolonged period. The BoE official rate has been held at 0.5% since March 2009: such near-zero interest rates have led to very low savings rates on instant access savings accounts, reducing the opportunity cost to personal and SME customers of holding deposits in low- or zero-interest current accounts. Several banks have also launched interest-bearing PCAs to attract customers who might otherwise open a savings account. We consider this aspect in Sections 4 and 7.

(b) The financial crisis impacted banks in many ways, for example:

(i) It resulted in significant government intervention in the banking sector to restore financial stability including the taking of large government holdings in RBSG and LBG.

(ii) It showed banks that reliance on the wholesale funding markets can be risky: banks' ability to access wholesale funding markets reduced significantly during the crisis. This has increased the importance of current account balances as a source of funding, known as retail funding. We consider the aspect of funding in more detail in Section 10.

(c) As banks sought to rebuild their balance sheets and improve their capital position after the financial crisis, partly in response to tightening regulatory capital requirements, and partly as a result of high levels of impairments, there was a general contraction of lending activity by the major banks, particularly to the SME sector. This contraction has also reflected a decreased demand for lending. The contraction has in part facilitated entry/expansion by new lending providers, including both new banks such as Aldermore and Shawbrook, and non-bank institutions such as peer-to-peer lenders. We analyse this in more detail in Section 10.

(d) The UK government has made a series of interventions with the aim of stimulating business lending, including the Funding for Lending Scheme (FLS), and the creation of the British Business Bank. We consider this in more detail in Sections 3 and 10.

(e) Following the financial crisis, the UK government has introduced a bank levy and recently also announced legislation to introduce a bank corporation tax surcharge, details of which are set out below.

Bank levy

2.4 Following the financial crisis, the UK government introduced a bank levy in January 2011, which applied to all banks (including building societies) operating in the UK. It is an annual charge on the value of all of the debts of the UK banks (including money deposited with the banks) on a global basis, with some exemptions:

(a) ordinary deposits covered by the UK's deposit insurance scheme;[17]

(b) borrowing backed by UK government debts;

(c) the first £20 billion of any bank's taxable debts; and

(d) the banks only pay half the tax rate on their long-term debts.[18]

[17] The Financial Services Compensation Scheme.
[18] Debts with a maturity of more than one year.

2.5 The rate was originally set at 0.05% at its introduction in 2011 and rose nine times to 0.21% up to the budget in March 2015. The bank levy raised £2.2 billion in 2013/14.

2.6 In the summer budget in July 2015, a reduction in the rate to 0.1% was announced over the next six years, and from 2021 the levy will only be charged on UK balance sheet liabilities. As the bank levy is charged at the balance sheet date, the new rates affect periods ending after 31 December 2015. The levy is not a tax on bank profits, but on the size of the balance sheet, so must be paid even when a bank does not make any profit.

Bank Corporation Tax surcharge

2.7 In the summer budget in July 2015, the Chancellor also announced a new 'bank corporation tax surcharge', a supplementary tax on banking sector profit of 8% to be levied on banks' and building societies' profits arising after 1 January 2016. The new tax surcharge will be collected alongside corporation tax, similar to the collection of the bank levy.

2.8 It will apply to 'total taxable profits' computed for corporation tax purposes, excluding group relief from non-banking companies. Losses arising prior to 2016 are also excluded, which effectively excludes any legacy losses incurred during the financial crisis and start-up losses of new entrant banks. There is a £25 million annual allowance, such that participants with profits below that level should not pay the surcharge. There is no facility to carry forward unused allowances.

2.9 The proposed surcharge has recently been subject to public debate, in the context of its likely impact on competition, and we will consider any submissions on this issue made to us. A number of building societies and smaller banks have expressed significant concerns with the proposed surcharge and the impact it will have on new entry and their ability to expand. We will be considering further the implications of the new surcharge in light of submissions we receive.

Previous competition reviews

2.10 The UK retail banking sector has been the subject of substantial scrutiny by the UK competition authorities and by other UK bodies over the last 15 years. These reviews have included:

- Sir Donald Cruickshank's review of retail banking, published in 2000;

- the CC's investigation into the supply of SME banking services, published in 2002 which resulted in the 2002 SME Undertakings;
- the CC Northern Ireland PCA investigation in 2007;
- previous OFT market reviews, 2008 to 2013, relating to SME banking and PCAs);[19]
- the ICB, chaired by Sir John Vickers, whose final report was published in 2011;
- the Parliamentary Commission on Banking Standards (the PCBS), whose report was published in 2013;
- the two CMA market studies published in 2014, which resulted in this investigation.

2.11 Many of the measures adopted in the past to address competition concerns identified by these reviews in PCA and SME banking have been enabling measures intended to improve customer engagement and in particular, transparency of bank charges and terms.[20] Some of these measures have been implemented through voluntary compliance on the part of the industry.[21] Others have required regulatory intervention. A remedies package focused on providing greater information to customers and helping facilitate the switching process was put in place by the CC following its 2007 market investigation on PCA banking services in Northern Ireland.[22]

2.12 Measures have been also taken to improve availability of credit information in order to facilitate switching, particularly for SME customers. For instance the Small Business, Enterprise and Employment Act 2015 provides for

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[19] These included *Personal current accounts in the UK. An OFT market study* (July 2008); *Personal current accounts in the UK. A follow up report* (October 2009); *Personal current accounts in the UK. Unarranged overdrafts* (March 2010); *Personal current accounts in the UK. Update on unarranged overdraft charges* (July 2010); *Personal current accounts in the UK: Progress update* (September 2010); *Review of barriers to entry, expansion and exit in retail banking* (November 2010); *Personal current accounts in the UK. Progress update* (March 2011), *Review of the personal current account market* (January 2013).

[20] The following are examples of measures introduced/proposed as a consequence of various OFT reviews carried out between 2008 and 2013: the provision to customers of an annual summary of cost of account; making charges more prominent on statements; providing average credit and debit balances; the provision to customers of illustrative scenarios showing unarranged overdraft charges. These measures were largely in the nature of voluntary initiatives agreed between the OFT and the industry.

[21] For example, the Lending Standards Board developed minimum standards on opt out of unarranged overdraft facilities and best practice guidance for PCA providers in dealing with customers in financial difficulty. These were incorporated in the Revised Lending Code published on 31 March 2011, a voluntary code of conduct within the banking sector.

[22] This remedy was implemented through the CC's Northern Ireland PCA Banking Market Investigation Order 2008 and came into effect in February of that year. The order was varied in 2011 following a review by the CC, which found that there had been a change of circumstances as a result of the coming into force of the Consumer Credit Directive and the Payment Services Directive. Section 14 discusses the order in more detail.

regulations to require larger banks to share data on their SME customers with other lenders through credit reference agencies, which are then required to ensure equal access to that data for all lenders. This is discussed in more detail in Appendix 3.1.

2.13 The ICB report recommended the introduction of the seven-day Current Account Switch Service (CASS), to facilitate switching of current accounts by personal and SME customers. CASS was launched in September 2013, as a voluntary scheme set up as part of an industry-wide programme by the Payments Council and is now owned and operated by Bacs Payment Schemes Ltd (Bacs).[23] The effectiveness of CASS and consumer confidence in CASS is discussed in more detail in Sections 7 and 8.

2.14 One of the remedies implemented following the CC's SME banking investigation in 2002 intended to directly control outcomes, required the four largest clearing banks in England and Wales to pay interest on BCA credit balances. This requirement was removed in 2007, following the OFT's review of the remedy.

2.15 Both the ICB and the PCBS recommended that consideration should be given to the CMA carrying out a market investigation reference by 2015, if not before, unless there had been sufficient changes in the state of competition in the retail banking sector.

2.16 Structural remedies such as divestitures have been considered by many inquiries, but have never been implemented on purely competition grounds; the divestiture of TSB in 2013 from LBG was undertaken in order to comply with the EU's state aid requirements. Under the same EU requirements, RBSG is required to divest Williams & Glyn by the end of 2017.[24]

2.17 The CMA SME study and the PCA update reports published on 18 July 2014 noted that there had been important developments and initiatives to improve competition in the sector in recent years. However, despite these developments, the market study reports identified a number of features which the CMA suspected prevent, restrict or distort competition in connection with the provision of retail banking services to SMEs and the provision of PCAs. Accordingly, alongside the market study reports, the CMA also published its provisional decision to make a market investigation reference. This decision

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[23] The FCA published a review of the effectiveness of CASS in March 2015: *Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability*.
[24] In May 2015, the CMA was asked by HMT to assess the likely impact of the latest proposals for the divestment of Williams & Glyn for competition in the UK banking sector. This work is being carried out separately from this market investigation. The CMA will conclude its advice once the Prudential Regulation Authority (PRA) has had the opportunity to examine the Williams & Glyn business plan.

was confirmed on 6 November 2014 when the CMA launched the current investigation.

Background to UK retail banking

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

2.19 There are over 5 million SMEs in the UK, which account for two-thirds of the private sector workforce and half of all UK private sector turnover. There are approximately 5.5 million BCAs which generated approximately £2.7 billion in revenue in 2014. The total stock of outstanding general-purpose business loan balances at the end of 2014 was £90 billion with a further £9 billion of invoice finance loans and £25 billion of new asset finance loans.

Overview of retail banking: products and customers

2.20 Retail banking generally refers to the provision of products and services provided by banks to personal customers and businesses, including SMEs, through a variety of channels including branches, telephony, internet and mobile technology. Retail Banking is generally used to distinguish these banking services from investment banking or wholesale banking. The main functions of retail banks are accepting deposits, making loans and providing payment services.

2.21 All retail banks distinguish between personal and business customers but may further organise their activities according to products offered (eg mortgages, credit cards) or size (eg smaller versus larger businesses). Many large UK retail banks have separate retail banking divisions or business units, with their own management and reporting structures, although there are differences in the way these banks define, organise and describe their retail activities. Appendix 2.2, Table 1 sets out further details on how the five largest UK banks segment their retail businesses.

2.22 There are many other products and services that comprise retail banking apart from PCAs and SME banking services, which are the reference products for our investigation. These include, for example, residential mortgages, personal loans, personal deposits, insurance, and merchant acquiring. The product characteristics of PCAs and SME banking are described in more detail in Section 4.

2.23 Typically, individuals and small businesses constitute the core of a retail bank's customer base. Some UK banks also have wealth management and private banking activities within their retail activities to serve high-net-worth individuals. Retail divisions of the UK banks tend to serve start-ups and smaller SMEs, while larger SMEs and corporates are generally served by commercial or corporate banking divisions. Most banks categorise SMEs by annual sales/turnover and/or borrowing requirements to determine which of their divisions would cater to these businesses, although the cut-off for separating SMEs and larger corporate customers varies between banks. PCA and SME customer characteristics are considered in detail in Sections 7 and 9, respectively.

Overview of retail banking: channels

2.24 Historically, customers interacted with banks solely through high street branches and by post. Since the 1990s, banks have increasingly offered access to banking services via telephone, online, and more recently through mobile applications (apps). The distribution channels through which customers can access products and services from their bank continue to evolve.

Branches

2.25 Branches have traditionally been the principal distribution channel for banks, used by customers for checking account balances, handling cash payments and withdrawals, and obtaining advice. On average 78% of PCAs were opened in branch in 2014, down from 81% in 2013.[25] A Charterhouse survey of SME start-ups found that 82% use their local branch to open their BCA.[26]

2.26 In recent years the number of bank branches in the UK has been in decline. At the end of 2013, there were 10,208 bank branches in the UK[27,28] reducing to 9,661 at the end of 2014. Some banks also have stand-alone 'business centres' for SME customers, and the total number of these was 495 in 2014[29]. Further information on branches is set out in Appendix 10.1.

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[25] See Appendix 10.1.
[26] See Appendix 10.1.
[27] Based on data provided by banks as at 1 January 2014 (approximated stock 2013) and at 1 January 2015 (approximated stock 2014). See Appendix 10.1 for further details.
[28] Includes retail branches and co-located business centres. Excludes business centres that only service SME customers.
[29] Based on data provided by banks as at 1 January 2014 (approximated stock 2013) and at 1 January 2015 (approximated stock 2014). Branches (business centres) that service SME customers only. See Appendix 10.1 for further details.

Telephone

2.27 Telephone banking services were launched in the 1980s with Girobank[30] offering the first telephone banking facility in Europe and First Direct launching in 1989 with the world's first telephone-only bank. Most banks now provide a range of telephone-based banking services to complement their other delivery channels.

Digital banking

2.28 Internet banking (using a computer rather than a mobile or tablet) has grown very rapidly. For example, LBG noted that in May 2014, 8.8 million of its customers accessed 16.4 million accounts online.[31] Whilst mobile banking has recently made a considerable impact on how customers access their accounts, internet banking remains a popular channel. A British Bankers' Association report noted that 'although many mobile banking apps now offer increased functionality, most do not quite replicate the services available through internet banking'.[32]

2.29 Mobile banking is nevertheless delivering a transformation of the way in which people interact with their money and their banks. In recent years, the capabilities of mobile banking via apps has increased to narrow the gap between internet and mobile channels.

2.30 The British Bankers' Association reports that apps offered by the larger banks were being used 18.2 million times a week in 2014 and more than £1.7 billion was transferred a week using mobile phones or tablets.[33] The European Financial Management Association projected in 2014 that 60% of all banking transactions would be conducted on mobile devices within three years.[34]

Other channels

2.31 Other channels for customers to access their banking services include:

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[30] Girobank was launched by the Post Office in 1968 and was intended to offer a complementary service to that of the clearing banks mainly for those people without a bank account. It relaunched as National Girobank and by the late 1980s, National Girobank had managed to become Britain's sixth largest bank. It became independent in 1988, became a public limited company, and was bought by the Alliance & Leicester Building Society in 1990; (now part of Santander). Source: Development of the post office network, Business and Enterprise Committee, HoC.
[31] British Bankers' Association report (2014), *The way we bank now: it's in your hands*.
[32] ibid.
[33] ibid.
[34] European Financial Management Association (ESMA), 2014, Mobile banking: The dawn of a new era for retail banks (from British Bankers' Association report (2014), *The way we bank now: it's in your hands*).

(a) Post Office – PCA and smaller SME customers of most UK banks can undertake a range of transactions at approximately 11,000 Post Office counters across the UK including depositing and withdrawing money, and checking account balances.[35]

(b) Inter-bank agency agreements – some banks offer their customers the ability to undertake a range of transactions at other bank branches, usually those with large geographic coverage across the UK.[36]

Market participants

Recent history: structural changes and M&A activity

2.32 There have been a number of mergers and demergers in the UK banking market in the last 15 years, which have shaped the structure of the retail banking industry today. We list the most significant below:

(a) In 2001, Lloyds TSB attempted to merge with Abbey National plc but the merger was blocked by the CC.

(b) In November 2004, Santander acquired Abbey National plc.

(c) In September 2007, Northern Rock sought and received a liquidity support facility from the BoE, to replace funds it was unable to raise on the money markets. This led to a ‘bank run’ by depositors, seeking to withdraw deposits en masse. Following two unsuccessful bids to take over the bank, it was taken into state ownership in February 2008, and split into two parts: assets (the so-called ‘bad bank’) and banking (the so-called ‘good bank’), in January 2010. Virgin Money acquired the ‘good bank’ in January 2012 and the assets (the ‘bad bank’) in June 2012.

(d) In October 2008, Santander acquired Alliance & Leicester. Santander also acquired in 2008 from the UK government the deposits and branches of Bradford & Bingley.

(e) In January 2009, Lloyds TSB acquired HBOS to create LBG in the light of serious concerns that without external support HBOS would fail. The OFT recommended that the merger not proceed, but the UK government in exercise of its powers under EA02 approved the merger by order in

[35] BIS press release (26 March 2015): Branch closures protocol.
[36] See, for example, LBG inter-bank agency agreements.

September 2008 on public interest grounds to ensure the stability of the UK financial system.

(f) Following the RBSG bailout by the UK government in October 2008, RBSG was subject to a European Commission state aid review and as a consequence is in the process of divesting Williams & Glyn, required by 31 December 2017.

(g) LBG was bailed out by the UK government in October 2009. In order to comply with European Commission state aid requirements, LBG was required to divest its TSB business, which it did via an initial public offering in June 2014.

(h) Clydesdale Group, which comprises the Clydesdale and Yorkshire Bank brands, is a wholly owned subsidiary of National Australia Bank Group (NAB). In May 2015, NAB announced its intention to pursue a demerger and IPO of Clydesdale.

(i) In March 2015 Sabadell, the fifth largest bank in Spain, announced the agreed acquisition of TSB.

Market participants

2.33 The UK retail banking landscape is complex and has changed substantially over the last 15 years because of the impact of the macroeconomic environment, government interventions and structural changes mentioned above, but also the development of new business models and advancements in technology. Retail banking providers in the UK can be broadly categorised as follows.

(a) Large UK banks, such as LBG, RBSG, HSBCG, Barclays and Santander, which have UK coverage and a full retail banking product offering. LBG, RBSG, HSBCG and Barclays have had in one form or another a UK-wide presence in retail banking for over 100 years; Santander entered the UK retail banking market with its acquisition of Abbey National plc over a decade ago.

(b) NI-focused banks: AIB, BoI and Danske.[37]

(c) Other banks, including new entrants and banks with more limited geographical coverage or which focus on particular product, customer segments and/or distribution channels include: Clydesdale, TSB,

[37] Ulster Bank also operates in NI and is wholly owned by RBSG.

Handelsbanken (part of a Swedish banking group), Tesco Bank, Virgin Money, Co-op, Metro, Aldermore, Shawbrook, Secure Trust Bank and Paragon Bank. See Appendix 10.2 for more detail on some of the new entrants.

(d) Building societies, which are owned by their members (ie customers) and not shareholders. Historically, they tended to focus on offering mortgages and savings products, but since 1986 many now offer a broad range of retail banking products. There are over 40 building societies in the UK, many of them with regional customer bases. The five largest building societies are Nationwide (by far the largest UK building society), Yorkshire Building Society, Coventry Building Society, Skipton Building Society and Leeds Building Society.

(e) Credit unions, which are small and local non-profit lending institutions, owned by their members and typically serving those customers who are unable to access standard retail bank products through the banks or building societies. Examples include London Mutual, Bristol Credit Union and Glasgow Credit Union.[38]

(f) Other market participants:

(i) Alternative finance providers cover a large range of different types of lending. These include crowd-funding, peer-to-peer lending, invoice trading/finance, community shares, pension-led funding and debt-based securities.

(ii) New payment providers offer alternative ways for customers to manage their money, including different ways to make payments and receive funds, facilities to hold credit balances, and to borrow money. Examples include digital wallets and other services offered by non-traditional, digital market participants in the payments sector such as PayPal, Amazon, Google and Apple, which are further considered in Section 4.

2.34 A more detailed description of the main banks and building societies operating in the UK is provided in Appendix 2.1 and in Appendix 10.2 on new entrants.

How retail banks generate income and profits[39]

[38] For more examples of credit unions see ABCUL website.
[39] This section draws on the information contained in the TSB IPO doc (Price range prospectus, 9 June 2014).

Introduction

2.35 As discussed above, retail banks offer a range of banking services, which include borrowing, saving, transaction services and insurance. Products offered include PCAs, savings accounts, mortgages, personal loans, credit cards, insurance products and investment products.

2.36 In this section we provide an overview on how retail banks use both the assets and liabilities on their balance sheets to generate income and profits. At the end of this section we present our findings on retail banking profitability. In Sections 5 and 6 we look at the financial performance of PCAs and SME banking.

Balance sheets: assets, funding and capital

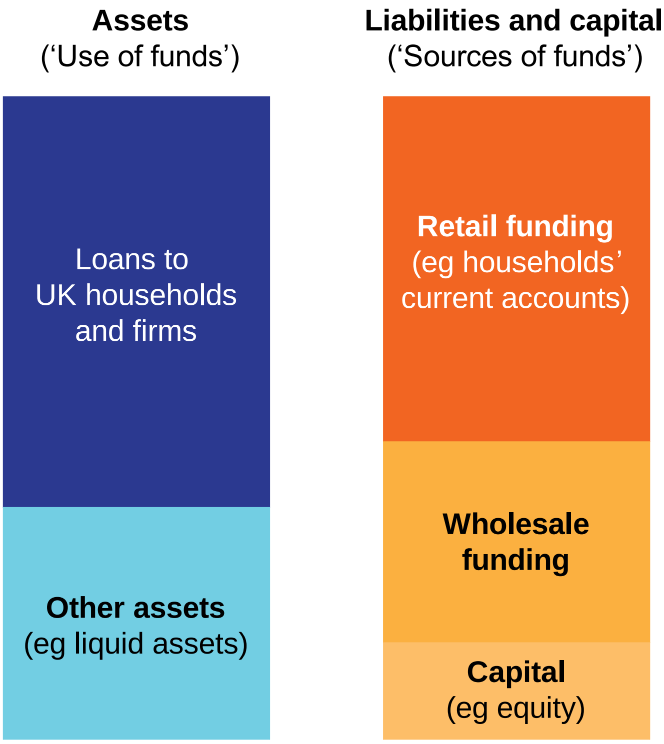
2.37 The majority of a retail bank's assets[40] consists of loans made to customers (including loans secured by mortgages). Those assets are funded by liabilities, in the form of retail funding (customer deposits) and wholesale funding. During the financial crisis there was a move away from wholesale funding as prices spiked relative to retail funding, and retail funding remains the main funding source for UK retail banks.[41]

2.38 Banks are also required to hold capital[42] to cover potential losses, such as impairments (see paragraph 2.42 below). The amount of capital a bank is required to hold depends on the bank's total assets and the risk weighting of these assets, which in turn depends on the risk profile of the underlying loans. Following the financial crisis, banks are now required to hold more capital than previously, enabling them to absorb some or all of their losses more readily in the event of a crisis.

2.39 Figure 2.1 illustrates a stylised bank balance sheet, showing a bank's sources of funds (liabilities and capital) and its use of those funds (assets). Total liabilities plus capital must equal assets, for the balance sheet to balance.

[40] When considering a bank's balance sheet, it is important to consider it from the point of view of the bank. That is, customer loans, mortgages etc are assets to the bank (ie money owed to the bank by its customers), and customer deposits, savings etc, are liabilities to the bank (ie money owned by customers).
[41] See Section 11 for further details on cost of funding.
[42] Capital is on the liabilities side of the balance sheet.

Figure 2.1: Stylised bank balance sheet



Profit and loss

2.40 Figure 2.2 illustrates a stylised bank profit and loss account, showing sources of income and costs.

Figure 2.2: Stylised bank profit and loss account

Net interest income	X
Net fees and commissions	X
Other income	X
Total income	X
Direct expenses, eg staff costs	X
Indirect costs, eg head office costs	X
Conduct and litigation costs	X
Total operating costs	X
Impairments	X
Total costs	X
Profit before tax	X

Income and expenses

2.41 Retail banks have two primary sources of income: interest income; and fees and commissions income.

(a) Interest income is primarily earned by a bank lending money to customers and charging interest on the amount lent. A bank earns interest income by lending money to customers at higher rates of interest than it costs the bank to borrow funds from depositors and/or wholesale markets.

(b) Fees and commissions income: banks earn fees and commissions income by charging customers fees for services and receiving commissions from, and participating in profit-sharing agreements with, other product providers. Examples of fees and commissions include fees for use of an overdraft, fees for packaged accounts, and income from the ATM (cash machine) network.

2.42 Retail banks have two main categories of costs: operating costs and impairments.

(a) Operating costs. A bank's operating costs typically consist primarily of costs relating to employees, IT and property. A common way of measuring a bank's operating cost efficiency is the cost:income ratio, which is defined as the ratio of operating costs (excluding impairments) to income.

(b) Impairments. Impairment charges are caused by losses on loans where customers have defaulted or are expected to default. Macroeconomic conditions, and in particular house prices, interest rates and unemployment, are significant drivers of impairment charges.

2.43 Recent years have seen increased volatility in the net profitability of retail banks in the UK as a result of regulatory fines and other sums paid by banks, including sums paid in settlement of regulatory proceedings, and their associated provisions (mainly related to the mis-selling of payment protection insurance (PPI)).

Net interest income and net interest margins

2.44 A bank's profit comes from the difference between its income and its costs. At a bank level, net interest income (NII) is the difference between the interest received on assets (loans) and that paid on liabilities (deposits). Net interest income is then used to determine the bank's overall net interest margin (NIM), which at a bank level is typically calculated as the bank's total net interest income expressed as a percentage of the bank's average interest-earning assets during a year.

2.45 In addition to measuring NII and NIM at a bank level, banks also use a variation of the concepts of these, at a product level. Product NII and product

NIM are used for internal purposes by a bank's management to reflect and monitor relative performance/profitability of a particular product or range of products.[43]

2.46 The starting point for the determination of product NIM is the customer rate, being the interest rate charged to the customer (in the case of loans) or paid to the customer (in the case of deposits).

2.47 For a customer loan, the product NIM is defined as the applicable customer rate less the applicable cost of funds. The cost of funds is an internal estimate of how much it costs the bank to raise the funding required to provide that customer loan. Therefore, product NII and product NIM measure the difference between the income generated by the assets and the estimated cost to the bank of funding those assets.

2.48 For a customer deposit, the product NIM is defined as the applicable value of funds, which is an internal estimate of how valuable that deposit is to the bank as a source of funding, less the applicable customer rate.

Cost and value of funds

2.49 The cost of funds is an internal estimate of how much it costs the bank to raise the funding required to provide a customer loan, and the value of funds is an internal estimate of how valuable that deposit is to the bank as a source of funding. The cost of funds and value of funds vary by product and depend on that product's characteristics, most notably its expected lifetime (often referred to as its behavioural maturity). The cost/value of funds is typically higher for products with longer behavioural maturities. Banks have different approaches to calculating their internal cost of funds and value of funds, but most banks use the cost of wholesale funding with the same behavioural maturity as the relevant product. For loans and deposits of the same behavioural maturity, the cost of funds and value of funds are typically very similar.

Retail banking financial performance

2.50 In paragraph 2.3, we discussed the effects of the global financial crisis on banks, including their efforts to rebuild their balance sheets and improve their capital position, partly in response to tightening regulatory capital requirements, and partly as a result of high levels of impairments.

[43] See further details in Sections 5 and 6 where we consider product profitability.

2.51 The following section summarises an analysis of retail banking profitability in the UK. This section is supplemented by Appendix 2.2 which contains more detailed analysis and evidence on retail banking financial performance.

2.52 The purpose of conducting a market-wide profitability analysis is to understand whether there are levels of profitability in excess of what we might expect in a competitive market. If excess profits have been sustained over a relatively long period of time, this could indicate limitations in the competitive process.

2.53 We decided it would not be possible to carry out a robust profitability analysis which would give us certainty as to whether this was, or was not, the case.

2.54 There are no stand-alone providers of PCAs or SME banking in the UK. Furthermore, no providers in the UK treat their PCAs or SME banking businesses as separate: they are reported within their retail banking businesses. Therefore, no providers were able to produce a separate profit and loss account or balance sheet for each of their PCA or SME banking businesses which had been produced as part of their management information reporting pack.

2.55 There were factors specific to the assessment of profitability in the PCA and SME banking markets which made the originally proposed analysis particularly problematic. These included the appropriate allocation of common and shared costs, equity capital, and revenues. We discuss each of these allocation issues in turn. We also considered that there were issues surrounding the estimation of a benchmark return on equity for stand-alone PCA and SME banking products. The background against which we were to carry out this analysis, in particular the impact of the financial crisis and the market restructuring which followed would have made any analysis of profitability over time complex.

Shared and common costs

2.56 PCAs and SME banking services are typically shared with one or more other customer groups or banking products and there is a significant degree of joint production. Branch networks, frontline staff, payment systems, ATMs, self-service kiosks, and IT systems are parts of the value chain that are shared with other customer groups or banking products. In addition to the shared costs, providers incur a variety of common costs such as head office costs. Thus, measuring income and costs for a specific product category (like PCAs) or customer segment (like SME banking services) would not be straightforward.

2.57 We noted that each bank uses a range of methods to allocate its shared and common costs, and that each bank's approach to the allocation of shared and common costs would differ depending on its organisational structure, activities, strategy and other business needs. In addition, different banks adopt different business models, and provide only a subset of personal and/or business banking products to different subsets of customers. Furthermore, we acknowledged that reported fully allocated costs for a product or service would not be comparable across providers; cost allocation methods would need to be adjusted regularly to reflect providers' changing business needs and cost structure; and that total cost data for a provider may not have been consistent over the relevant period. We therefore noted that the range of outcomes from an allocation of costs would be extremely wide.

Equity capital

2.58 As noted above, no providers were able to produce a separate account or balance sheet for each of their PCA or SME banking businesses which had been produced as part of their management information reporting pack, and therefore an appropriate amount would have had to be estimated.

Revenues

2.59 Given the interdependency of PCAs and SME banking with other banking products, no providers were able to product a profit and loss account for each of their PCA or SME banking businesses which had been produced as part of their management information reporting pack, therefore an appropriate figure would have had to be estimated. Funds transfer pricing (FTP) is the means by which banks attribute funding costs to the business unit making use of the deposits raised (ie loans originated) and to attribute income to the business unit generating the deposit (ie deposits taken). FTP arrangements are necessarily provider specific and will reflect each provider's individual circumstances, including its balance sheet position, credit rating and possibly its business strategy.

2.60 We considered that there were a particularly large number of allocation adjustments and assumptions necessary in order to arrive at a profit and loss account for each provider. Taken cumulatively, this would have made an objective judgement extremely difficult. We also considered that any scenario analysis would have resulted in a very wide range of outputs, rendering the results of any analysis meaningless.

2.61 Due to these reasons, we decided not to undertake the market-wide profitability analysis as originally proposed, and instead have used the financial information from banks' annual reports and accounts, together with selected industry publications, reports by equity analysts and consulting/ accounting firms, to inform our understanding of the overall profitability trends in retail banking in the UK.

Data sources

2.62 The publications and reports we used for our analysis include the following:

(a) Oliver Wyman's reports on UK and European retail banking (2012, 2014).[44]

(b) Deutsche Bank report on UK retail banking (2014).[45]

(c) Credit Suisse UK retail banking Seminar (2014).[46]

(d) KPMG reports on UK banks' financial results (2015).[47]

(e) A T Kearney retail banking radar (2015).[48]

(f) Association of British Insurers (ABI) report on UK banks (2012).[49]

(g) EY European banking barometer.[50]

2.63 In addition, we gathered data and financial metrics on the recent financial performance of the selected divisions of the five largest UK retail banks,[51] using their published annual reports and accounts for the period 2012 to 2014.[52,53] The financial metrics we analysed included:

(a) NIM;

(b) cost income ratio;

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[44] Oliver Wyman (2012), *Perspectives on the UK Retail Banking Market.* Oliver Wyman (2014), *European Retail and Business Banking: Laying the Foundations for Recovery.*
[45] UK Retail Banking 2014: Bank to the Future, Deutsche Bank Equity Research, September 2014
[46] Credit Suisse UK Retail Banking Seminar (July 2014).
[47] KPMG (2015), *A paradox of forces. Banking results: What do they mean for you?* KPMG (2015), *The game changers – Challenger Banking Results.*
[48] AT Kearney, *The 2015 Retail Banking Radar: Time to Reinvent Your Banking Model.*
[49] ABI (2012), *Investibility of UK Banks.*
[50] EY (2015), European Banking Barometer.
[51] The information and data we gathered was from the published annual reports and accounts of Barclays plc, HSBC Bank plc, Lloyds Banking Group plc, Royal Bank of Scotland Group plc and Santander UK plc. See Appendix 2.2 for details about the retail divisions we included in our analysis.
[52] We would have liked to present data across a wider time period/full economic cycle, but this was not possible due to the lack of comparability between years and banks due to changes in the banks' reporting structure, as the time period increased.
[53] See Appendix 2.2 for further details, and definitions of these metrics.

(c) impairments and other provisions as percentage to total income;

(d) share of net interest income in total income; and

(e) Return on equity (ROE).

2.64 Although using data from published reports and accounts has the advantage of having been reviewed by the banks' management, and being largely based on audited financial information, it also has many limitations, including the following:

(a) Each bank is organised differently, and there is no common definition of retail banking. Banks' divisional structures do not align with the definitions of PCA and SME banking services in our terms of reference. Banks' divisions include businesses that are not relevant, or exclude the ones, which are relevant to understand financial performance of their UK retail banking operations.

(b) Some banks allocate their common/central costs to their main business divisions or units, while others keep them in a central division.

(c) Where banks have undergone organisational changes, they have not always reported or restated prior years' financial data at a divisional level.

(d) Lastly, reported results are affected by the accounting policies and definitions of metrics each bank follows; some banks present profits and financial metrics net of what management considers exceptional or non-recurring items, while others do not.

2.65 Due to these limitations, financial data and metrics reported in annual reports and accounts are not directly comparable between banks. That said, financial accounts provide a useful overview of the banks' performance, especially of the evolution of a bank's financial metrics over time.

Summary evidence on retail banking performance

2.66 Based on the reports we looked at, UK retail banking performance and its outlook paint a mixed picture. Although banks appear to be benefiting from improved economic conditions, lower impairments and improved NIM, they continue to face high customer remediation and conduct costs, which has an adverse impact on profitability. While profitability of retail banks is improving as they recover from the financial crisis, persistent low interest rates continue to limit profits, even as banks' risk provisions decline from the 2012 historical highs.[54]

2.67 Banks are becoming more reliant on net interest income rather than fees to increase their total income. Mortgages appear to be the most profitable business segment within UK retail banking, although it faces some pressure on margins. Banks also continue to benefit from having access to stable customer deposits, which remain a valuable source of relatively cost-effective funding.

2.68 While the total reported income of the banks' retail divisions we analysed remained relatively stable between 2012 and 2014, the reported profit, in general, showed an upward trend during this period. Impairments and other provisions for the retail banking divisions declined sharply during 2012 to 2014; overall, changes in impairment charges accounted for over half of the profit changes for these divisions during this period.[55]

2.69 The ROE estimates in different reports we referred to, varied substantially. The 2014 Oliver Wyman report stated that the retail banking industry in the UK earned high (around 20%) ROE in the recent years after excluding exceptional items such as PPI redress costs. Estimates provided by other reports were significantly lower, in the range of about 8 to 13%.Our analysis showed that UK retail banks' average reported ROE during 2012 to 2014 was about 9%.[56]

2.70 Our analysis further revealed that the banks' retail divisions' average reported ROE (and therefore accounting profitability) improved from 7.5% in 2012 to 11.8% in 2014, as banks continued to recover from the effects of the financial crisis and gained from lower impairments.

2.71 We have not undertaken an analysis to estimate the cost of equity of retail banks in the UK, and so cannot provide a view on how much higher banks' reported ROE is above their cost of equity. An ABI study to which we referred suggested that the cost for equity for retail banking in the UK was in the range of 8 to 10%.[57]

2.72 Due to our focus on identifying overall industry trends, we did not undertake an analysis comparing the profitability of the larger/longer-established and

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[54] A T Kearney, *The 2015 Retail Banking Radar: Time to Reinvent Your Banking Model,* p1.
[55] Refer to Figure 5 in Appendix 2.2 for further details.
[56] Some of the reasons for the differences between these estimates could be due to a combination of the following: *(a)* treatment of conduct penalties and charges; *(b)* coverage in respect of number of banks and type of operations; and *(c)* methodology to calculate ROE. For details, refer to Appendix 2.2.
[57] ABI (2012), *Investibility of UK Banks.* p6.

smaller/newer entrant UK retail banks at the retail banking level. A KPMG report presented an analysis of the financial results of 'challenger' banks, including some comparisons with larger, longer-established UK banks (referred to as the 'Big Five' by KPMG) during the period 2012 to 2014. Its findings included the following:[58]

(a) 'Smaller Challengers' achieved a higher average ROE of 18.2% in 2014 compared with ROE of 2.1% of 'Larger Challengers'.[59] KPMG stated that among the 'Larger Challengers', there was a wide range of reported ROE, from –7.2% to +10.4%, reflecting (at the lower end) conduct-related charges and accounting adjustments.[60]

(b) Average cost:income ratio of the largest five banks was 63% in 2014, which was similar to that of all the 'Challengers' (excluding NAB) at 64%.[61] The 'Smaller Challengers', however, had a much lower cost income ratio of 53% in 2014, which according to KPMG, could be down to a range of factors, including a number of one-off costs offset by a simpler business model and product set.[62]

(c) The 'Smaller Challengers' average NIM during the period 2012 to 2014 was in the range of about 2 to 3%, while the corresponding range for the 'Larger Challengers' and the largest five UK banks was lower at about 1.5 to 2%.[63] The 'Smaller Challengers' achieved an increase in average NIM between 2012 and 2014 primarily as a result of cheaper funding, which was largely because of the introduction of the FLS. The 'Larger Challengers' also gained from the FLS, but according to KPMG, this benefit was offset by the effect of increased competition in prime residential mortgage lending.[64]

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[58] KPMG (2015), *The game changers – Challenger Banking Results*'. 'Large Challengers' were defined by KPMG to include Bank of Ireland UK (Post Office), NAB, TSB and Virgin Money. 'Small Challengers' were: Aldermore, Handelsbanken, Metro, OneSaving Bank, Shawbrook Group and Secure Trust Bank. 'Big Five' UK banks as defined by KPMG were Barclays, HSBC, Lloyds Bank, RBS and Santander. KPMG's report made reference to the 2014 results. It obtained the information for its analysis from published 2014 year-end reports and company websites. The total numbers presented in the report were the total of the sub-division of banks in scope as described above, excluding Metro which had not released its 2014 results at the date of drafting the report. p2, p22.
[59] ibid.
[60] ibid.
[61] ibid, p3.
[62] Ibid.
[63] KPMG stated that the, 'Larger Challengers mostly offer retail mortgages, while the Smaller Challengers offer a mix of SME lending, second charge mortgages, asset finance, invoice financing and unsecured lending – all of which, for the moment at least, generate higher margins.' KPMG (2015), *The game changers – Challenger Banking Results*. p8.
[64] ibid.

(d) 'Challenger' banks had on average a higher ROE than the largest five banks in 2014.[65] Average ROE for the Challenger banks grew from –4% to 2012 to +3.8% in 2014, while the corresponding ROE for the largest five UK banks was 0.7% and 2.8% in 2012 and 2014 respectively.[66]

2.73 KPMG acknowledged that ROE based on reported profits was a crude measure of profitability, given the complexity of accounting and the scale and frequency of non-recurring items. However, it stated that 'directionally the picture was clear' in respect of improvement of profitability across the 'Challenger' banking sector. Further, according to KPMG, the 2014 average ROE of 18.2% for the 'Smaller Challengers' demonstrated that despite record low interest rates and intensifying market competition, there were 'pockets of profitability' in UK banking.[67]

2.74 The difference between the 'Smaller and Larger Challengers' as categorised by KPMG appears to be that most of the banks in the former category are 'niche players',[68] while the latter offer a wider range of banking products and services. This difference could potentially be one of the reasons driving higher relative profitability of the 'Smaller Challengers'.

2.75 Overall, due to the differences in the definitions and methodology to calculate the banks' profitability metrics in the published accounts and other reports we looked at, we cannot draw any definitive conclusions about the relative profitability of retail banks in the UK. However, we note the following general highlights of the financial performance of the retail banking divisions in scope of our analysis during 2012 and 2014:[69]

(a) stable total income;

(b) improving profits and average ROE (from 7.5% in 2012 to 11.8% in 2014), largely driven by lower impairments;

(c) stable or increasing NIM: average NIM increased from 2.5% in 2012 to 2.7% in 2014;

(d) declining cost income ratio: average cost income ratio declined from about 63% in 2012 to about 60% in 2014;

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[65] ibid, p4.
[66] ibid, p6.
[67] ibid.
[68] ibid.
[69] See Appendix 2.2 for further details and analysis.

(e) declining impairments: percentage of impairments and other provisions to total income declined from an average of 14% in 2012 to about 6% in 2014; and

(f) declining share of non-interest income in banks' total income: this share decreased from 32% in 2012 to about 28% in 2014.[70]

[70] This means that the share of net interest income in banks' total income increased from 68% in 2012 to about 72% in 2014.

3. Regulatory framework

3.1 This section provides a high-level overview of the key aspects of banking regulation affecting retail banks operating in the UK market. Please refer to Appendix 3.1 on the regulatory background to the retail banking industry for a greater level of detail on many of the points covered in this section.

3.2 The section is structured as follows:

- UK regulatory bodies and their respective roles (paragraphs 3.3 to 3.24).
- Key European and international regulatory bodies and their respective roles (paragraphs 3.25 to 3.32).
- A description of core banking regulations with which banks must comply (paragraphs 3.33 to 3.54).
- Ongoing UK government and regulatory initiatives affecting the retail banking sector (paragraphs 3.55 to 3.92).

UK regulatory authorities

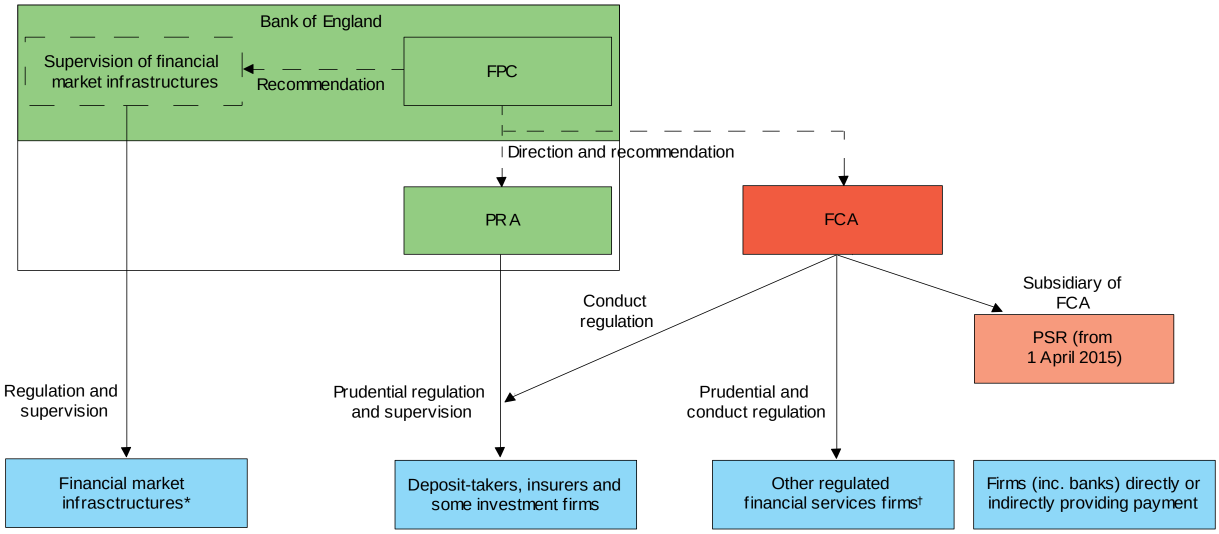
3.3 The Financial Services Act 2012 (FS Act) implemented a new regulatory framework for financial services in the UK. Changes introduced by the FS Act include separating the prudential and conduct regulation of banking operations. Both forms of regulation were previously carried out by the Financial Services Authority (FSA). From 1 April 2013, prudential regulation of banking operations has been carried out by the PRA, which was established by the FS Act, and conduct regulation by the FCA, which replaces the FSA.

3.4 In addition to the changes to the regulatory framework brought about by the FS Act, the Financial Services (Banking Reform) Act 2013 (FSBRA) enacted a number of further reforms related to the UK's banking sector. In particular, FSBRA gave HMT and the relevant regulators, primarily the PRA, powers to implement some of the recommendations made by the ICB[71] – in particular, the ICB's recommendations for ring-fencing requirements for banks. It also

[71] The ICB was a UK government inquiry looking at possible reforms to the banking industry in the wake of the financial crisis of 2007-08. It was established in June 2010 and published its final report and recommendations in September 2011. It was chaired by Sir John Vickers. Its headline recommendation was that banks should 'ring-fence' their retail banking divisions from their investment banking arms, to safeguard against riskier banking activities, The UK government announced the same day that it would introduce legislation to implement the recommendations.

provided for the establishment of the PSR. Figure 1 provides an overview of the financial institutions regulatory framework.

Figure 3.1: Overview of regulatory landscape



*Excludes regulation of trading platforms, which is the responsibility of the FCA.
†Includes asset managers, hedge funds, exchanges, insurance brokers and financial advisers.

The Bank of England

3.5 The BoE is the central bank of the UK. The FS Act brought about a major expansion of the BoE's main responsibilities, which are now clearly defined by Parliament.

3.6 The BoE performs its main functions through the following committees and authorities:

- Financial policy (eg looking out for future risks and weaknesses in the financial system) – The Financial Policy Committee (FPC).
- Monetary policy (eg setting interest rates, decisions on quantitative easing) – The Monetary Policy Committee.[72]
- Safety and soundness of banks and other financial institutions – The PRA.

3.7 The FS Act established both the FPC and the PRA, and gave each of these bodies new responsibilities for the supervision of financial institutions.

[72] The activities of the Monetary Policy Committee are not relevant to the CMA's investigation so are not discussed further in this section.

3.8 The BoE has responsibility for overseeing certain payment systems, as well as securities settlement systems and central counterparties.[73] The BoE's oversight regime concerns only the stability of recognised payment systems and does not give rise to any responsibility for relationships between members of payment systems and individual users or consumers; these responsibilities fall to the FCA and PSR.

3.9 The BoE has entered into a joint Memorandum of Understanding (MoU)[74] with the FCA, PRA and PSR, covering payment systems regulation.

The Prudential Regulation Authority

3.10 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. The PRA works alongside the FCA creating a 'twin peaks' regulatory structure in the UK,[75] with the FCA carrying out conduct regulation of deposit-takers, and prudential and conduct regulation of other financial firms. It is a subsidiary of the BoE.[76]

3.11 The PRA has two primary statutory objectives: to promote the safety and soundness of the firms it supervises and, specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders.

3.12 The PRA has a secondary objective to facilitate effective competition in relevant markets, so far as reasonably possible. The PRA has no concurrent competition powers, and this secondary objective only applies when the PRA is advancing its primary objectives and therefore does not operate as a self-standing objective.[77]

The Financial Conduct Authority

3.13 The FCA replaced the FSA on 1 April 2013. It is accountable to HMT and Parliament, but operates independently of government and is funded entirely by the firms it regulates. The FCA's strategic objective is to ensure that the

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[73] Its oversight powers derive from Part 5 (Interbank Payment Systems) of the Banking Act 2009: Part 5 (Interbank Payment Systems) Banking Act 2009.
[74] MoU outlining how the PSR will interact with the BoE, the FCA and the PRA.
[75] The FCA is a separate institution and not part of the BoE.
[76] A Bank of England Bill was announced in the Queen's Speech on 27 May 2015, including a proposal to bring the PRA within the BoE, ending its status as a subsidiary, and creating a new committee of the BoE to be known as the Prudential Regulation Committee (PRC). The government recently consulted on these proposals. The consultation closed on 11 September 2015: the consultation paper is on GOV.UK.
[77] The obligation on the PRA is only to facilitate competition, not to behave as a competition advocate, promoting competition in markets.

relevant markets function well. To support this, it has three statutory objectives:[78]

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK financial system; and
- to promote effective competition in the interests of consumers.

3.14 The FCA is responsible for the prudential regulation of those financial services firms not supervised by the PRA, such as asset managers, payment service providers (except those which are also credit institutions) and independent financial advisers.

The FCA Handbook

3.15 Firms regulated by the FCA are bound by the rules contained in the FCA Handbook.[79] The Handbook was developed out of the FSA Handbook, which was split between the FCA and the PRA to form the FCA Handbook and the PRA Rulebook[80]. The FCA's Handbook contains rules applicable to banks, and sits alongside those provisions that are imposed and monitored only by the PRA. Dual-regulated firms have to attend to the provisions of both the FCA Handbook and the PRA Rulebook.

Concurrent competition powers of the FCA

3.16 One of the FCA's operational objectives is to promote competition in the interests of consumers. As a result it can, for example, make rules and exercise certain firm specific powers to advance that objective. In addition, the FCA must, so far as is compatible with acting in a way which advances its consumer protection or integrity objectives, discharge its general functions (broadly, making rules or codes, giving general guidance and determining its general policy and principles) in a way that promotes competition in the interests of consumers. The FCA has concurrent powers with the CMA to:

- enforce the competition law prohibitions under Chapters 1 and 2 of the Competition Act 1998 (CA98) and Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU) in relation to the provision of financial services; and

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[78] Set out in section 1B Financial Services and Markets Act (FSMA) (as amended by the FS Act).
[79] FCA Handbook.
[80] PRA Rulebook.

- conduct market studies and make market investigation references to the CMA under EA02, for detailed review of a particular financial services market.

3.17 The FCA and CMA entered into an MoU on 12 June 2014,[81] setting out the framework for cooperation between the two authorities in relation to competition issues, consumer protection and access to payment systems. The FCA and CMA intend to enter into a revised MoU to reflect the FCA's concurrent powers which vested on 1 April 2015.

Payment Systems Regulator

3.18 FSBRA created a new economic regulator, the PSR, with concurrent competition powers in relation to the participation in payment systems. The PSR has been fully operational since 1 April 2015.

3.19 FSBRA also provided that the PSR will regulate those domestic payment systems that are designated by HMT. The following payment systems[82] are currently designated by HMT for regulation by the PSR:

- Bacs;
- CHAPS;
- Faster Payments Service;
- LINK;
- C&C (Cheque & Credit);
- Northern Ireland Cheque Clearing;
- MasterCard; and
- Visa Europe.

3.20 The PSR has published a series of guidance documents[83] setting out how it intends to act, the expectations it has and the procedures and processes it will typically follow.

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[81] MoU between CMA and FCA.
[82] For further details of all these payments systems please see Appendix 3.1.
[83] PSR's written guidance.

The PSR's duties

3.21 In discharging its functions relating to payment systems, the PSR must, so far as is reasonably possible, act in a way that advances one or more of its payment systems objectives, which are set out in statute.[84] Its objectives include:

- The competition objective – to promote effective competition in:
  - the market for payment systems;
  - the markets for services provided by payment systems; and
  - the interests of those who use, or are likely to use, services provided by payment systems.
- The innovation objective – to promote the development of, and innovation in, payment systems in the interests of users of services provided by payment systems, with a view to improving the quality, efficiency and economy of payment systems. This includes in particular promoting the development of, and innovation in, infrastructure to be used for the purpose of operating payment systems.
- The service-user objective – to ensure that payment systems are operated and developed in a way that takes account of, and promotes, the interests of those who use, or are likely to use, services provided by payment systems.

3.22 The PSR's regulatory powers as set out in FSBRA are wide-reaching and fall into the following categories, which are covered in greater detail in Appendix 3.1:

- **Directions** – the PSR can give participants in regulated payment systems written specific or general directions, for example requiring or prohibiting the taking of specified action in relation to a system.
- **System rules** – the PSR has the power to require a system operator to establish rules for its system or to change existing rules.
- **Access to payment systems** – if a person applies to the PSR for access to a regulated payment system, the PSR can require a system

[84] Section 49(1) FSBRA. For the PSR's objectives, see sections 50–52 FSBRA.

operator or a payment service provider with direct access to a system to grant access to the applicant.

- **Variation of agreements relating to payment systems** – the PSR has power to vary the terms and conditions in existing agreements relating to payment systems.

- **Disposal of interest in payment systems** – the PSR has the power to require a person who has an interest in the operator of a regulated payment system or an infrastructure provider in relation to such a system to dispose of all or part of that interest. The PSR is only able to do this if it is satisfied that, if it does not exercise its power, there is likely to be a restriction or distortion in competition in the market for payment systems or the market for services provided by payment systems. This power is subject to the consent of HMT.

Concurrent competition powers of the PSR

3.23 The PSR has enforcement powers under Chapters I and II of CA98 and market study and market investigation reference powers under Part 4 of EA02, as far as these powers relate to participation in payment systems. These powers will be exercised concurrently with the CMA.

3.24 In August 2015, the PSR published guidance relating to the exercise of its concurrent competition powers under both EA02[85] and CA98.[86]

EU/international regulatory authorities

European Supervisory Authorities

3.25 The European System of Financial Supervision consists of the European Systemic Risk Board (ESRB) and the three European Supervisory Authorities: the European Securities and Markets Authority (ESMA) based in Paris, the European Banking Authority (EBA) based in London and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt.

3.26 The ESRB monitors and assess potential threats to financial stability that arise from macroeconomic developments and from developments within the financial system as a whole.

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[85] PSR's Market Studies Guidance.
[86] PSR's CA98 Guidance.

3.27 ESMA contributes to the work of the ESRB, by providing data and undertaking stress tests in close coordination with the fellow ESA's and the ESRB.

3.28 The EBA is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.[87]

DG FISMA

3.29 The Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA) is one of the Directorates-General and specialised services that make up the European Commission.

3.30 DG FISMA is responsible for initiating and implementing policy in the area of Banking and Finance. It is based in Brussels and works under the political authority of EU Commissioner Jonathan Hill, and is managed by Director General Olivier Guersent.

Basel Committee on Banking Supervision

3.31 The Basel Committee on Banking Supervision (BCBS) is a committee made up of representatives of banking supervisory authorities from major economies and banking hubs, providing a forum for regular cooperation on banking supervisory matters, and to encourage convergence toward common standards. It is expected that member authorities and other nations' authorities will take steps to implement BCBS recommendations in their own national regulatory frameworks, whether in statutory form or otherwise. The BCBS is part of the Bank for International Settlements. One of the key roles the BCBS has played in recent years is to set regulatory capital standards via the Basel Accords.

The Financial Stability Board

3.32 The Financial Stability Board (FSB)[88] is an international body that monitors and makes recommendations about the global financial system. The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector

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[87] EBA website.
[88] FSB website.

policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions. The current chair of the FSB is the Governor of the BoE Mark Carney.

Core banking regulation

3.33 The following section considers some of the key pieces of regulation, and regulatory frameworks, with which UK retail banks must comply.

Becoming authorised as a bank

3.34 One of the PRA's key functions is the authorisation of new banks.[89] In March 2013, the FSA and the BoE published a 'Review of requirements for firms entering or expanding in the banking sector'.[90] This report led to a number of changes to the authorisation process. The three main features of the changes were:

- reduced capital requirements at the authorisation stage;
- removal of new bank liquidity premium; and
- a changed authorisation process to ease business start-up (the so-called 'mobilisation' approach, under which firms are authorised, but with a restriction, to enable them to have the certainty of being authorised before committing to costly infrastructure builds and staff hire).

3.35 When authorising a firm, the PRA and the FCA must ensure that the applicant firm will currently satisfy, and will continue to satisfy, the Threshold Conditions for which each regulator is responsible. The PRA and the FCA's Threshold Conditions are set out in statute,[91] but in summary include consideration of the following matters:

- Viability of the business plan.
- Capital and liquidity.
- Governance arrangements (including ownership, legal structure and management).

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[89] A bank, which is a deposit taker and a credit provider, would be subject to prudential regulation by the PRA and conduct regulation by the FCA. This is known as being dual-regulated.
[90] Review of requirements for firms entering or expanding in the banking sector.
[91] Set out in Schedule 6 to FSMA, as amended by the Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013.

- Risk management and controls.

- Resolvability[92] of the applicant firm (relevant to the PRA's assessment of an applicant bank, building society or credit union).[93]

3.36 The process for obtaining authorisation as a bank is set out in detail in Appendix 3.1.

Ongoing compliance: PRA Rulebook and the Fundamental Rules

3.37 Firms must ensure they are compliant with all applicable PRA rules and directly applicable EU regulations,[94] including the Fundamental Rules[95] as set out in the PRA Rulebook. The Fundamental Rules require firms to act in accordance with the PRA's 'safety and soundness' objective, by setting specific high-level requirements.

3.38 The Fundamental Rules are supported by more detailed rules, contained in the PRA Rulebook,[96] and directly applicable EU regulations.

Reporting to the PRA

3.39 The PRA works closely with the FCA in the collection and management of regulatory data, most of which is collected by the FCA through its GABRIEL[97] online system.

Supervision and intervention by the PRA

3.40 The PRA supervises firms to judge whether they are 'safe and sound', and whether they meet, and are likely to continue to meet, the Threshold Conditions.[98] Its approach is forward-looking; it assesses firms not just against current risks, but also against those that could plausibly arise in the future.

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[92] For example, how easy it would be to put the bank into bankruptcy or restructuring while inflicting the minimal damage possible on the rest of the UK financial system.
[93] Firms judged to be resolvable are eligible for lower capital requirements.
[94] The term 'directly applicable' in the context of EU legislation means that it applies directly to firms and/or individuals within the EU, without first having to be transposed into domestic law.
[95] BoE Policy Statement outlining Fundamental Rules.
[96] PRA Rulebook.
[97] GABRIEL.
[98] The PRA and the FCA's Threshold Conditions are set out in statute, but in summary judging new firm applications against the PRA and FCA Threshold Conditions will include consideration of the following matters: Viability of the business plan; Capital and liquidity; Governance arrangements (including ownership, legal structure and management); Risk management and controls; Resolvability of the applicant firm (relevant to the PRA's assessment of an applicant bank, building society or credit union).

3.41 Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage. It focuses on those issues and those firms that pose the greatest risk to the stability of the UK financial system, and the frequency and intensity of supervision applied by the PRA to a particular firm increases in line with the risk it poses.

Regulatory capital framework

3.42 All UK banks are required to maintain a minimum capital base, to protect themselves in the event of a banking crisis. The aim of the capital adequacy regime is to require banks always to hold a certain amount of 'safe' capital resources (ie capital that is not owed to anybody) to absorb some or all of its losses in the event of a crisis.

3.43 The PRA is the competent authority for implementing and overseeing the various rules which govern minimum capital requirements. A brief summary of these is set out below. Appendix 3.1 on the regulatory background to the banking industry, and Appendix 10.1 on barriers to entry set out in detail what requirements on capital adequacy, leverage and liquidity UK banks must meet.

Basel Accords I, II & III

3.44 The Basel Accords – Basel I, Basel II and Basel III – is a set of recommendations for regulations in the banking industry. They are issued by the Basel Committee on Banking Supervision (BCBS).

3.45 Under the Basel Accords, among other requirements a bank must hold sufficient capital against its total assets held, weighted for risk.[99] In order to apply a risk weight to each asset it holds, a bank has two approaches available under Basel II:

- Standardised Approach – using standardised risk weights.
- IRB approach – risk weights based on a firm's own estimates of risk parameters.

3.46 The PRA is responsible for reviewing firms' IRB models and granting approval for their use where the IRB requirements are met.

[99] Assets are ascribed a value according to how high the risk is that the bank will not recover its investment. Risk weights can reflect credit risk, market risk and operational risk. For example, a high loan-to-value residential mortgage will be ascribed a higher risk-weight than low-risk EU nation sovereign debt.

The EU Capital Requirements Directive IV

3.47 The EU Capital Requirements Directive IV (CRD IV) imposes the standards set out in Basel III on EU member states, and that Directive has been transposed into UK law by the PRA,[100] which will also be responsible for ongoing compliance with its requirements.

3.48 CRD IV comprises:

- the Capital Requirements Regulation (CRR), which is directly applicable to firms across the EU, and implements the Basel III standards on capital, leverage ratios, liquidity and related matters such as large exposures and standardised regulatory reporting; and

- the Capital Requirements Directive (CRD), which must be implemented through national law, and which makes changes to rules on corporate governance, remuneration and introduces capital buffers.

3.49 CRD IV is a maximum harmonisation Directive,[101] meaning national authorities have little discretion to apply standards other than those set out in CRD IV, to create a level playing field in banking regulation across all EU member states.

Anti-money laundering regulations

3.50 UK banks must comply with AML legislation aimed at preventing money laundering and combating terrorist financing. This AML legislation is based on internationally agreed standards from the Financial Action Taskforce (FATF), which are enacted in the EU through the Third Money Laundering Directive and transposed into UK law by the Money Laundering Regulations 2007 (the MLR).

3.51 The FCA is the competent authority for supervising the compliance of most credit and financial institutions with the MLR. Relevant guidance on the

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[100] The provisions of the Capital Requirements Directive were transposed into UK law by inclusion in the PRA Rulebook. Under paragraph 16 Schedule 1ZB FSMA, the PRA is able to legislate through the making of rules. The Capital Requirements Regulation is directly applicable to firms, so did not need to be transposed into UK law.

[101] Most EU legislation is not directly applicable, and instead has to be transposed by the governments of the member states into domestic law, in order to be binding on the citizens of those member states. If a piece of EU law is described as 'maximum harmonisation', this means that when a member state transposes it into domestic law, the resulting domestic law must meet the standards set out in the Directive, but must not exceed the terms of the original EU legislation. This creates a level playing field between member states. 'Minimum harmonisation' means that the original piece of EU legislation contains only the minimum requirements that must be transposed into domestic law; member states are free to include more onerous requirements if they wish (but cannot 'water down' the original EU law). It is common for EU legislation to consist of a mixture of maximum harmonisation and minimum harmonisation clauses.

implementation of these regulations is provided by the Joint Money Laundering Steering Group (JMLSG). The FCA also publishes a financial crime guide, which sets out what firms can do to reduce their financial crime risk and brings together all its guidance on financial crime, from thematic reviews and other work.

3.52 All firms that are subject to the MLR (including all banks) are required, in accordance with the requirements of the FCA Handbook, to put in place policies and procedures to prevent and detect money laundering.

3.53 The MLR establishes a risk-based regime where firms are expected to apply the rules in a manner proportionate to the risk assessed. The rules and guidance set out are principles based and enable firms to exercise appropriate discretion in their implementation of AML processes. Firms must ensure the policies and procedures they establish include systems and controls that:

- enable firms to identify, assess, monitor and manage money laundering risk; and
- are comprehensive and proportionate to the nature, scale and complexity of a firm's activities.

3.54 As part of these systems and controls, banks are obliged to carry out customer due diligence (CDD) measures and monitoring to manage the money-laundering risks identified. Banks must determine the extent of CDD measures and monitoring on a risk-sensitive basis depending on the type of customer, business relationship and product or transaction.[102]

Current EU, BCBS and UK initiatives affecting the banking industry

3.55 A detailed summary of the main initiatives and actions currently being taken by UK regulators, the UK government, and/or deriving from EU legislation that have an impact on the retail banking industry within the UK is included in Appendix 3.1. These are briefly summarised below.

[102] The AML requirements the FCA imposes on banks are contained in the FCA Handbook at SYSC 6.1 and SYSC 6.3, which should be read in conjunction with other relevant guidance, such as the Financial Crime Guidance and JMLSG Guidance.

Pillar 2: supervisory review

3.56 On 29 July 2015, the PRA issued a policy statement[103] on how it will assess capital adequacy under a new framework for the Pillar 2 regime, which will come into force on 1 January 2016.

3.57 The policy statement sets out changes to rules and supervisory statements and finalises a separate statement of policy: 'The PRA's methodologies for setting Pillar 2 capital'.[104] The policy statement is relevant to banks, building societies and PRA-designated investment firms.

3.58 The Pillar 2 capital framework for the banking sector is intended to ensure that firms have adequate capital to support the relevant risks in their business, and that they have appropriate processes to ensure compliance with CRD IV.

Implementation of leverage ratio

3.59 On 1 July 2015, the FPC directed the PRA to implement a UK leverage ratio framework, as follows:

- A 3% minimum leverage ratio requirement that is to apply immediately to UK G-SIIs[105] and major UK banks and building societies on a consolidated basis.

- A G-SII additional leverage ratio buffer (ALRB) that is to apply to UK G-SIIs identified by the PRA, also on a consolidated basis. The rate of the G-SII ALRB is to be calibrated at 35% of a relevant firm's G-SII buffer rate. This buffer will be phased in from 2016, alongside the risk-weighted G-SII buffer.

- A countercyclical leverage ratio buffer (CCLB) that is to apply immediately to UK G-SIIs and major UK banks and building societies on a consolidated basis. The rate of CCLB is to be calibrated at 35% of a relevant firm's countercyclical capital buffer (CCB) rate, and rounded to

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[103] Assessing capital adequacy under Pillar 2 - PS17/15.
[104] Statement of Policy - The PRA's methodologies for setting Pillar 2 capital.
[105] Defined in the consultation paper as 'G-SIIs and other major domestic UK banks and building societies, including ring-fenced banks [ie under the new ring-fencing regime]'. The FPC has further signalled that it intends to expand the scope of the leverage framework to all PRA-regulated firms from 2018, subject to a review in 2017. This review will take into account developments on an international leverage ratio framework. Current UK G-SIIs are HSBC, Barclays and RBS. The list of G-SIIs is updated annually.

the nearest 10 basis points. It comes into force on the same timescale as the minimum leverage ratio requirement.

3.60 The PRA issued a consultation paper[106] the same day, setting out how the PRA intends to achieve the new leverage ratio framework. The consultation is relevant to PRA-regulated banks and building societies with consolidated retail deposits equal to or greater than £50 billion.

3.61 The PRA is also providing UK input on a number of international initiatives.

Proposed standard for Total Loss Absorbing Capacity for systemically important firms

3.62 On 10 November 2014, the FSB published a consultation on a proposed standard for 'Total Loss Absorbing Capacity' (TLAC) for Global Systemically Important Banks (G-SIBs).[107] TLAC requires G-SIBs to be funded by a minimum amount of capital and unsecured, uninsured liabilities with a residual maturity of more than one year. These requirements are additional to the capital requirements placed on all banks.

BCBS consultations affecting internal ratings based/Standardised Approach approaches

3.63 The BCBS is consulting[108] on the design of a standardised floor to be applied to banks using the internal ratings based (IRB) approach to setting their capital adequacy ratio, to replace the current transitional floor, which is based on Basel I risk-weighted assets.

3.64 The floor would be a percentage of standardised capital charges, but this calibration is yet to be discussed. The BCBS intends to publish the final standard, including calibration and implementation arrangements, by the end of 2015.

3.65 The BCBS is also reviewing the IRB and Standardised Approach to setting the capital adequacy ratio.

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[106] Implementing a UK leverage ratio framework – CP24/15.
[107] A G-SIB is defined as a financial institution whose distress or disorderly failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. Current UK banks meeting the threshold for G-SIB status are HSBC, Barclays and RBS.
[108] BCBS consultation on a standardised floor for IRB.

DG FISMA consultation on CRR and CRD IV

3.66 DG FISMA is currently consulting[109] on the potential impact of the CRR and CRD IV on bank lending to the economy.

Current and recent FCA initiatives

3.67 The initiatives set out below are all ongoing, or have recently been completed by the FCA. Of most note are the following:

- **Current Account Switch Service review**:[110] the FCA's CASS review found that CASS addresses the main concerns expressed by consumers about switching, such as having to transfer salary payments and utility bills. The vast majority of switches are completed within seven days and without error, and most consumers who have used the service rated it positively. However, it also found that consumers lack awareness and confidence in CASS, and uncovered a small number of operational issues associated with CASS and the switching process more broadly. The FCA has recommended measures to address these points.

- **Study of account number portability**:[111] alongside its review of CASS, the FCA also gathered evidence on other measures that may help make switching current accounts simpler and easier for consumers, including account number portability. The FCA found that being able to keep bank account details (ie account number and sort code) would increase consumer confidence in the bank account switching process and that a significant number of individual and small business customers would be more likely to switch if they could retain their account details.

  The FCA has provided the PSR with the evidence gathered in relation to account number portability for it to consider, alongside other possible innovations in payment systems, as part of its work going forward.

- **Cash savings market study**:[112] the FCA has carried out a market study to examine, among other things, the extent to which consumers' choice of savings provider is influenced by where they hold their personal current accounts. The FCA concluded that the cash savings market is not

[109] Consultation homepage.
[110] FCA CASS review.
[111] FCA Account Number Portability review.
[112] Cash savings market study.

working well for many consumers, and recently consulted on a number of proposed remedies.

3.68 Other FCA initiatives include (for more detail see Appendix 3.1):

- credit card market study;[113]
- monitoring of overdrafts;[114]
- review of handling of unauthorised transactions;[115]
- review of packaged bank accounts;[116]
- Project Innovate (to encourage start-ups and established firms to bring innovative ideas to financial services markets, including innovation in retail banking);[117]
- market study into investment and corporate banking;[118]
- work on SMEs as users of financial services;
- Call for Inputs on competition in the mortgage sector;[119] and
- work on sharing of SME credit information.

Current PSR initiatives

3.69 Ahead of its launch on 1 April 2015, the PSR published a Policy Statement alongside its planned programme of policy work. This work included the establishment of a Payments Strategy Forum (a new strategy setting process for the payments industry), and a programme of work in relation to card payment systems to examine the implications of the interchange fee caps and business rules introduced by the Interchange Fee Regulation (IFR), taking into account the wider characteristics of card payment systems.

3.70 In May 2015 the PSR launched two market reviews.[120] The first aims to assess the ownership and competitiveness of infrastructure provision in payment systems in the UK and consider whether the current provision of infrastructure services in UK interbank payment systems delivers a good

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[113] Credit card market study.
[114] Review of overdraft usage.
[115] Review of handling of unauthorised transactions.
[116] Review of packaged bank accounts.
[117] Project Innovate.
[118] Market study into corporate and investment banking.
[119] Call for Inputs
[120] Terms of Reference of PSR market reviews.

outcome for service users. The second aims to assess the supply of indirect access to payment systems, and whether competition is working well for service users. The reviews are each expected to take 12 months.

UK government initiatives and actions

3.71 The initiatives set out below are all ongoing, or have recently been completed by the UK government. Of most note are:

- **The Midata project**.[121] This is a programme of work being carried out by the UK government, together with businesses and consumer groups, to give consumers more control over, and better access to, personal data that companies hold about them. The aim of the Midata programme is to give consumers access to their transaction data in an electronic, portable and safe way, so that they can make more informed choices.[122]

- **Implementation of the Small Business, Enterprise and Employment Act 2015 (SBEEA)**. The SBEEA includes provisions designed to give SMEs easier access to credit facilities. It received royal assent on 26 March 2015 and comes into force at staggered periods over 2015 and onwards. It aims to:

  - enhance the transparency in the ownership of UK companies and increase trust in UK businesses;
  - simplify company filing requirements and reduce 'red tape';
  - improve the ability of SMEs to access finance; and
  - reform aspects of the UK restructuring and insolvency regime.

  The SBEEA contains provisions on access to finance for SMEs, and from an SME banking perspective, these are the most significant provisions contained in the Act.

- **Open API standard in banking**. The government has announced[123] its intention to deliver an open Application Programming Interface (API) standard in UK banking. HMT will work closely with banks and financial technology firms to take the design work forward and will set out a detailed framework for an open API standard by the end of 2015. The aim is to increase consumer engagement by making it easier for customers to

[121] Midata.
[122] Department for Business, Innovation and Skills (December 2012), *Better Choices: Better Deals: Report on progress on the Consumer Empowerment Strategy*.
[123] HMT (18 March 2015), Call for evidence on API in banking.

see where they could get a better deal. It also aims to increase competitive intensity by supporting the growth of technology that can be adopted by banks and non-bank providers to compete to offer new products.

- **Divestiture of TSB by LBG, as required under state aid regulations (Project Verde)**. In November 2009, the European Commission approved, under state aid rules, a restructuring plan for LBG, following the bail-outs of LBG by the UK government in October 2008 and November 2009.

  In order to limit the impact of the state aid on competition, the restructuring plan required LBG to divest part of its UK retail banking operations, code-named Verde, and subsequently rebranded as TSB. Under the restructuring plan, the divested entity was to have a 4.6% market share in the PCA market, gained through a network of at least 600 branches. The deadline for the divestment was 30 November 2013.[124]

  The new TSB Bank began operations on 9 September 2013. TSB Banking Group plc was listed on the London Stock Exchange in June 2014, at which time LBG sold 38.5% of TSB's ordinary shares in issue. On 26 September 2014, LBG announced that it had sold a further 11.5% of TSB's shares. As a result, LBG held approximately 50% of TSB's shares. On 20 March 2015, LBG announced that it had agreed to sell a 9.99% interest in TSB to Sabadell (this has now taken place), and had also entered into an irrevocable undertaking to accept the offer in respect of its entire remaining 40.01% shareholding in TSB. The sale of the stake in TSB has been approved by the European Commission from a merger control perspective and on 30 June 2015 the acquisition was approved by the PRA and FCA.

- **Divestiture of Williams & Glyn by RBS, as required under state aid regulations (Project Rainbow)**. In December 2009 the European Commission approved, under state aid rules, a restructuring plan for RBSG, which had also been bailed out by the UK government in October 2008.

  Under the restructuring plan, RBSG was required to divest certain insurance, merchant acquiring and commodity trading operations and also (through Project Rainbow) a part of its UK retail, SME and mid-

[124] European Commission (18 November 2009), 'State aid: Commission approves restructuring plan of Lloyds Banking Group' (IP/09/1728).

corporate banking operations based around the RBS branch network in England and Wales and the NatWest branch network in Scotland. The Rainbow entity was initially required to have a 5% market share in the SME and mid-corporate banking markets.[125]

RBSG has stated[126] that Williams & Glyn will begin operating by the end of 2016.

- **Funding for Lending Scheme (FLS)**. The FLS is designed to incentivise banks and building societies to boost their lending to SMEs.[127]

Implementation of ICB recommendations: ring-fencing of retail banking functions

3.72 FSBRA set out a number of requirements intended to implement the core recommendations of the ICB, contained in the ICB Report (also known as the Vickers Report).

3.73 It introduces a ring fence around ‘core deposits’ (mainly retail and SME) held by UK banks, with the aim of separating certain core banking services critical to individuals and SMEs, from other banking services. The ring-fencing regime will be established through amendments to FSMA made by FSBRA, as well as statutory instruments made by HMT setting out the detail of the ring-fencing regime, specifying which entities will be ‘ring-fenced banks’ (RFBs) and the activities and services that RFBs can, and cannot, carry out.

3.74 Currently the only UK banks that would meet the threshold requiring them to ring-fence their retail and SME activities are HSBCG, Barclays, Santander’s UK arm, the Co-op, LBG and RBSG. However, this list is subject to change as any bank with deposits of £25 billion or more by 2019 could also be expected to become subject to the ring-fencing requirements in due course, which has implications for smaller banks.

3.75 The primary and secondary legislation will be supported by ring-fencing rules to be made by the PRA,[128] intended to achieve legal, economic and operational separation between RFBs and other members of their groups (ie the parts of banking groups that fall outside the ring fence). The FCA will also make rules relating to disclosures that non-RFBs should make to consumers.

[125] European Commission, ‘State aid: Commission approves impaired asset relief measure and restructuring plan of Royal Bank of Scotland’ (IP/09/1915) (14 December 2009).
[126] RBSG information on Williams & Glyn launch.
[127] Funding for Lending Scheme.
[128] In October 2014, the PRA published its first consultation paper (CP19/14) on these rules.

3.76 The PRA will play a key role in establishing the ring fence, by making ring-fencing rules and supervising the ring fence. It will be required to carry out annual reviews of the operation of the ring fence, and a review of the ring-fencing rules every five years.

3.77 The government has stated its intention for ring-fencing to take effect from 1 January 2019.

3.78 In October 2014, the PRA issued its first consultation paper[129] on rules and guidance relating to the ring fence. On 27 May 2015, the PRA issued a Policy Statement[130] providing feedback on the responses received to that consultation paper, and some amendments to the draft rules and supervisory statements included therein.

3.79 On 15 October 2015 the PRA published a further consultation paper[131] on the implementation of ring-fencing: prudential requirements, intra-group arrangements and use of financial market infrastructures.

3.80 The paper sets out PRA policy proposals in three areas:

- the capital and liquidity requirements applicable to a ring-fenced body and how the PRA will determine the adequacy of its financial resources;
- the management of intra-group exposures and arrangements; and
- the use of financial market infrastructures.

3.81 The paper also includes a preliminary discussion on potential reporting requirements, setting out the PRA's initial thinking ahead of future consultation.

3.82 The PRA has stated it intends to publish final rules and supervisory statements covering the policies proposed in these two consultations during the first half of 2016, to provide firms with sufficient time for implementation.

EU initiatives

The Payment Accounts Directive

3.83 The Payment Accounts Directive (PAD) sets common regulatory standards that member states must meet in order to improve the transparency and

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[129] PRA consultation on ring-fencing Guidance.
[130] PRA Policy Statement on ring-fencing.
[131] PRA consultation paper.

comparability of fees related to current accounts; facilitate switching of those accounts; and ensure access to bank accounts with basic features.

3.84 EU member states must implement the terms of PAD by 18 September 2016. PAD requires member states to give effect to the following provisions:

- **Fee information** – banks will be legally required to have to provide more detailed information on fees to consumers than is presently the case, and will have to do so in a standardised format.[132]

- **Comparison website** – PAD requires member states to ensure that consumers have access, free of charge, to at least one independent price comparison website (PCW) comparing fees charged by payment service providers for commonly used services.

- **Payment account switching** – banks must put in place a switching service for payment accounts held in the UK and falling within the scope of PAD. PAD stipulates the duties on both the 'old' and 'new' bank conducting the switch, including maximum periods within which certain elements of the switching process must be completed.

- **Basic bank account (BBA) provision** – anyone legally resident in the EU will have a right to open a BBA in any EU member state. PAD stipulates some basic features that the account must have, such as ATM access and the ability to perform basic payment transactions, and stipulates that the accounts can be made available either free of charge, or for a reasonable fee.

The Payment Services Directive (and Payment Services Regulations)

3.85 The Payment Services Directive[133] (PSD) harmonises the regulatory regime for payment services across the EU. The Payment Services Regulations 2009 implement the Payment Services Directive in the UK. The legislation sets out information which must be provided to payment service users, including consumers. As between a consumer and their bank, the information will almost always be provided through the bank's terms and conditions.

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[132] The PAD requires each member state to create a standard list of 10 to 20 of the most representative services for which a fee might be applied. These services have to be those that are most commonly used by consumers, or which generate the highest costs for consumers. In June 2015 the FCA published a call for input setting out the UK's submission for the most representative terms.
[133] Payment Services Directive (2007/64/EC).

3.86 The PSD is a maximum harmonisation directive; however, several provisions of the PSD leave a margin of discretion to member states.

Proposed Second Payment Services Directive

3.87 The European Commission published a proposal for a Second Payment Services Directive (PSD2) in July 2013. The proposed directive will repeal the current PSD.

3.88 Like the current PSD, PSD2 is a maximum harmonisation directive. In June 2015 political agreement was reached on the final text of the PSD2. If adopted, member states will be required to transpose the Directive into national law within two years. It is therefore expected that PSD2 will need to be implemented by the end of 2017.

3.89 PSD2 aims to update the current framework on payment services, extending its scope to payment services providers that were previously unregulated, and to improve the transparency and security of payment services. The updated rules aim to stimulate competition to provide payment services and foster innovative payment methods, especially for online payment services.

Interchange Fee Regulation

3.90 The IFR imposes a cap on the level of interchange fees for transactions based on consumer debit and credit cards of 0.2% and 0.3% respectively. It also bans the imposition of surcharges on transactions using these types of cards. The caps reflect those accepted in the European antitrust cases against Visa and MasterCard.

3.91 On 27 July 2015 HMT issued a consultation paper[134] setting out the government's proposed steps to meet the UK's obligation to put in place an adequate and efficient regulatory regime to supervise compliance with the IFR.

Bank Recovery and Resolution Directive

3.92 The Bank Recovery and Resolution Directive (BRRD) establishes a recovery and resolution framework for EU credit institutions and investment firms. The BRRD provides national authorities with harmonised tools and power to tackle crises at banks and investment firms early on, and to minimise costs for taxpayers. As of 1 January 2015 all member states have to apply a single rulebook for the resolution of banks and large investment firms, as

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[134] HMT interchange consultation.

prescribed by the BRRD. The new rules harmonise and improve the tools for dealing with bank crises across the EU.

4. Market definition

Introduction

4.1 Our guidelines state that defining the market helps to focus on the sources of any market power and provides a framework for the assessment of the effects on competition of features of a market. However, market definition and the assessment of competition are not distinct chronological stages of an investigation but rather are overlapping and continuous pieces of work, which often feed into each other.[135]

4.2 A market is a collection of products provided in particular geographic areas connected by a process of competition. The process is one in which firms seek to win customers' business over time by improving their portfolios of products and the terms on which these are offered, so as to increase demand for them. The willingness of customers to switch to other products is a driving force of competition. In forming our views on market definition, we therefore consider the degree of demand substitutability. In some markets, supply-side constraints will also be important.[136] Market definition in a market investigation flows from the statutory questions the investigation is required to address. Markets defined in the context of answering other statutory questions, or under other regimes, may not therefore be comparable.[137]

4.3 Our guidelines also state that market definition is a useful tool, but not an end in itself, and that identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of our competitive assessment in any mechanistic way. The competitive assessment takes into account any relevant constraints from outside the market, segmentation within it, or other ways in which some constraints are more important than others.[138]

4.4 There are normally two dimensions to the definition of a market:

(a) a product dimension where the relevant product market comprises a set of substitute products; and

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[135] *Guidelines for market investigations: their role, procedures, assessment and remedies (CC3)* (April 2013), paragraphs 94 & 132.
[136] *CC3*, paragraph 130.
[137] *CC3*, footnote 74 (paragraph 132).
[138] *CC3*, paragraph 133.

(b) a geographic dimension, where the relevant geographic market may be national (or wider), regional or local.

We consider each of these aspects below.

4.5 In considering the substitutability of goods or services or areas of supply set out in the terms of reference (ToR), the CMA may conclude that the market definition goes wider or narrower than those goods and services.[139] Our starting point for assessing market definition is therefore the ToR for this investigation, which concern PCAs and SME banking products, including BCAs, overdrafts, general-purpose business loans and deposit accounts.[140]

4.6 The guidelines also state that, in some cases, the CMA may treat a group of product, geographic or other types of markets together for the purposes of assessing competitive effects. It is stated that this can be the case where a feature manifests itself in a similar way across several different markets (for example, the need for an operating licence may be an aspect of many local markets) and the CMA is able to reach a view about the effects of the feature on competition across the group of markets as a whole.[141] Thus we are not required to identify the narrowest possible market(s).

Personal current accounts

Previous approaches to market definition

4.7 The OFT and the CC looked into the provision of PCAs on a number of occasions. A more detailed summary of previous approaches to market definition is provided in Appendix 4.1.

4.8 The CC's 2007 market investigation into PCA banking services in NI listed the following as the main characteristics of a PCA:

(a) provision of a facility to deposit and store money, with quick and easy access;

(b) provision of a facility to receive payments by cheque or electronic transfer;

[139] *CC3,* paragraph 131.
[140] For further details see the retail banking market investigation terms of reference.
[141] *CC3*, paragraph 152.

(c) provision of a facility to make instant and/or regular payments without using cash, eg through cheques, switch payments, bank transfers, standing orders and direct debits; and

(d) provision of the means for short-term borrowing through an overdraft.

4.9 The CC concluded that the relevant product market should include all PCAs, including packaged accounts, but should not be drawn more widely to include BBAs, instant access savings accounts, credit union accounts, offset/current account mortgages or other personal financial products.[142]

4.10 With regard to the relevant geographic market, the CC saw no need to define the market at a local level and considered that the market in NI was separate from that in GB (and also that in the Republic of Ireland).[143]

4.11 The OFT and CMA have subsequently carried out a number of market studies into PCAs and the OFT also investigated the issue in its 2008 Lloyds TSB/HBOS merger report to the Business Secretary. These followed the CC's 2007 approach, but BBAs were considered with other PCAs as part of its competitive assessment.[144]

Relevant product market(s)

4.12 As regards PCAs, our ToR refer to the provision of an account marketed to individuals rather than businesses, which provides the facility to hold deposits, to receive and make payments by cheque and/or debit card, to use ATM facilities and to make regular payments by direct debit and/or standing order.[145]

4.13 All PCAs enable customers to make and receive payments and provide a store of value. PCAs may or may not offer other facilities such as personal banking advice and borrowing facilities.

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[142] CC (2007), *Personal current account banking services in Northern Ireland market investigation*, paragraphs 3.2–3.30.
[143] ibid, paragraphs 3.31–3.37.
[144] The question of whether BBAs should be included in the same market as PCAs is discussed below in paragraphs 4.32–4.35.
[145] Our ToR exclude non-UK sterling accounts, accounts that do not have all the functionalities set out in our ToR, such as managed accounts and credit union accounts, and current account mortgages. However, where a mortgage product (often marketed as an 'mortgage offset account') comprises two separate accounts, a mortgage and a PCA with credit interest on the PCA being credited to the mortgage account, the mortgage would fall outside and the PCA would fall inside our ToR, even though the two products are linked for the purposes of interest calculations.

4.14 The majority of PCAs offer borrowing facilities (overdrafts) – an ability to withdraw money beyond the amount held in the account, entering into a negative balance in the PCA. Overdrafts can be arranged or unarranged:

(a) An arranged overdraft is one where the customer knows in advance the amount that can be borrowed: arranged overdrafts may be provided at the customer's request though banks may also provide an arranged overdraft facility unprompted so that the customer can borrow on arranged terms without specific request.

(b) Unarranged overdraft is the name given to the practice whereby banks allow customers to exceed their borrowing limit (or where the customer's balance becomes negative and no such limit has been arranged), rather than refuse the customer's payment.

4.15 PCAs are conventionally divided into a number of categories according to features or customer type:

(a) **Standard and 'reward' accounts**:

(i) We regard standard accounts as those paying zero or very low (for example, 0.01%) rates of interest on credit balances, and not falling into any of the other categories below.

(ii) We regard reward accounts as those paying higher interest rates on credit balances and/or significant rewards such as a monthly cash payment or cashback on utility bills. Reward accounts usually contain eligibility conditions, for example requiring the customer to pay in a certain amount per month and to set up a certain number of direct debits on the account. Some reward accounts have a monthly fee of about £2 to £5 per month though if the customer meets the eligibility conditions this would usually be more than offset by cash rewards received.

Approximately 74% of all PCAs in the UK in 2014 were standard or reward accounts (62% standard and 12% reward). The proportion of reward accounts has increased and in 2014 they accounted for 25% of new PCAs (compared with 8% in 2011). Reward accounts account for a higher proportion of main accounts[146] (15% of all main PCAs and 37% of new main PCAs in 2014).

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[146] Accounts where £500 or more is paid in per month. See paragraph 5.10 for more details.

(b) **Packaged accounts**: provide additional services such as travel insurance, car breakdown cover and mobile phone insurance. Such accounts have monthly or annual fees, typically of £10 to £15 per month. Rules on selling packaged accounts have been tightened in recent years, in particular banks are required to inform customers whether or not they would be eligible to claim under each policy.[147] The Financial Ombudsman recently reported an increase in complaints about mis-selling of packaged accounts.[148] Packaged accounts represented about 12% of all UK PCAs in 2011 and had declined to 9% in 2014 (but they still account for a rather larger 2014 share, 13%, of main PCAs).

(c) **BBAs**: do not provide any overdraft facility, or usually a cheque book. They may also have other limitations, for example, restrictions on use of branch services. BBAs do not require a credit check and hence are attractive to those with low credit scores and those dependent on government benefits. In December 2014, the UK government agreed with nine banks that they would within 12 months provide BBAs (including debit cards) free of all charges to anyone who does not already have a bank account or who cannot use their existing account due to financial difficulty.[149] BBAs represented approximately 11% of all UK PCAs (and 7% of main PCAs) in 2014.

(d) **Student/graduate accounts**: available only to students at UK universities or those who have recently graduated, they are similar to standard accounts but offer lower-cost or interest-free overdraft facilities; they may also offer a reward such as a free student travel card. Student and graduate accounts comprised nearly 3% of all UK PCAs in 2014.

(e) **Youth accounts**: these are typically available to customers between the ages of 7 and 17 years and, depending on customer age, have reduced functionality, for example, no cheque book or overdraft facility. They accounted for 3% of all UK PCAs in 2014.[150]

4.16 The great majority of PCAs do not charge for the most common sterling transactions including withdrawals and payments into the account by cash or cheque at ATMs, branches, and electronically via faster payments (so-called ‘free-if-in-credit’ (FIIC) charging model). Charges and/or interest are levied

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[147] See FCA packaged account summary.
[148] See Financial Ombudsman complaints data.
[149] See Section 3 and Appendix 3.1 for more details on the provision of BBAs.
[150] Other types of account that are sometimes identified include private bank accounts (providing a relationship manager and usually other benefits and requiring high income and/or savings), mortgage offset accounts (where account balances are set against a mortgage) and Islamic accounts (Shariah-approved). The number of such accounts is small.

when a customer is in overdraft, for foreign currency transactions and for less commonly used services such as stopping a cheque. Most (but not all) banks also charge when payments are refused[151] and for opting out of unarranged overdrafts[152] on accounts other than BBAs. As described in the previous paragraph, some accounts, however, have monthly fees in particular if they are reward or package accounts.

4.17 The definition of PCAs in our ToR represents the starting point for defining the relevant product market(s). We therefore consider whether *(a)* the relevant product market is wider than PCAs and *(b)* whether we need to define more than one product market within PCAs.

Whether the product market should be wider than PCAs

4.18 In the UK, around 97% of adults aged 16 and over have a PCA[153] which they regularly use to receive and make payments and to organise their finances. The very small proportion (3%) of those who remain without a PCA transact in cash, and may use alternative products, such as instant access savings accounts, home credit and payday loans to replace some of the functionalities of a PCA.

4.19 Various financial alternatives can act as a substitute for one or more of the different facilities offered by a PCA. For example, credit cards, personal and payday loans can be used to substitute for an overdraft facility; savings accounts and cash instant access savings accounts could be used to substitute for the facility to hold deposits and credit cards; and pre-paid debit cards and digital wallets could be used to substitute for the facility to make payments. Nevertheless, none of these products could fully substitute for all the features of a PCA.

4.20 We stated in the UIS that we did not consider that these alternative products exercised sufficient constraint on PCAs to be included in the product market. Respondents generally agreed with this approach, with the exception of the four biggest GB PCA banks, which argued that the competitive pressure exerted by digital wallets, such as those provided by PayPal, should be taken into account.

4.21 Below we consider in more detail how each of these alternative products may act as a substitute for services offered by PCAs, ie the facility to make

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151 Usually referred to as unpaid item charge. From December 2015 this will not apply on BBAs of the nine major banks (see paragraph 4.15).
152 Often referred to as adding 'control' to the PCA.
153 Source: GfK FRS.

and receive payments, to store money and borrow money on a short-term flexible basis.

- *Digital wallets*

4.22 A digital wallet is a service that facilitates the storage of payment (and possibly other) credentials and enables users to make payments, either online or via a mobile device. In some cases it can also be used as a facility to store money. In the UK, digital wallets are currently offered by several providers, including PayPal, Apple, Google and Amazon but not by banks, with further entry possible (for example Android Pay and Samsung Pay). Digital wallets are discussed further in Appendix 4.2 and in the report by Deloitte on the impact of innovation in the UK retail banking market.[154]

4.23 Digital wallets compete directly with payment systems, which is an upstream market to the supply of PCAs. While the growth of digital wallets may potentially impact on PCAs,[155] for example by lowering income from interchange fees, we have not seen evidence of digital wallets substituting for PCAs, or of a significant impact on banks' income from interchange fees. Although digital wallets provide a money transfer service, customers will still need a PCA to make full use of their PayPal or Apple Pay account or other digital wallet facilities. Several banks have also indicated that they see digital wallet services as enhancements to their PCA and credit card offerings, suggesting a degree of complementarity rather than substitutability.[156]

4.24 Importantly, their ability to provide an alternative to a money storage facility is very limited. The difficulty of paying salaries into digital wallets limits their ability to act as a substitute for PCAs. In addition, for example, at present Google Wallet only provides a deposit storage service for an additional fee of 2.9% and PayPal payments made directly from PayPal account balances amount to only 10% of transactions.[157]

4.25 None of the banks have reported changing their PCA prices or improving the quality of their PCA offering as a response to suppliers of digital wallets products. Although the four biggest banks have reported that they have been innovating and improving their digital proposition, it is unclear to what extent such innovations were prompted by digital wallets rather than being

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[154] Deloitte innovation report.
[155] In fact, some larger banks referred to increasing competitive pressure from digital wallet providers, in particular through loss in transaction revenues, disintermediation and reduction of access to customer data (LBG, RBS, HSBCG, and Nationwide). See also responses to the UIS and banks' hearing summaries.
[156] See banks' hearing summaries. For instance, Apple Pay is currently offered as an additional payment method feature by HSBCG, RBSG, Santander and Nationwide. LBG and TSB are also introducing this feature, see Apple pay website.
[157] See Deloitte innovation report, p33.

developed for other purposes, including responding to the actions taken by other banks. Apple Pay launched in the UK only in July 2015 and other digital wallets (eg Android Pay and Samsung Pay) may launch in the future thus suggesting that the impact on PCAs may increase in the future. However, the longer-term extent of such impact on PCAs remains highly uncertain and as described above, at present and in the foreseeable future, digital wallets will not be a substitute for a PCA but rather a complementary product.[158]

- *Savings accounts*

4.26 Savings accounts allow money to be held in a bank and also pay interest on the money deposited in the account. Although some savings accounts, in particular instant access savings accounts, allow for payments and withdrawals to be made whenever needed without incurring a penalty, in essence, such accounts are designed to serve as a device for storage and savings, rather than to handle day-to-day operations.

4.27 Although it might be possible to use instant access savings account together with an ATM/debit card where a customer is in credit, this would only substitute for a limited set of a PCA's functionalities and is rarely used in practice.[159]

- *Personal and payday loans*

4.28 Personal loans and payday loans are unlikely to act as substitutes for overdrafts due to the inherent differences in their main characteristics and usage. Overdrafts act as a short-term lending facility offering instant access to the funds, whereas personal loans are usually available for a fixed term and are better suited to meeting long-term financial needs. Similarly, evidence from the CMA's payday lending market investigation confirms that there is only limited substitutability between overdrafts and payday loans,[160] which is also supported by banks' responses.[161]

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[158] See also Deloitte innovation report, pp33–36.
[159] For example, Clydesdale reports that its analysis undertaken in 2014 suggested that around [✂] of its instant access savings accounts (equivalent to [✂]% of its PCAs) exhibited some usage characteristics similar to those of a PCA.
[160] For instance, the payday lending market investigation found that consumer willingness to substitute payday loans with other credit products was very low and that payday lending was typically used as a last resort when other types of credit, including overdrafts, were not available. See CMA (24 February 2015), *Payday lending market investigation: Final report*, Section 5, for more information.
[161] For instance, Barclays stated that it did not consider that payday loan providers competed with its core offering; Clydesdale indicated that, using internal data as at May 2014, it found that the number of customers who were making payments to payday lenders from their PCAs was [✂], accounting for [✂]% of its current account base and had been [✂] over time; similarly, LBG reported that 'many payday loan customers would be outside

- *Credit cards*

4.29 Credit cards can be used for making payments, provide quick and easy access to borrowing funds and often allow for cash withdrawals (albeit at significant additional cost). However, credit card accounts do not provide other PCA facilities, in particular the possibility to receive payments, make electronic transfers, direct debits and standing orders, thus significantly limiting their ability to act as a substitute for a PCA.

- *Provisional finding on whether market is wider than PCAs*

4.30 While some products may potentially be able to substitute for elements of the facilities provided by a PCA, there is no other product or combination of products that can fully replicate the core facilities of a PCA. Although some products in combination could technically be used as a substitute for a PCA, this would require significant additional input from customers in managing several different facilities without a significant benefit for doing so, and the customer would still lack some of the core facilities of a PCA such as setting up direct debits and standing orders, making free cash withdrawals and would limit the ability to receive salary credit and clear cheque payments.[162] In addition a customer would incur significantly more fees in combining such products than in using a PCA. The majority of customers generally use these alternative products in addition to their PCAs (and indeed some products require a PCA to function fully), which suggests that they are not substitutes for a PCA.

4.31 Our provisional view, therefore, is that that the market is not wider than PCAs.

Whether we need to define more than one product market within PCAs

4.32 As discussed above, there are a number of different types of PCA (see paragraph 4.15). Demand-side substitutability between different PCA types may be limited to some extent by certain restrictions as to which types of customers are eligible for them (for example, student accounts). However, many customers are eligible for various types of the most common PCAs and the degree of supply-side substitutability appears to be high – the majority of retail banks supply all types of PCAs and are easily able to switch

LBG's risk appetite' and the number of LBG's customers with payday loans amounted to less than [✂]% of all its PCA customers in 2013,

[162] For instance, Santander indicated that 'the majority of customers are unlikely to consider such alternatives as substitutes for a PCA given the additional complexity such approach would provide'.

resources from the supply of one type to the supply of another, in response to changes in demand.

4.33 Our ToR include PCAs that do not provide overdraft facilities, for example BBAs and youth accounts. Banks' submissions did not indicate that they view current accounts with and without overdraft facilities to be in separate product markets. Banks told us that there was demand for a current account without an arranged overdraft facility and that they would offer BBAs even absent the requirements imposed by the government.[163] In addition, banks have started offering the ability to opt out from using unarranged overdraft facilities in other types of account, either for a fee or in a few cases free of charge.

4.34 As mentioned in paragraph 4.6, our guidelines do not require us to identify the narrowest possible market(s) when the conditions of competition are similar across them.[164] We also consider that the issues underlying our theories of harm[165] are common to the different types of PCAs identified and within our ToR. Thus, while the approach of the 2007 CC inquiry would imply a separate market for accounts without a borrowing facility such as BBAs (see paragraph 4.8),[166] we consider that it is sufficient for us to identify differences between different types of PCA where appropriate in our competitive assessment.

4.35 We said in the UIS that we did not intend to define separate markets for different types of PCAs or service elements within PCAs. None of the respondents to the UIS disagreed with this approach. We maintain the UIS approach and our provisional view is that we should define a single market for PCAs including all the facilities provided by most PCAs, including overdrafts, with relevant differences between different types of PCA dealt with in the competitive assessment.

Relevant geographic market(s)

4.36 Our guidelines state that geographic markets may be based on the location of suppliers and defined as an area covering a set of firms or outlets which compete closely because enough customers consider them to be

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[163] For instance, LBG reports [✂] customers opening a BBA in 2014 despite being eligible for a full facilities PCA and asserts that BBAs 'are likely to be very attractive to a large number of customers'.
[164] *CC3*, paragraph 152.
[165] See Section 1, paragraph 1.14.
[166] We note that CC's decision not to include BBAs in the market for PCAs in its 2007 market investigation might have been influenced by several factors: (i) the CC interpreted the terms of reference for the 2007 market investigation to include only accounts with overdraft facility; (ii) the investigation only looked at the demand side and did not consider supply-side substitutability between different current accounts offered by banks; and (iii) at the time of the investigation BBAs had been introduced only relatively recently which could have added some uncertainty. See Appendix 4.1 for more details on previous approaches to market definition.

substitutes.[167] Our ToR are limited to UK sterling bank accounts and given the UK-wide regulatory framework and conditions of supply and demand, we did not consider that the PCA market was wider than the UK.

4.37 In this section we consider whether the market for PCAs is local and whether separate markets can be identified in the four nations of the UK. Our approach to geographic market definition is discussed in more detail in Appendix 4.3.

4.38 Although the local aspect, mainly through the usage of local branches for customer acquisition and retention, remains important,[168] pricing, product offering, service levels and marketing activities are determined for each brand at a UK-wide level. Regulatory requirements[169] do not differ materially across the UK and customers' needs and behaviour are broadly similar across different parts of the UK. Some banks argued that the increasing importance and widespread availability of digital banking rendered any regional differences between banks immaterial. Some banks also noted that the barriers to entry and expansion were similar across the UK and that new entrants, including alternative service providers, with a few exceptions, were entering the market on a UK-wide level.[170]

4.39 We said in the UIS that we would consider the local dimensions of competition, such as the importance of local branches to customer acquisition for new entrants, as part of our competitive assessment[171] and that we were considering either three geographic markets (England and Wales, Scotland and NI) or two geographic markets (combining England, Wales and Scotland into a single GB-wide market with a separate market for NI).[172] We have not received any evidence or submissions from parties that we needed to consider separate local (ie sub-national) markets. The majority of banks agreed that the market for PCAs was at least GB- or even UK-wide.[173] As mentioned in paragraph 4.6, we do not need to define the narrowest possible markets – our guidelines state that the CMA may treat a group of geographic markets together for the purposes of assessing competitive effects, for instance, where a market feature manifests itself across several

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[167] *CC3*, paragraph 145.
[168] For example, the GfK PCA consumer survey reported that local branch convenience was the third most important reason for PCA customers in choosing whom to bank with. However, the reliance on local branches has been diminishing over the years and the usage of internet and mobile banking has been growing significantly. This is also in line with the expected growth of online-only banks, such as First Direct, Smile and the expected entry by Atom. For more information on the role of branches, see Section 10.
[169] The main exception is the Northern Ireland PCA Order. See Appendix 3.1 for more details.
[170] See Appendix 4.3.
[171] This issue is discussed in Section 10.
[172] UIS, paragraph 24.
[173] See Appendix 4.3.

different markets.[174] Accordingly, we maintain the view that we should not define local banking markets, and consider aspects relevant to local competition as part of our competitive assessment.

4.40 We now turn to which separate regional and/or national markets we should identify. As previously mentioned in paragraph 4.38, pricing, product offering, service levels and marketing activities are determined for each brand at a UK-wide level and regulatory requirements do not differ materially across the UK. However, the fact that banking brands have a UK-wide offering would not necessarily imply a UK-wide market if customers in different parts of the UK use different brands (because brands in each area would compete only with each other). We have looked at the extent to which this is the case for the devolved nations and the English regions by looking at differences between regions/devolved nations in individual brand market shares, see Appendix 4.3, paragraphs 20 to 21.[175]

4.41 The Welsh government told us it considered that there was a separate Welsh geographic market, but no other party suggested Wales was a separate geographic market. As already mentioned, pricing, product offering, service levels, marketing activities and regulatory requirements do not differ in England and Wales. Our analysis showed that market shares in Wales were also broadly similar to market shares for the whole of GB, as was also the case for the English regions. Hence, for the purposes of our analysis, we consider there is a single geographic market covering England and Wales.

4.42 Most parties that expressed a view considered there was a single geographic market covering the whole of GB. We found some differences in market shares between Scotland and the rest of GB. In Scotland, most PCAs were supplied in 2014 by RBSG (through the RBS brand), LBG (through the BoS and Halifax brands), TSB, Clydesdale and Santander. In England and Wales LBG (through the Lloyds and Halifax brands), Barclays, RBSG (through the NatWest brand), HSBCG and Santander were the five biggest banking groups in 2014. In addition, the NatWest and RBS brands of RBSG have almost identical product offerings across both brands, and apply the same criteria and charging structures. The Lloyds and BoS brands of LBG also have very similar products.[176] Hence, our analysis has shown that there is some, although limited, difference between Scotland and the rest of GB. However, as mentioned before, the majority of banks view GB as a

[174] *CC3*, paragraph 152.
[175] We combined the market shares of the RBS and NatWest brands of RBSG and those of the Lloyds and BoS brands of LBG as they have very similar product offerings.
[176] Halifax has a different product offering and is marketed as a ‘challenger’ brand in England, Wales and Scotland. Its market shares across these markets do not vary as much as for other brands.

single market and the competition in both Scotland and England and Wales occurs, to a large extent, between the same banks as the vast majority of PCAs in both regions are provided by the same banking groups each offering similar products in all three nations subject to the same regulatory requirements and similar customer characteristics. Accordingly, we do not consider that there is enough difference between Scotland and England and Wales to consider the two as separate geographic markets.

4.43 However, the situation is different in NI, where 63% of main PCAs were supplied in 2014 by Ulster, Danske, BoI, and AIB, whereas the large GB-based brands, such as Lloyds, Barclays and HSBCG had only 4% of the market combined. While Ulster is owned by RBSG, its product offering and management is currently separate from NatWest and RBS.[177] Of the larger GB-based brands, only Santander, Halifax and Nationwide also have a relatively large market share in NI.

4.44 We stated in the UIS that our current view was that NI remained a separate geographic market to the rest of the UK. As discussed in more detail in Appendix 4.3, parties, in general, agreed with this, but some banks suggested there was a single UK-wide market. These banks noted that each provider had consistent offering in terms of price and service levels across the UK; that there were similar customer needs in NI to the rest of the UK and that GB-based banks were expanding in NI.[178] However, as discussed in the previous paragraph, banks' market shares in NI remain quite different to those in GB. Although we have seen evidence that some GB-based banks, in particular Santander and LBG (through its Halifax brand), have been able to increase their market share in NI, we have not seen the reverse, namely Irish banks trying to expand their presence in GB, which is currently very small. We take this as evidence that competition in NI is to a large extent between different banks to competition in GB. Accordingly, we consider there is at least the potential for competitive conditions to differ between the two territories.

4.45 Our provisional view is therefore to regard NI and GB as separate geographic markets for the purposes of our analysis. We recognise that some aspects of the two geographical markets are similar and we do not consider that the distinction between NI and GB affects most of our competitive analysis, which is to a large extent the same for both geographic markets.

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[177] [✂]
[178] See Appendix 4.3.

Provisional findings on PCA market definition

4.46 Our provisional view is that the relevant product market is limited to PCAs, both with and without overdraft facilities.

4.47 Our provisional view is that GB and NI should be considered as separate geographic markets.

SME banking

Previous approaches to market definition

4.48 In the past there have been several instances in which the OFT and the CC have looked into the provision of SME banking services. A more detailed summary of previous approaches to market definition is provided in Appendix 4.1.

4.49 In its 2002 SME banking market investigation, the CC identified four separate product markets within the banking services provided to SMEs:

(a) liquidity management services: BCAs, together with short-term bank deposit accounts and overdraft facilities provided in conjunction with current accounts;[179]

(b) general-purpose business loans;

(c) other types of business loans: invoice discounting and factoring, hire purchases, leasing and other asset finance; and

(d) business deposit accounts.

4.50 The CC did not define geographic local markets. It considered that England and Wales, Scotland and NI constituted three separate geographic markets for liquidity management services and for general-purpose business loans, while the markets for other types of loans and other deposit accounts were found to be UK-wide.[180]

4.51 The OFT and CMA have subsequently considered the issue in the 2008 Lloyds TSB/HBOS merger report to the Business Secretary and a BCA market study report, however, these did not engage in a formal market definition exercise, but relied on the previous findings by the CC.

[179] This excludes PCAs used by SMEs.
[180] CC (2002), *The supply of banking services by clearing banks to small and medium-sized enterprises*, paragraphs 2.31–2.61.

Relevant product market(s)

4.52 The ToR refer to 'the provision of banking services, which includes, but is not limited to, the provision of business current accounts, overdrafts, general-purpose business loans and deposit accounts, but which excludes the provision of other non-lending products such as insurance, merchant acquiring, hedging and foreign exchange'.[181]

4.53 Our ToR therefore encompass a wide range of products and services provided to SMEs. We have focused in our investigation on the three banking services specifically referenced in our ToR, namely BCAs and overdrafts, general-purpose business loans and deposit accounts. We have not received any submissions to suggest that we should broaden our focus from these core SME banking products. We now consider different types of SME banking services focusing on BCAs, different types of business loans, business deposit accounts and whether these different products constitute distinct product markets. We then consider differences between SMEs and their relevance for product market definition in paragraphs 4.88 to 4.94.

Business current accounts

4.54 BCAs are core payment accounts, generally used to make and receive payments and to manage cash flow, offered to business customers and designed to meet all of their everyday basic banking needs.

4.55 Most BCA customers pay a monthly fee and/or transactions fees for using their account. SMEs, particularly larger SMEs, may negotiate bespoke pricing terms for BCAs. Start-up businesses usually benefit from a period of 'free banking' during which these fees are waived, and SMEs switching from another BCA provider also often benefit from a free banking period.

4.56 Like PCAs, BCAs may include an overdraft facility. Typically, SMEs use overdrafts to meet working capital requirements or to manage fluctuations in cash flow. However, unlike PCAs, overdrafts are granted for a one-year period, meaning that businesses have to re-apply for an overdraft facility each year and pay arrangement fees. In some cases security might be required which will depend on the risk assessment. The Charterhouse BBS reports that 15% of BCA holders had an arranged overdraft facility in 2014.[182]

[181] See the retail banking market investigation terms of reference.
[182] Source: Charterhouse BBS.

4.57 Banks also provide special accounts for charities, clubs and societies, schools and other educational establishments, which are generally provided free for in-credit customers. As in the case of PCAs and for the same reasons, we do not see a need to define separate product markets for different types of BCAs.

4.58 For the purposes of our analysis we define a BCA as a bank account which includes the following services:

(a) provision of a facility to deposit and store money, with quick and easy access;

(b) provision of a facility to receive domestic and international payments; and

(c) provision of a facility to make instant and/or regular domestic and international payments without using cash, eg through, switch payments, bank transfers, standing orders, direct debits.

A BCA may or may not offer other facilities, such as overdrafts and access to relationship managers/business advisers.

4.59 From a demand-side point of view, there is no product that could fully substitute for all the services provided by a BCA. While other products, such as digital wallets, instant access savings accounts and business loans, can substitute for some services of a BCA in the same way as for a PCA (see paragraph 4.19 above), none of them could substitute for a BCA in full.

- *Digital wallets*

4.60 Some banks said they faced increasing competitive pressure from digital wallet providers, such as PayPal and Apple Pay and potentially others such as Google Wallet.[183] Digital wallets are discussed further in Appendix 4.2. As mentioned in the previous paragraph, none of these products can be used to effectively substitute for the full set of features of a BCA. As in the case of PCAs (see paragraph 4.23) digital wallets compete directly in the upstream payment systems market. PayPal is increasingly competing with banks in merchant acquiring for SMEs (which is outside our ToR) and may be impacting on banks' BCA income, for example through loss of transactional fees (if SME customers use PayPal rather than cheques or faster payments) as well as through loss of interchange fee income. However, we have not seen evidence that PayPal or other digital wallet providers have yet had a

[183] See paragraph 4.23.

significant impact on banks' BCA supply or of a competitive response from BCA suppliers. Therefore (and for the reasons given above for PCAs) we do not consider the provision of digital wallets to be part of the BCA market.

- *PCAs as an alternative to a BCA*

4.61 There are significant interlinkages between BCAs and PCAs, for instance, Charterhouse BBS reports that more than a half of SMEs open a BCA with their main PCA provider.[184] We have considered the use of a PCA as an alternative to a BCA. We have found that the number of businesses that use PCAs for business purposes is small (14%)[185] and the usage of PCAs is mostly prevalent among the smallest SMEs, mainly sole traders.[186] However, we have been unable to calculate how many PCAs are being used by SMEs for business purposes as the banks have told us that they do not typically monitor whether PCAs exhibit business activity.

4.62 Although a PCA can offer the core transfer, storage and lending services associated with a BCA, it lacks some additional features which are attractive to business customers and which can only be provided by a BCA. This includes access to business centres and business advice or a relationship manager. BCAs can also be used by SMEs to build up their credit record, apply for a business loan and other business banking products, assist with record keeping for audit or tax purposes, offer currency conversion services, provide access to internet banking services to multiple members of staff and permit various methods of business payment processing. The fact that most businesses choose BCAs and incur additional costs associated with them, despite potentially being able to use a PCA for business purposes free of charge, indicates that the availability of these additional services is important to SMEs.

4.63 In addition, we have observed other market features indicating that PCAs and BCAs are in separate relevant product markets. First of all, the charging structures are different, with most PCAs being FIIC and most BCAs carrying a monthly fee and/or transaction charges even if customers are in credit. Secondly, trends affecting PCAs and BCAs appear to be different, with increasing payment of interest to PCA customers in credit, but no such trend for BCAs. Finally, the majority of the banks have indicated that they either seek to discourage or even prohibit businesses from using a PCA for

[184] Source: Charterhouse BBS. See Section 8 for more details on cross-product holdings.
[185] See BDRC SME finance monitor, Q4 2014, p65.
[186] SME finance monitor reports that 94% of the SMEs using a PCA for business purposes were sole traders, see BDRC SME finance monitor, Q4 2014, p65.

business purposes.[187] This indicates that there is limited substitutability between BCAs and PCAs.

4.64 Given the above, we consider that PCAs and BCAs belong to separate relevant product markets for the purposes of our analysis.

- *Business loans and business deposit accounts as substitutes for BCAs*

4.65 Business loans and business deposit accounts may be a substitute for specific services provided by BCAs – a business loan may be a substitute for an overdraft and a business deposit account may be an alternative to a BCA as a store of value. As explained previously, they do not substitute for all the services provided by a BCA and therefore we do not consider that they should be included in the same product market.[188]

4.66 There are some similarities between overdrafts and business loans, which we take into account in our competitive analysis. Overdrafts are usually granted for a set period, usually 12 months, after which SMEs have to reapply for an overdraft facility and pay an arrangement fee[189] – this is similar to most business loans, though the term of a business loan would usually be longer than 12 months. In addition, as discussed in paragraphs 4.73 to 4.75 below, there is some overlap between the purposes for which overdrafts and business loans tend to be used.

4.67 However, despite a degree of substitutability between overdrafts and other types of business loans, overdrafts are characterised by distinctive features, including a unique relationship with BCAs, in that it is not possible to use an overdraft without having a BCA. The combination of deposit storage, payment and short-term lending facilities together provide an integrated liquidity management service for SMEs. Accordingly, we consider that it is more appropriate to regard overdrafts as an add-on facility to BCAs rather than a

[187] For instance, RBSG and TSB indicated that their terms and conditions prohibited the use of a PCA for business purposes; Santander indicated that its PCA terms contained a clause requiring that the account was not used for business purposes; Barclays noted that its terms and conditions required that PCA use met regulatory requirements, which meant that where a business used a distinct legal form, eg company or partnership, the option of opening a PCA would not be available to them; [✄] reported that it required the use of a BCA for customers operating a business; AIB informed us that it required business customers to open a BCA and might even close the PCA, if the account was being used for business purposes and the customer did not agree to transfer to a BCA; similarly, HSBC noted that PCAs were not intended for use by business customers and where such use was identified the customer would be given notice of intention to close the account if the account continued to be used for business purposes.

[188] We note that, in relation to business deposit accounts, this is different from the approach of the CC in its 2002 inquiry, which included BCAs and short-term business deposit accounts in a liquidity management market. This is because business deposit accounts only substitute for one of the services provided by a BCA.

[189] Arrangement fees will generally be payable annually at renewal but also if extending an existing overdraft facility or if it is necessary to renegotiate the terms of an overdraft.

stand-alone business loan and our provisional view is, therefore, to consider BCAs and overdrafts to be part of the same relevant product market.

4.68 We consider business loans and business deposit accounts further below.

- *Provisional finding on BCAs*

4.69 Our provisional view is that the market should be defined as a market for BCAs, with or without an overdraft facility.

Business loans

4.70 Banks and other providers provide a variety of business lending products to SMEs which can differ in various respects, such as the loan term, type of security required and interest rates. In the following paragraphs we consider different types of business loans, including general-purpose business loans, credit cards, asset finance, invoice finance and alternative lending platforms, and examine the competitive constraints posed by the different types of lending products on each other. See Section 8 and Appendix 8.2 for more details on SME lending.

4.71 In this section we focus our analysis on debt-based finance. Although we recognise that some businesses might choose to obtain equity finance rather than a business loan, we consider that equity finance exhibits different characteristics to debt-based financing options and would be only attractive to a specific group of SMEs, and, therefore, is unlikely to act as an effective constraint on debt-based finance.[190]

4.72 We consider that the market for business loans could be further subdivided into the following segments depending on their characteristics:

(a) Short-term loans, which are generally used to finance short-term business needs and to manage working capital and day-to-day cash flows. This includes credit cards, invoice finance and various forms of alternative finance.

(b) Medium- and long-term loans, which are suitable for dealing with longer-term financial business needs, eg investing in business development, acquisition of property or other business assets. General-purpose business loans, including commercial mortgages, and asset finance are the most common types of business loans in this segment.

[190] See Appendix 8.2 for more information.

4.73 General-purpose business loans may or may not require security whereas asset finance and invoice finance are linked to specific assets of the business. The charging structures and terms and conditions may also differ depending on the nature of any security required as well as the providers.[191]

4.74 Our analysis has shown that there is a degree of overlap between various types of lending products. Loans are offered on a bespoke basis and are tailored to the individual needs of each customer. Banks have told us that during the standard loan application process all different types of lending products are considered and the most suitable product is then chosen based on the specific business needs and the nature of borrowing, taking into account the purpose of the loan, repayment options, type of facility required, the interest rate preferred, and the type of collateral required. Often, businesses tend to purchase several lending products which are then used in combination to finance different business needs. The availability of external finance and the urgency with which it is required will also influence the decision to obtain a specific type of a loan.[192] Notwithstanding the fact that different loan types are more suitable to address different business needs, different types of loans can be used to substitute for each other when the preferred option is not available.

4.75 While we recognise the different characteristics of different lending products and of providers, in light of the above we do not think that the differences in product characteristics are sufficient to warrant defining separate product markets for each of them for the purposes of our analysis in this investigation. Moreover, the issues underlying our theories of harm are common across the different types of SME lending products and we are not required to identify the narrowest possible product markets. We take into account the differences between the various types of business loans in our competitive assessment.

4.76 We recognise the growing importance of alternative lending platforms, such as peer-to-peer lending and invoice trading. Currently, alternative finance accounts for a very small proportion of business lending,[193] but it has been growing rapidly. Alternative lending platforms are not within our ToR, but our provisional view is that they should be included in the competitive assessment as another way that SMEs can borrow.

4.77 From a supply-side perspective, certain types of business loans are offered by a wider range of banks and other types of providers than general-purpose

[191] See Appendix 8.2 for more information.
[192] See Section 8 and Appendix 8.2 for more information on the importance of access to finance.
[193] See Appendix 8.2.

business loans. For instance, some smaller banks, including Aldermore, Close Brothers and Shawbrook offer specific types of SME loan (commercial mortgages, asset finance and invoice finance) rather than a full range of SME banking products. This indicates that there are differences in the nature and strength of competition, which we will take into account in our competitive assessment.

4.78 To summarise, there are distinctions between different types of business loan, in particular between shorter- and longer-term loans and the nature of any collateral required, but there are overlaps between them and our provisional view is to consider competition within business loans as a whole in light in particular of our theories of harm.[194] We also consider that alternative lending should be included in the market for business loans. However, we do, where relevant, take into account the differences between business loans in our competitive assessment.

Business deposit accounts

4.79 Business deposit accounts allow SMEs to hold money on deposit, in exchange for which interest is received. Business deposit accounts are not designed to handle day-to-day operations, but serve as a device for storage and savings. Banks offer a wide range of business deposit accounts, including instant access savings accounts, which differ in length of term, minimum/maximum amounts to be deposited, interest rates and limits of amount and mode to be withdrawn.

4.80 Our analysis has shown that the possibilities to substitute business deposit accounts with other products are very limited. Most banks do not offer interest on business current account credit balances to SMEs. Only a few banks[195] have reported paying interest on positive BCA balances and the interest rates appear to be lower than the ones paid on business deposit accounts. We also do not consider that investments in equity, government or corporate bonds could substitute for long-term deposit accounts, as these alternatives are significantly less liquid, carry higher risk and do not generally provide quick access to funds. Personal savings accounts could be a substitute for sole traders, although not for other types of SMEs.

4.81 Banks may offer SMEs the ability to sweep funds between BCAs and instant-access business deposit accounts. The Charterhouse BBS suggests

[194] We recognise that this is different from the approach of the CC in its 2002 inquiry, which distinguished between general-purpose and other types of business loan. We did not define explicitly different markets for these two types of loan but we do recognise the importance of the distinction in our competition analysis.
[195] This includes AIB, [✄], RBS/NatWest, Santander and Co-op.

a high level of linkage between SMEs' choice of a BCA and of business deposit accounts, reporting that of those SMEs that have an instant access savings account around 95% hold this with their main BCA bank. Similarly of those that were using a term deposit account, around 82% held it with their main BCA bank.[196]

4.82 From a supply-side perspective, business deposit accounts are offered by a wider range of banks than BCAs, including building societies and smaller banks, such as Aldermore, Close Brothers and Shawbrook.

4.83 Hence, our provisional view is that there is a separate product market for business deposit accounts.

Classification of SMEs

4.84 The ToR define an SME as a business that has annual sales revenues (exclusive of VAT and other turnover-related taxes) not exceeding £25 million.[197] We recognise that there are differences in the provision of banking services to larger and smaller SMEs, particularly with regard to their specific banking needs and possibilities to negotiate better contract terms.

4.85 Below we consider *(a)* whether the upper turnover limit of £25 million is a reasonable upper limit for our assessment and *(b)* whether separate economic markets should be identified according to SME size.

- *Whether the upper turnover limit of £25 million is a reasonable upper limit*

4.86 The upper limit of £25 million is a widely accepted definition of an SME and is also consistent with the definition provided in the Companies Act 2006.[198] This was also the definition used in the CC's 2002 SME banking market investigation.

4.87 Four of the five largest banks[199] use £25 million as one of their thresholds for helping to determine the level of relationship management offered to businesses which supports the use of £25 million as a cut-off point. Accordingly, £25 million seems to us a reasonable upper limit to adopt.

[196] Source: Charterhouse BBS.
[197] The ToR state that a 'business' shall have the same meaning as an 'undertaking' under CA98. Clubs and charities may be undertakings in this sense (if they carry on commercial or economic activities relating to goods or services) and hence banking services provided to clubs and charities may be within the ToR.
[198] Companies Act 2006, Articles 382 and 465.
[199] [✂]

- *Whether separate economic markets should be identified according to SME size*

4.88 Our guidelines state that one set of customers may be more affected than others by any particular feature. Where such diversity exists, and where suppliers can charge different prices to different groups (ie price discriminate), the CMA will recognise these differences. In terms of market definition, depending on the market and the evidence presented, the CMA may choose either to treat these different groups as separate markets, or as segments within one market, noting the scope for price discrimination between different groups within the market.[200]

4.89 SMEs can be grouped into several different levels based on their turnover or life stage. For instance, the CMA's 2014 market study divided SMEs into the following groups:

(a) Start-ups, establishing a business banking relationship for the first time and which often benefit from introductory offers.

(b) Smaller established SMEs. These tend to have simple banking needs, often requiring a transactional relationship with their banks (making payments, cash handling). Usually, SMEs with turnover below £2 million would be included in this category.

(c) Larger established SMEs. These have a greater degree of financial sophistication (including employing financial management staff) and often require a wider range of products and services. Generally, these include SMEs with turnover of over £2 million.[201]

4.90 Different types of SMEs have different financial needs and require different services, eg larger SMEs tend to require more sophisticated products and services, whereas start-ups often benefit from 'free-banking' offers and have simple banking needs. They also have little experience and therefore may require more advice. The range of products offered to SMEs also differs by SME type, for example start-ups, sole traders and small SMEs typically take out a simpler range of products, whereas larger SMEs are more likely to obtain more specialised products, such as invoice or asset finance. Unlike smaller SMEs, which obtain products on their standard terms and prices, larger SMEs are also often able to negotiate bespoke terms.

[200] *CC3*, paragraph 150.
[201] SME Market Study, paragraph 3.6.

4.91 Banks segment their business customers according to turnover and their need for relationship management. As indicated in Table 4.1, different banks tend to use different categories and different thresholds. Smaller banks, including banks whose main UK activities are limited to NI, tend to have less clear segmentation and fewer categories, with some segmenting on the basis of amount of lending rather than turnover. Thus, we have not seen any clear separating point, in terms of turnover or other variable, which would allow us to easily subdivide SMEs into different segments according to their size or life stage.

Table 4.1: Segmentation of SME customers by the major UK banks

*Barclays**	*HSBC*	*Lloyds (excluding BoS)*	RBS†	*Santander‡*
[✄]	[✄]	[✄]	[✄]	[✄]

Source: Information from banks.
*[✄]
†[✄]
‡[✄]

4.92 We recognise that there are important differences between the provision of banking services to smaller and larger SMEs. Some providers might put more focus on specific SME segments, leading to different levels of competition for different segments of SMEs. However, there is a high degree of supply-side substitutability as banks are easily able to shift their focus to other groups of SMEs in response to changes in demand.

4.93 It may also be possible to segment SMEs based on alternative categorisations, such as the sector in which they operate, eg agriculture or construction. Although there may be differences between banks in the distribution of the SME types they serve, we have not seen evidence that would indicate a need to define separate product markets according to different sectors. From the supply-side perspective, banks tend to serve all types of SMEs and are easily able to switch resources in response to changes in demand.

4.94 Accordingly, the evidence does not lead us to define separate product markets by SME size or type for the purposes of our analysis. Our view is to consider different size and types of SMEs as falling into different market segments of the relevant product markets, in the light of the different intensity of competition to which they are subject. Therefore, in our competitive assessment we, where relevant, take into account differences between SMEs, in particular between start-ups and established SMEs and between smaller and larger SMEs.

Conclusions on relevant product market(s)

4.95 Thus, our provisional view is that the following relevant SME banking product markets may be distinguished:

(a) BCAs (including both BCAs with an overdraft facility and those without);

(b) business loans, including both short-term and medium/long-term business loans; and

(c) business deposit accounts.

Relevant geographic market(s)

4.96 In this section we consider whether the markets for BCAs, business loans and business deposit accounts are local or whether separate national markets can be identified. Our approach to geographic market definition is discussed in more detail in Appendix 4.3.

4.97 As for PCAs, the local aspect, mainly through the usage of local branches for customer acquisition and retention, remains important in relation to BCAs, business loans and business deposit accounts.[202] However, as mentioned earlier in paragraph 4.38, our analysis has shown that banking brands' policies are largely centralised, with pricing, product offering, service levels and marketing activities being determined at a UK-wide level. Regulatory requirements and customers' needs also do not differ materially across the UK.

4.98 We said in the UIS that we would consider the local dimensions of competition, such as the importance of local branches to customer acquisition for new entrants, as part of our competitive assessment.[203] We noted that previous inquiries had tended to focus on three geographic markets (England and Wales, Scotland and NI) and that we were considering either a similar approach, or two geographic markets (combining England, Wales and Scotland into a single GB-wide market with a separate market for NI).[204] We have not received any evidence or submissions from banks that we needed to consider separate local (ie sub-national) markets. Banks, by and large, agreed that the geographic markets for SME banking were at least GB-wide. Our guidelines do not require us to define narrowest possible

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[202] For instance, the Charterhouse BBS reported that local branch convenience was the second most important reason for SMEs in choosing whom to bank with. For more information on the importance of branches, see Section 10.
[203] This issue is discussed in Section 10.
[204] UIS, paragraph 24.

markets.[205] Accordingly, as in the case of PCAs, we maintain the view that we should not define local banking markets, but we consider aspects relevant to local competition as part of our competitive assessment.

4.99 We now turn to which separate regional and/or national markets we should identify. As mentioned above, pricing, product offering, service levels and marketing activities are determined by brands at a UK-wide level and that regulatory requirements do not differ across the UK. However, the fact that each brand has a UK-wide offering would not necessarily imply a UK-wide market if customers in different parts of the UK tend to use different brands (because brands in each area would compete only with each other). Our analysis and the views of parties are similar to those in regard to PCAs (see paragraphs 4.40 to 4.44) and are set out further in Appendix 4.3.

4.100 As in the case of PCAs, we do not find that market shares in the regions of England and Wales are significantly different to market shares for the whole of GB or the UK. Similarly, pricing, product offering, marketing activities and regulatory requirements do not differ in both regions. Hence, we consider that there is a single geographic market covering England and Wales.

4.101 In Scotland, the largest share of BCAs were held by LBG (through the BoS brand), RBSG (through the RBS brand) and Clydesdale. However, this was relatively similar to England and Wales, where LBG, RBSG (through NatWest), HSBCG and Barclays held the largest share. While LBG and RBSG operate via different brands in Scotland compared to England and Wales, the NatWest and RBS brands of RBSG have almost identical product offerings across both brands, and apply similar criteria and charging structures, as is also the case for the Lloyds and BoS brands of LBG.[206] Hence, although there is some difference between Scotland and the rest of GB, the competition in both markets, by and large, takes place between the same market players. Thus, on balance, we do not consider that there is enough difference between Scotland and England and Wales to consider the two as separate geographic markets.

4.102 By contrast, in NI, the largest share of the market for BCAs was held by different brands (including Ulster Bank which has a distinctive different offering from the rest of RBSG).[207] In 2014 86% of the market for BCAs was shared between Ulster, Danske, BoI and AIB, whereas the larger GB-based brands (HSBCG, Barclays and Lloyds/BoS) collectively had less than 4% of the market for BCAs. Of the larger GB-based brands, only Santander was

[205] *CC3*, paragraph 152.
[206] The similarities seem somewhat less in the case of the LBG brands than the RBSG brands.
[207] [✂]

able to acquire a relatively large market share of slightly less than [5–10]%. As in the case of PCAs, competition for BCAs in NI is to a large extent between different brands to competition in the rest of the UK and we have not seen evidence that this might change in the foreseeable future. We therefore consider that the competitive situation in NI is sufficiently different from the rest of the UK to treat NI as a separate geographic market.

4.103 This analysis relates to BCAs only. We do not have sufficient data to carry out a similar analysis for business loans and business deposit accounts. We acknowledge that there is more uncertainty, in particular about whether NI is a separate market from GB, for business loans and business deposit accounts than for BCAs as the range of providers is wider (see paragraphs 4.77 and 4.82). However, we expect analysis for these markets to show broadly similar results to that for BCAs, as SMEs generally take out these products with their main BCA provider.[208]

4.104 Our provisional view is therefore that NI and GB are separate geographic markets for SME banking products for the purposes of our analysis. We recognise that some aspects of the two geographical markets are similar and we do not consider that the distinction between NI and GB affects most of our competitive analysis, which applies similarly to both geographic markets.

Provisional findings on SME banking market definition

4.105 Our provisional view is to consider the following relevant product markets:

(a) BCAs (including both BCAs with an overdraft facility and those without);

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

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

4.106 Our provisional view is that the relevant geographic markets are GB and NI.

[208] For more details see Section 8.

5. Structure and market outcomes: personal current accounts

5.1 To develop our findings on whether or not features in the markets for PCAs are harming competition, we have analysed information on the main characteristics of the markets, including on market shares and concentration.

5.2 We have also analysed information on the outcomes of the competitive process within the markets. Information of this nature, including on profitability, levels of prices, quality and levels of innovation can provide important information on how well the market is functioning. Evidence on outcomes may also assist in the later consideration of possible remedies.

5.3 This section is structured as follows:

- An overview of the market structure for PCAs and concentration levels.
- An overview of our analysis of PCA net revenues by source.
- An analysis of the recent financial performance of PCA providers, including revenues (by source) and impairment margins.
- An overview of profitability of PCA customers and products.
- An analysis of PCA pricing, including the extent to which there is a relationship between pricing and market share.
- An analysis of the quality of service offered by PCA providers.
- A summary of the available evidence on the degree of innovation within, and around, the PCA market, and our assessment of the potential impact of these innovations on competition.
- Finally, we set out our provisional conclusions on market structure and outcomes in the PCA market and the implications for the wider investigation.

5.4 In formulating our provisional findings on structure and market outcomes we have paid particular attention to the strength of customer response to variations in pricing and quality outcomes, and separately, whether there is evidence of a relationship between outcomes and concentration.[209]

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[209] As postulated under our second theory of harm (ie concentration giving rise to market power of some banks leading to worse outcomes for customers).

Market shares and concentration

5.5 If a firm has a high market share it might have less incentive to compete vigorously with its rivals. When market shares have been stable over time, especially in the face of historical changes in prices or costs, high concentration may indicate that competition within the market is weak.

5.6 We here summarise our provisional findings on the structure and concentration in the market for the provision of PCAs. As set out in Section 4, we have defined PCAs (with and without overdraft facilities) as a relevant product market and separate geographic markets for the provision of PCAs in GB and in NI.

5.7 This section is supplemented by Appendix 5.1, which contains more detailed evidence on market structure.

Background

5.8 There were approximately 67 million active PCAs in GB in 2014,[210] and 1.7 million in NI. Around 70% of active accounts in both GB and NI received average incoming monthly payments of more than £500.

5.9 New account opening in the UK has remained broadly constant since 2011. In 2014, approximately 5.9 million accounts were opened in GB and 130,000 in NI. Two-thirds of new accounts opened in the UK in 2014 were either standard or reward accounts; nearly 15% were BBAs; and around 2% were packaged accounts. The remainder of new accounts opened were mainly youth or student/graduate accounts. The different types of bank accounts are discussed further in Section 4.

Market shares and concentration

5.10 The evidence we saw indicated that competition focused on acquiring and retaining the primary banking relationship with customers, ie on the PCA into which the customer's income is paid and from which direct debits and other payments are paid.[211] In assessing market shares by volume, we have therefore focused on such primary or 'main' accounts.[212] When survey data

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[210] Defined as an account that has had at least one customer-generated payment or transfer (including standing orders and direct debits, but excluding charges and interest on the account) coming into, or leaving, the account in the previous 12 months.
[211] Some customers may have two such accounts: for example a joint account with their partner, from which joint expenses are paid, and an individual account, from which individual expenses are paid, with regular payments from one to the other.
[212] Results are similar if active accounts are used instead, see Appendix 5.1.

is used a main account is defined as one which the survey respondent identifies as their main account; and when data from banks is used we define a main account as one where £500 or more is paid in per month.[213]

5.11 Table 5.1 sets out the GB market shares by volume by banking group at the end of 2014. The combined share of the four largest banking groups[214] was just over 70% in 2014. These four banking groups are, together with Clydesdale, the successors through merger to the 'clearing banks' which cleared cheques between themselves and thus provided payment transaction services prior to the advent of electronic transactions.[215] The combined share of the four largest banking groups has decreased by about 4 percentage points since 2005 (excluding the impact of LBG's acquisition of HBOS and subsequent divestment of TSB), see Figure 5.1.

Table 5.1: GB market shares by number of main PCAs

Banking group	*Market share in 2014 (%)*
LBG	[20–30]
RBSG	[10–20]
Barclays	[10–20]
HSBCG	[10–20]
Santander	[10–20]
Nationwide	[5–10]
TSB	[0–5]
Clydesdale	[0–5]
Co-op	[0–5]
Metro	[0–5]
Other	[0–5]

Source: CMA calculations based on GfK FRS.

Figure 5.1: GB market shares by volume of main PCAs

[✄]

Source: CMA analysis of GfK FRS.

5.12 Over the same ten-year time period, other banks (Santander, Nationwide, Co-op and Metro, which entered in 2010) experienced an increase in their share of GB main accounts. The combined absolute impact on the market has been a total increase in their share of less than five percentage points (though proportionately their share increased by about one-third).[216] Another smaller bank (Clydesdale Group) has experienced declining market share.

[213] More precisely, an account is defined as a main account if at least an average of £500 credit turnover per month in the previous 12 months (or since the account was opened if less than 12 months).
[214] In 2014 LBG, RBSG, Barclays and HSBCG were the largest PCA providers in terms of market share of main accounts.
[215] Some other financial institutions, eg trustee savings banks (subsequently acquired by LBG) and Co-op started to clear cheques and provide PCAs from the 1960s and 1970s. The building societies were able to clear cheques and hence provide PCAs from 1986.
[216] This includes Alliance & Leicester (acquired by Santander in 2008).

5.13 Overall, therefore, market shares have been quite stable but the largest four banks have collectively been losing market share and other smaller banks have been gaining market share. One of these (Santander) now has a share in excess of [10–20]% (see Figure 5.1) although this has been achieved primarily through the acquisition of the Abbey and Alliance & Leicester brands, rather than internal growth in market share.

5.14 We have also calculated market shares on the basis of the number of new PCAs opened (see Table 5.2), which will include new-to-market customers as well as switchers. The share of GB market flow of the four largest banking groups was just over 60% in 2014, lower than their share of PCA stock. Santander, Nationwide, TSB and Metro had a share of new accounts in excess of their share of all PCAs in 2014.

Table 5.2: GB market shares of new PCAs

%

Banking group	*2011*	*2012*	*2013*	*2014*
LBG	[30–40]	[30–40]	[20–30]	[20–30]
RBSG	[10–20]	[10–20]	[10–20]	[10–20]
Barclays	[10–20]	[10–20]	[10–20]	[10–20]
HSBCG	[10–20]	[10–20]	[5–10]	[10–20]
Santander	[10–20]	[10–20]	[10–20]	[10–20]
Nationwide	[5–10]	[5–10]	[5–10]	[5–10]
TSB	[0–5]	[0–5]	[0–5]	[5–10]
Clydesdale	[0–5]	[0–5]	[0–5]	[0–5]
Co-op	[0–5]	[0–5]	[0–5]	[0–5]
Metro	[0–5]	[0–5]	[0–5]	[0–5]
Other	[0–5]	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on GfK FRS.

5.15 The four traditional clearing banks in NI[217] have a slightly smaller total share of PCAs than the four in GB, reflecting a more rapid loss of market share to former and continuing building societies (Santander, Halifax and Nationwide). In particular, Santander has a larger share of PCAs in NI than in GB and is the [✄] largest PCA provider in NI. Overall, however, the current level of concentration in NI (see Tables 5.3 and 5.4) is broadly similar to that in GB.

5.16 In NI, Santander had the largest share of new accounts in 2014 (around [20–30]%). Other providers in NI with a larger share of new PCAs than of the stock of all PCAs are BoI, LBG, Nationwide, Barclays and HSBCG.

[217] These are RBSG (Ulster), Danske (trading name of Northern Bank Limited), AIB (First Trust) and BoI.

Table 5.3: NI PCA market shares

%

Banking group	*Main PCAs*		*New PCAs*	
	2013	*2014*	*2013*	*2014*
RBSG	[20–30]	[20–30]	[20–30]	[10–20]
Danske	[20–30]	[10–20]	[10–20]	[10–20]
Santander	[10–20]	[10–20]	[20–30]	[20–30]
AIBG	[10–20]	[10–20]	[5–10]	[5–10]
LBG	[10–20]	[10–20]	[10–20]	[10–20]
BoI	[10–20]	[5–10]	[10–20]	[10–20]
Nationwide	[5–10]	[5–10]	[5–10]	[5–10]
Barclays	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[0–5]	[0–5]	[0–5]	[0–5]
Other	[0–5]	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by banks.

5.17 Table 5.4 shows concentration levels as measured by Herfindahl-Hirschman Indices (HHIs) since 2005. The main changes in HHI for GB have been due to structural changes – the merger of LBG HBOS at the start of 2009[218] and the divestment by LBG of TSB in 2014.[219] The HHI for NI in 2014 was similar to that for 2005, though as we have noted the traditional clearing banks in NI have lost market share to former and continuing building societies.

Table 5.4: Concentration indices for main PCAs in GB and NI

HHI	*GB*	*NI*
2005	1,379	1,554
2006	1,355	1,502
2007	1,320	-
2008	1,293	-
2009	1,801	-
2010	1,817	-
2011	1,806	-
2012	1,812	-
2013	1,801	1,531
2014	1,550	1,511

Source: CMA analysis of GfK FRS and data submitted by banks (TSB treated as independent from LBG from 2014).
Note: Data not available for NI before 2013 (except for 2005 and 2006 which are from the CC report on Northern Ireland Banking). Figures for 2008 treat Santander (Abbey National) and Alliance & Leicester as separate.

5.18 We also considered market shares on the basis of net revenue.[220] We were only able to do this on a UK-wide basis (not separately for GB and NI), but we consider that the results are nevertheless useful for considering how far revenue shares may differ from volume shares (which we can also calculate for the UK as a whole).

5.19 Table 5.5 shows 2014 market shares by volume and net revenue. In most cases, market shares are broadly similar but the revenue shares of the

[218] The merger of Santander and Alliance & Leicester in 2008 also increased HHI, though to a much smaller extent.
[219] The divestment of Williams & Glyn from RBSG will result in a further small reduction in concentration.
[220] See paragraphs 5.25–5.33 below and Appendix 5.2 for our analysis of revenue, including the definition of net revenue.

largest four UK banks (LBG, RBSG, Barclays and HSBCG) are higher than their volume shares, reflecting that their average net revenue per account is higher relative to the smaller banks. The revenue shares of banks with increasing market shares, such as Santander, Nationwide, Co-op and Metro are lower than their volume shares. We consider this reflects that expanding banks tend to earn lower net revenue per account as in most instances they seek to attract new customers by offering lower charges or better interest and cashback payments.

Table 5.5: UK 2014 market shares – on volume and revenue basis

	Market share (%)		
	Volume	*Revenue*	*Adjusted revenue**
LBG	[20–30]	[20–30]	[20–30]
RBSG	[10–20]	[10–20]	[10–20]
Barclays	[10–20]	[10–20]	[10–20]
HSBCG	[10–20]	[10–20]	[10–20]
Santander	[10–20]	[5–10]	[5–10]
Nationwide	[5–10]	[5–10]	[5–10]
TSB	[0–5]	[5–10]	[5–10]
Clydesdale	[0–5]	[0–5]	[0–5]
Co-op	[0–5]	[0–5]	[0–5]
Ulster	[0–5]	[0–5]	[0–5]
Danske	[0–5]	[0–5]	[0–5]
AIBG	[0–5]	[0–5]	[0–5]
Metro	[0–5]	[0–5]	[0–5]
BoI	[0–5]	[0–5]	[0–5]
Total	100	100	100
HHI	1,573	1,731	1,681

Source: CMA analysis based on data from banks shown above.
*Revenue of largest five banks is adjusted by deducting the cost of packaged account benefits. The cost of packaged account benefits is not available for other banks.
Note: Volume and revenue market shares relate to the average for the year. Volumes are based on averages of number of accounts at start and end of the year (hence are not on exactly the same basis as shown in Tables 5.1 and 5.3). Revenue is based on revenue for the year.

5.20 Our main revenue calculations net off interest and cashback payments to customers, but do not take account of non-monetary benefits to customers from packaged accounts (which are costly for banks to provide relative to non-packaged accounts). Consequently they may overstate the share of banks with a higher proportion of packaged accounts. As a way of assessing the significance of this point, we deducted the cost of providing packaged benefits for the largest five banks from their revenue.[221] As we did not have information on the packaged account benefits of other smaller banks, the resulting shares are likely to understate the share of the largest banks. Nevertheless, the total revenue share of the largest four banks remains greater than their volume share.

[221] This only affected the revenue of four banks as Santander told us it had no on-sale or off-sale packaged accounts.

Summary of evidence on market shares and concentration

5.21 The combined share of main GB PCAs of the four largest bank groups has reduced by around four percentage points since 2005 (excluding the impact of LBG's acquisition of HBOS and divestment of TSB) and stood at around 70% in 2014. Over the same period smaller banking groups (Santander, Nationwide, Co-op and Metro) experienced an increase in their combined market share. While in proportionate terms this combined share increased by a third, the absolute change in market share was less than 5 percentage points. Changes in concentration over this period (as measured by the HHI) have largely been as a result of mergers and divestments, and in 2014 the HHI stood at 1,550.

5.22 The flow of new PCAs is less concentrated than the stock, with the share of GB market flow of the four largest banking groups standing at just over 60% in 2014.

5.23 The combined share of main PCAs of the four largest banks in NI is slightly lower than in GB (69% in 2014), reflecting the loss of accounts from the traditional clearing banks to the former and continuing building societies. At around 50%, the combined share of the four clearing banks in the flow of new PCAs in 2014 was lower than their corresponding share of stock. Furthermore, Santander had the second highest share of new PCAs in 2014 (around [20–30]%). Nevertheless concentration, as estimated by the HHI, was similar to GB in 2014 (at 1,511) and has remained broadly unchanged since 2005.

5.24 We also considered market shares on the basis of net revenue. Due to data limitations we were not able to calculate revenue shares separately for GB and NI. Our calculations for the UK as a whole show that in most cases market shares calculated using net revenue are broadly similar to those calculated using account volumes. However, the revenue shares of the largest four UK banks (LBG, RBSG, Barclays and HSBCG) are higher than their volume shares. Conversely expanding banks such as Nationwide, Co-op and Metro have lower revenue than volume shares.

PCA revenue analysis

5.25 In this section we summarise the main findings of our analysis of PCA net revenues. Our analysis relates to banks' net revenue across the UK, and includes results from banks operating across the UK (eg RBSG, the Halifax brand of LBG and Santander); from banks whose NI shares are small (eg Barclays and HSBCG) and banks whose UK operations are primarily in NI

(AIB, BoI and Danske). We consider that the results are applicable to both of the geographic markets we identified (GB and NI).

5.26 In undertaking this analysis we have sought to gain an understanding of the primary sources of PCA net revenue (and how this has evolved over time). We have also undertaken comparisons of net revenue per customer to assess the degree of variability between banking groups.

5.27 We have normalised net revenue by the number of main PCA accounts held so as to obtain net revenue numbers that are comparable over time and between banks. In doing so, we use the main account as the basic unit of analysis.

5.28 A fuller discussion of the revenue analysis along with a more detailed set of results is contained in Appendix 5.2.

Aggregate revenue per PCA

5.29 Table 5.6 summarises the results of our analysis of aggregate revenue per main PCA over the period 2011 to 2014.

5.30 Since the decomposition of revenue represents a weighted average across banks, changes over time will reflect both changes in the composition of accounts, both within and across banks, as well as more general trends (affecting all accounts) over time.

Table 5.6: Analysis of revenue (£ per main PCA per year*) 2011 to 2014

Type of revenue	*2011 (£)*	*2012 (£)*	*2013 (£)*	*2014 (£)*	*2014 (%)*	*Decomposition of ∆ in net revenue since 2011 (%)*
Arranged overdraft	37.27	35.66	35.22	34.86	20	6
Unarranged overdraft and unpaid item fees	29.30	28.83	26.74	24.45	14	13
Foreign ATM and debit card fees	9.85	8.68	8.60	8.67	5	3
Interchange fees (debit card)	15.47	15.77	16.43	17.01	10	–4
Monthly account fees	29.74	25.91	23.42	21.24	12	22
Other receipts (net)†	3.97	2.16	2.69	3.53	2	1
Total receipts from charges and interest	**125.61**	**117.00**	**113.10**	**109.76**	**62**	**41**
Interest payments to customers	–8.19	–7.55	–11.95	–18.17	–10	26
Other payments to customers	–0.09	–0.81	–2.00	–2.99	–2	8
Net value of funds‡	97.84	85.38	80.56	88.03	50	26
Net revenue	**214.94**	**194.02**	**179.71**	**176.62**	**100**	**100**

Source: CMA calculations based on data submitted by banks in response to data requests.
*Aggregate revenue is divided by the average number of main PCAs at the start and end of the year.
†Other receipts consists of revenue from charges for failing to meet account criteria, revenue from charges for withdrawing cash from ATMs abroad, revenue from charges relating to cheques, revenue from charges relating to domestic payments, revenue from charges relating to foreign payments, revenue from account management charges, other revenue from account holders and other revenue which is not from account holders.
‡Banks' own assessment of the value of funds from PCA credit balances less cost of funding PCA debit balances (except for Clydesdale, Co-op and Metro, where the weighted average for the other banks has been used).
Note: 2011 data is not available [✄]; 2012 data is not available for [✄]. In order to assess the effect of different coverage in 2011 from 2012, we recalculated 2012 revenue per main account for those banks providing 2011 data. The reduction in average net revenue per main account between 2011 and 2012 for these banks was 6% (compared with the 10% for all banks shown in the table).

5.31 Net revenue per account declined over the period 2011 to 2014 by about 14%.[222] This reduction was driven by an increase in interest payments to customers, a reduction in revenue from monthly account fees and unarranged overdraft fees, and a decline in the net value of funds from credit balances. This in turn is likely to reflect underlying trends both in pricing and in the composition of accounts. For example, the decline in monthly account fees per account reflects a decline in the share of packaged accounts which have relatively high monthly fees, and the increase in interest payments to customers reflects an increase in the share of accounts making significant interest payments to customers, such as Santander 123. A further reason for the decline in unarranged overdraft and unpaid item fees is that customers have increased information about their accounts, through SMS messages from banks and increased usage of internet and mobile banking, that helps them avoid incurring such fees.[223]

5.32 The decline in the net value of funds from credit balances is likely to reflect a reduction in term interest rates during the period (and more than offsets an increase in net balance per account). This trend is likely to reverse if and when interest rates begin to rise. Furthermore, despite the observed reduction, the net value of funds remains the largest source of PCA revenue, accounting for approximately 50% of net revenue in 2014. Although we found variation between banks in the value of funds attributed to PCA credit balances, in nearly all cases the assigned values were higher than the short-term interest rate (the BoE base rate was 0.5% throughout the period 2011 to 2014).[224]

5.33 Interest payments to customers accounted for around 10% of the industry average net revenue in 2014. Total overdraft (arranged and unarranged) and unpaid item fees were the second most important component of revenue in 2014 (accounting for approximately one-third of net revenue) but there has been a reduction in the relative importance of unarranged versus arranged overdraft charges since 2011.

5.34 We noted two specific factors that were likely to have affected net revenue per main account. First, the declining share of packaged accounts has reduced the average cost per account of providing packaged account benefits. Second, the increasing number of main accounts, if due to multi-banking, would be likely to have reduced interest and charges per main

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[222] The 14% figure is calculated after adjusting for differences in coverage of the data between 2011 and 2012.
[223] See FCA (March 2015) *Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour*, and Appendix 5.3, Annex B.
[224] See Appendix 5.2, Table 2.

account (since we would expect multi-banking customers to incur charges on one or other of their accounts but not on all of them). We discuss these points further in Appendix 5.2, paragraph 9. Stripping out these two factors, we estimate that the reduction in net revenue per main account between 2011 and 2014 would have been about 8%.

Summary of evidence on PCA revenues

5.35 Our analysis of PCA net revenues shows a reduction in net revenue per account since 2011. The reduction has been driven by an increase in interest payments to customers, a reduction in revenue from overdrafts, and a decline in the net value of funds associated with credit balances. Nevertheless, the net value of funds remained an important source of PCA revenues, accounting for around 50% of net revenue in 2014.

PCA financial performance

5.36 We examined the revenues and impairment margins of the eight largest banks' PCA businesses, using the financial data collected from banks.

5.37 Due to the difficulty of cost allocation, we considered that examining a full profit and loss account for banks' PCA business would not be appropriate, so we have focused on an analysis of revenues, and an examination of impairments.

5.38 Further, we were not able to undertake an analysis of the banks' PCA businesses by devolved nation, or segment the analysis, for example between different types of PCA customers, because the banks did not collect, analyse or present the data, in this way.

5.39 Where we refer to any named bank in this section, we are referring to its PCA banking business only, and not the whole of its UK banking operations or its UK retail banking operations.

5.40 For the reasons set out in Section 2 we did not undertake a market-wide profitability assessment.

Total revenues and number of accounts

5.41 Figure 5.2 shows total PCA revenues[225] by bank, 2011 to 2014, for the eight largest banks.[226] PCA revenues for the eight largest banks totalled

[225] Includes value of funds.
[226] Data missing for [✂] in 2011 – not provided to CMA due to systems limitations.

£7.44 billion in 2014. There was a small decline in PCA revenues between 2011 and 2014: the most significant change during this period was the separation and subsequent divestiture of TSB from LBG (LBG excluded TSB from the PCA figures it submitted to us from 2013 onwards).

5.42 [✂] has the largest PCA revenues with [✂] second and [✂] third. After [✂] and [✂], there is a big gap in size of revenue between the five larger banks and the smaller three. Apart from the decline in LBG's revenues between 2011 and 2012, and between 2012 and 2013 after adjusting for the exclusion of TSB, each bank's PCA revenues do not show much change between years.[227]

Figure 5.2: PCA total revenues by bank, 2011 to 2014, £m

[✂]

Source: CMA analysis based on data provided by the parties.

5.43 Figure 5.3 shows the average number of PCAs by bank, in the period of 2011 to 2014 for the eight largest banks.[228,229] We looked at main accounts only.[230] The ranking of banks based on the number of accounts is the same as the ranking by total PCA revenues.

Figure 5.3: Average number of PCA accounts by bank, 2011 to 2014

[✂]

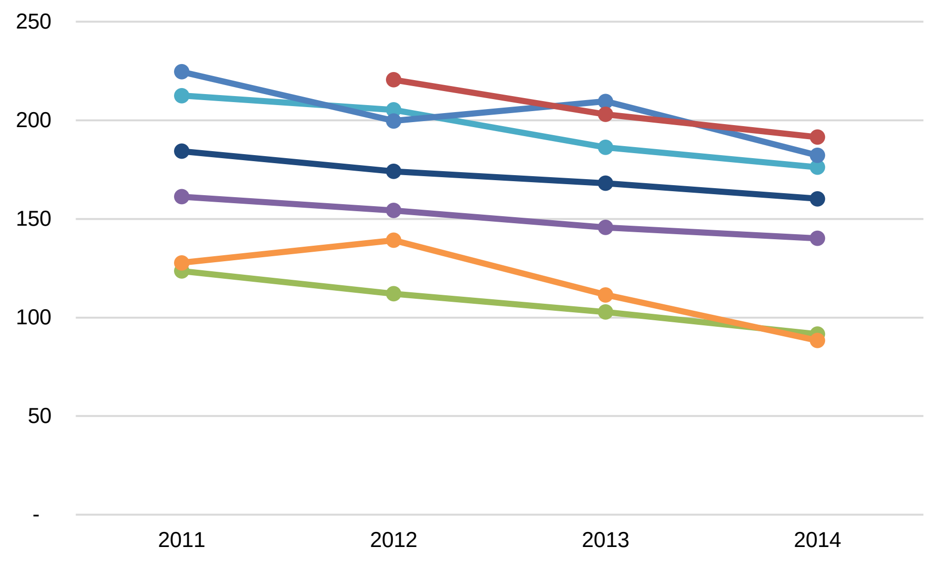
Source: CMA analysis based on data provided by banks.

Average revenues per account

5.44 Figure 5.4 shows average revenues per PCA,[231] for 2011 to 2014 for the eight largest banks.[232,233]

[227] With the exception of [✂].
[228] Data missing for [✂] in 2011 – not provided to CMA due to systems limitations.
[229] [✂] data is not shown for 2011 and 2012 because the data provided was not internally consistent: [✂]
[230] We define a 'main account' as one with average credit inflow of more than £500/month. [✂] questioned our use of 'main accounts' instead of all accounts on the basis that it earned income on all accounts. Our approach normalises revenues and as such we do not need to make adjustments between banks for the proportion of non-main accounts held.
[231] Main accounts only, and includes value of funds.
[232] Data missing for [✂] in 2011 – not provided to CMA due to systems limitations.
[233] [✂] data is not shown for 2011 and 2012 because the data provided was not internally consistent: [✂]

Figure 5.4: PCA average revenues by bank, 2011 to 2014, £



Source: CMA analysis based on data provided by the parties.

5.45 PCA average revenues declined over the period for all banks (as discussed in more detail in paragraph 5.31 above). This reflects both an increase in the average number of accounts (see Figure 5.3 above) and a slight decrease in total revenues for most banks (see Figure 5.2 above).

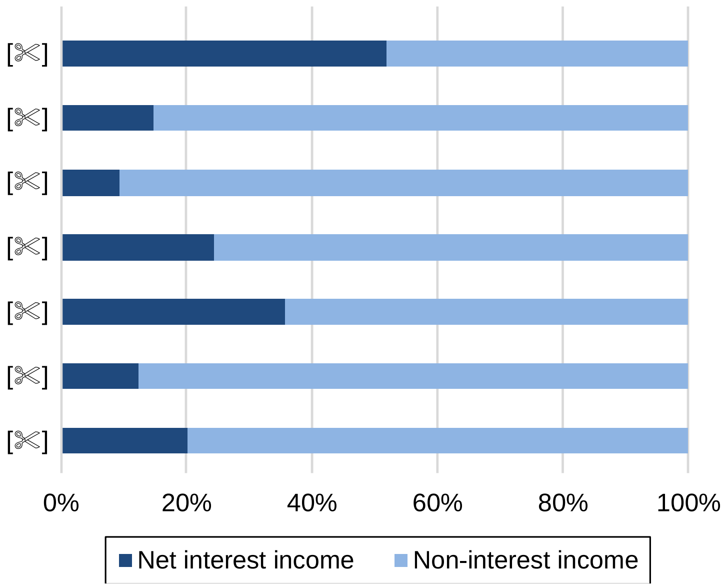
5.46 Four of the five larger banks have higher average revenues than two of the three smaller banks.[234]

Total PCA revenues by source

5.47 We assessed the split of revenues for each bank between net interest income and non-interest income. Net interest income consists of interest income less interest paid; non-interest income consists of fees from overdrafts, packaged accounts, returned items and VISA/ATM charges. We excluded amounts relating to value of funds: we noted that funds transfer pricing arrangements are necessarily provider-specific and will reflect each provider's individual circumstances, including its balance sheet position, credit rating and possibly its business strategy. We totalled each bank's revenues over the four-year period (three years for [✂], as 2011 data was not provided), and examined the split between net interest income and non-interest. Figure 5.5 shows PCA revenues by source, for 2011 to 2014.

[234] [✂] told us that differences in average revenues might be driven by factors such as the profile of respective customer bases and the scope of service propositions; and [✂] told us that differences in average revenues might reflect variations in customer characteristics and their use of PCA and SME banking services.

Figure 5.5: PCA revenues by source, 2011 to 2014



Source: CMA analysis based on data provided by the parties.

5.48 In general, non-interest income makes up a large proportion of PCA revenues, and a larger proportion of PCA revenues for the smaller banks than the larger ones ([✂] is an exception).[235,236] [✂]

Impairments

5.49 We looked at impairments as a percentage of revenues, including value of funds (as each bank measures them).[237] Impairments are credit and first party (customer) fraud losses.[238] Figure 5.6 shows the impairment rate for each of the eight banks, for 2011 to 2014.

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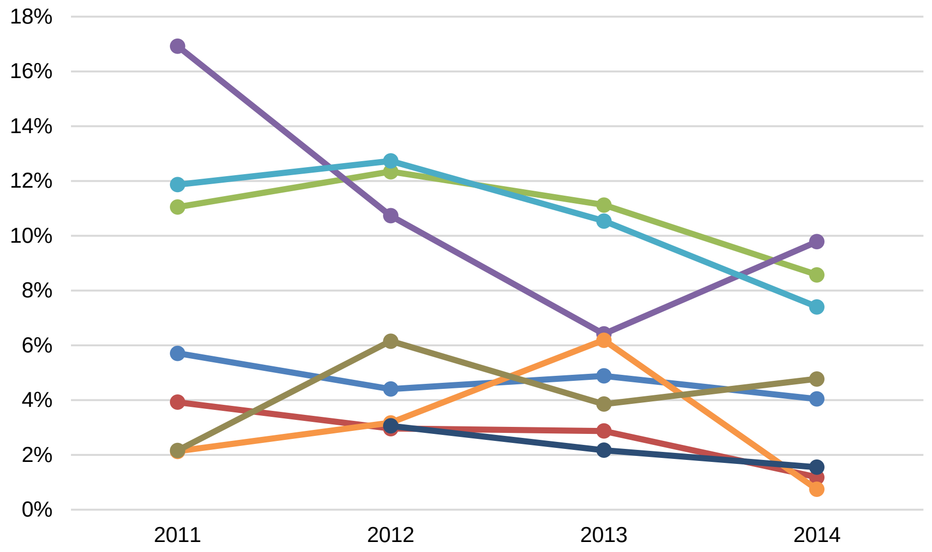
235 [✂] told us that amounts included in other income (non-interest income) related to internal financial management of the PCA balances, rather than direct customer interest payable or receivable or funds transfer pricing. [✂] financial data response included line items for customer interest and funds transfer pricing for the deposits and lending income sections; all remaining net interest income was included in 'other income'.
236 Banks appear to treat interest and non-interest income differently. We expected to see amounts relating to fees in non-interest income. [✂] told us that it included overdraft fees in customer interest receivable to ensure total net interest income reconciled to its management accounts, in line with published accounting policies. This includes recognition of fees within net interest income where appropriate and required using the effective interest rate method. RBSG stated that from 2011 it transferred [✂]. This appears to reflect the underlying nature of some elements of non-interest income.
237 [✂] told us that this measure was an uninformative metric to compare between providers: it told us that impairments were driven by customers' credit quality and lending balances, whereas total income was driven by customers' credit and debit balances. We considered that our impairment measure was nonetheless a useful metric in the context of PCAs.
238 Third party fraud losses are included in direct costs.

Figure 5.6: PCA impairments as a proportion of total revenues, 2011 to 2014



Source: CMA analysis based on data provided by the parties.

5.50 In general, impairment rates improved over the period and by 2014 were, for all banks, under 10%.[239] This appears to reflect in part an improving macro-economic environment resulting in lower provision levels than in previous years. There appear to be two broad groupings among the eight banks: [✂] with higher impairments, and [✂][240] with lower impairments (the last three have particularly low rates).

Summary of evidence on financial performance

5.51 With regard to the analysis of the PCA financial performance of the eight largest banks we examined we found that:

(a) there was a small decline in total revenues between 2011 and 2014;

(b) ranking of banks based on number of accounts is the same as ranking by total revenues;

(c) average revenues per account declined over the period;

[239] The impairment rate for [✂] declined steeply between 2011 and 2013 and rose in 2014. [✂] told us that the decline from 2011 was mainly due to lower defaults, and that the small increase in 2014 was due to 2013 including higher one-off adjustments from provision adequacy (balance sheet) adjustments in 2013 than in 2014.
[240] [✂] told us that the increase in 2013 was due to methodological changes to credit model parameters on loss rates, and that the figures prior to 2014 included fraud costs.

(d) four of the five larger banks have higher average revenues than two of the three smaller banks;[241]

(e) in general, non-interest income makes up a large proportion of PCA revenues, and a larger proportion of PCA revenues for the smaller banks than the larger ones; and

(f) in general, impairment rates improved over the period.

Profitability of PCA customers and products

5.52 As noted in Section 2 our ability to conduct our own analysis of the profitability of PCAs is complicated by the difficulty and subjectivity of allocating a significant proportion of common or shared costs (eg branch costs, HR costs and marketing spend) to individual products and/or customers.

5.53 We have nevertheless collected information from the five largest UK banks (LBG, Barclays, HSBCG, RBSG and Santander)[242] on ways in which they assess the profitability of PCAs or wider personal banking and, to the extent possible, the profitability of individual products and customers. The banks take different approaches to assessing the performance of PCAs and they do not all assess the profitability of PCAs in the normal course of business. Therefore we do not have a comprehensive view of PCA profitability across all the banks.

5.54 The details of our findings for the five banks mentioned above are included in Appendix 5.3.

5.55 Through the economic cycle, for [✂], PCAs are [✂], and for [✂], personal banking, including the provision of PCAs, is [✂].[243]

5.56 Our analysis of PCA revenues in paragraphs 5.25 to 5.35 above summarised the main drivers of PCA profitability from the revenue

[241] [✂] told us that it did not believe that the data was sufficiently robust to comment on differences between the banks. There was a wide margin of variation: given the sample was eight banks, the two exceptions were likely to carry significant weight. Also, it told us that variations in revenue could have many reasons: it may reflect variations in customer characteristics and their use of PCA banking services.
[242] We focus our analysis on the PCA banking activities of the five largest banks in the UK, as together they had a combined market share (by number of main PCAs) of [✂] in 2014. See Table 5.1 for further information. Our assessment is based on financial data provided by the banks and generally reflects accounting (and not economic) profits.
[243] [✂] provided stand-alone profit and loss forecasts for their PCA propositions, whereas [✂]provided forecasts for their personal banking businesses, which includes the provision of PCAs and other personal banking products.

perspective. Other drivers include: the number of active customers and the type of PCA held.

5.57 Packaged accounts tend to be the most profitable type of PCA, as they generally require a monthly fee for their use (which exceeds the cost of the benefits provided to customers) and are more likely to be held by main banking customers who are active users of their account, have higher credit balances, and use other personal banking products.

5.58 Both standard and reward PCAs are less profitable than packaged accounts, as either there is no monthly fee, or in the case of reward accounts, if there is a monthly fee it is usually waived or offset by customer benefits. There also tends to be a greater proportion of secondary PCA customers within these groups.

5.59 BBAs and non-adult PCAs (ie youth, graduate and student accounts) tend to be less profitable than standard and reward PCAs. The reasons for the lower profitability of such accounts typically include: low credit balances, and no access, or interest-free access to an overdraft facility. Further, customers of these accounts are unlikely to have a great need for other personal banking products.

5.60 Primary banking customers[244] tend to hold a greater proportion of their personal banking products with their primary bank and tend to be more active users of their account.

PCA pricing

5.61 As discussed in Section 4, PCAs are complex products providing a number of different services to customers. The structure of PCA pricing differs between accounts but has the following broad characteristics:

(a) Common sterling transactions are not charged for, but in nearly all cases foreign currency transactions are charged for.

(b) Most PCAs allow customers to go into overdraft and charge customers for doing so – the structure of such charges depends on whether the

[244] We understand that a bank deems a customer to be a primary banking customer if they hold their main transactional account (ie the account in which they hold their income and from which the majority of their payments are made) and therefore, their main banking relationship with them, and that all other customers are deemed to be secondary banking customers, as they hold their main banking relationship elsewhere.

overdraft is arranged or unarranged and differs between individual PCAs.[245]

(c) Most PCAs also charge customers when a payment is refused due to the bank being unwilling to extend further credit (unpaid item fee).

(d) Most PCAs do not have a monthly fee.

(e) Some PCAs provide customers with monetary and/or non-monetary benefits.

(f) Packaged accounts provide non-monetary benefits, usually insurance, and have a monthly fee.

(g) Reward accounts may pay interest on credit balances, or pay a monthly amount to customers, or provide cashback on spending.[246]

5.62 Some PCAs are only available to certain groups of customers, in particular banks usually have young persons (under 18), student and recent graduate accounts. Student and recent graduate accounts often provide no-charge or low-charge arranged overdrafts.

5.63 Most PCAs neither charge for sterling transactions nor have a monthly fee (FIIC). About 80% of PCA customers have a PCA without a monthly fee. This means that the majority of customers who remain in credit gain the benefit of all transactional services without having to pay explicitly (though for most FIIC PCAs they do forego interest on their credit balance). Customers going into overdraft, however, do incur charges and/or interest which can be substantial.[247]

5.64 Given the complexity both of services provided and of pricing, making comparisons between PCA prices is not straightforward. The approach we have adopted is set out in Appendix 5.4 and can be summarised as follows:

(a) We have taken a representative sample of customers and calculated an average price for each brand across the whole sample.

(b) We have based the average price on standard and reward PCAs only, as all BBAs are similar (or will be so following the implementation in

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[245] BBAs do not include overdrafts. Most PCAs that offer overdrafts allow customers to opt out, though in some cases there is a monthly charge for doing so.
[246] Reward accounts often provide benefits only if customers meet certain criteria, eg paying in £X per month with two or more direct debits, and may have a monthly fee though this may be waived if customers meet the eligibility criteria.
[247] PCAs usually include a buffer before overdraft charges are incurred.

December of the agreement between the UK government and the major banks)[248] and there are more difficulties in comparing other types of PCA (packaged accounts and young persons/student/graduate accounts).

(c) We calculated average net monthly cost including, as far as possible, all charges paid by customers less the value of all benefits provided to them; our main results include upfront switching incentives and net monthly costs averaged over five years.[249]

(d) Where brands have more than one standard and/or reward PCA, we have taken a weighted average of all such PCAs.[250]

(e) Similarly, where banking groups have more than one brand, we have taken a weighted average across brands of that banking group.

5.65 The cost and/or benefits of some PCAs depend on eligibility requirements. We have dealt with this issue by making the above comparisons separately for a number of different customer segments. The average price for each brand and banking group is then based on a weighted average across segments, see Appendix 5.4 paragraph 36.[251] This is to ensure that the calculated average prices reflect each brand's average price in each segment.

5.66 The results for GB are set out in Table 5.7. As with any complex exercise of this nature, it has been necessary to make a number of assumptions (see Appendix 5.4). We note in particular that the calculations calculate the average value of each PCA on the basis of customers' existing behaviour. Thus they do not take into account preferential rates on linked products, for example instant access savings accounts nor do they reflect any differences between PCAs in the availability of credit (and hence the overdraft that would be available). This may be important because overdraft charges are an important aspect of the structure of pricing (see paragraphs 5.61 and 5.63). Also they do not take into account quality differences, which are considered below.

[248] HMT news story on BBAs, 15 December 2014.
[249] We also calculated average net monthly cost including upfront switching incentives over 12 months and excluding switching incentives.
[250] Weights are based on the number of customers of each PCA in the sample.
[251] Average prices across segments are weighted according to the total sample in the segment, not the sample for the PCA or brand concerned.

Table 5.7: Average PCA prices, GB

£ per month (negative figure indicates payment to account holder)

Group	*Brand*	*Average cost per month*† across all segments*	
		Brand	*Group*
Barclays	Barclays	3.89	3.89
BoI/Post Office	Post Office	1.64	1.64
Clydesdale‡§	Clydesdale & Yorkshire Bank	3.19	3.20
Co-op	The Co-operative Bank	5.66	5.50
HSBCG	HSBC	2.86	2.96
	First Direct	3.99	
	M&S Bank	–0.95	
LBG	Lloyds	7.74	5.68
	Halifax	3.25	
	BoS	6.51	
Metro	Metro Bank	1.15	1.15
Nationwide	Nationwide	–1.38¶	–1.38¶
RBSG	RBS	5.67	4.44
	NatWest	4.18	
Santander	Santander	4.09	4.09
Tesco	Tesco Bank	0.88	0.88
TSB	TSB	7.25	7.25

Source: CMA calculation using Runpath data (average over five years including switching incentives).
*Average cost per month for brand and group are weighted averages where weights are customers in the segment for all banks (from the transaction data set).
†Group averages may include brands not listed in the table.
‡Yorkshire Bank is not shown separately as it has the same prices as Clydesdale.
§Clydesdale/Yorkshire Current Account Direct has been omitted as it does not allow full branch access.
¶Nationwide FlexAccount includes free multi-trip UK and European travel insurance for UK customers aged 16-75 regularly crediting £750 per month – this has been valued at £50 per year. Excluding this benefit would increase monthly cost for Nationwide to £1.68 (average monthly cost is increased when the monthly benefit from free travel insurance is no longer offset against the costs of the account for the proportion of Nationwide FlexAccount regularly crediting £750 per month).

5.67 Table 5.7 shows significant variation in average price between brands and between banking groups. Generally recent entrants and expanding brands seem to offer lower average prices. This is illustrated further in Figure 5.7 which compares average price with the average length of time customers have held their account.

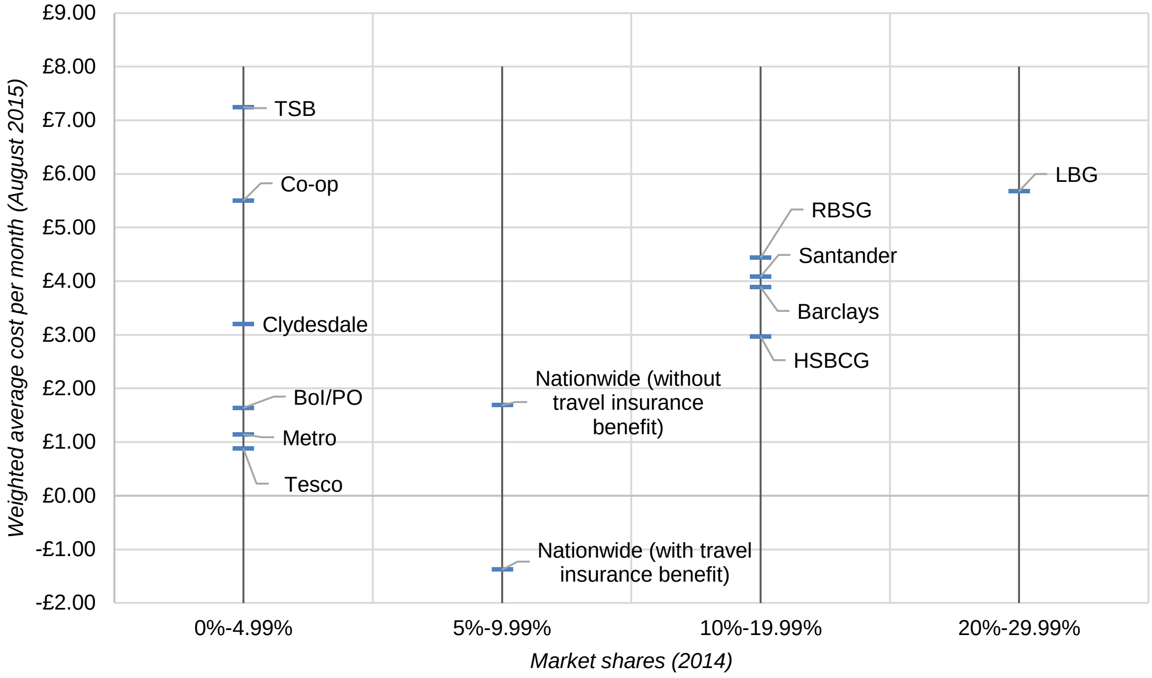
Figure 5.7: Average price versus length of time account held, GB brands

[✂]

Source: CMA calculation using Runpath data.
[✂]

5.68 Figure 5.8 similarly shows that banking groups with the highest market shares tend to have the highest average prices.

Figure 5.8: Price versus market share, GB banking groups



Source: CMA calculation using Runpath data.

5.69 A similar exercise for NI did not show much evidence of a positive correlation between market share in NI and average price (see Appendix 5.4, Annex B). However, there were some limitations to the data for NI and we attach less weight to the comparison for NI than to that for GB.

PCA quality

5.70 It is difficult to draw inferences on the existence of any relationship between market structure and outcomes by reference to the pricing analysis alone. This is because variations in price between banking groups may reflect differences in the quality of PCA service provided. We have therefore undertaken comparisons between banks based upon a number of indicators of service quality. We have considered these, together with the pricing analysis, in drawing our conclusions about market structure and outcomes.

5.71 In undertaking these comparisons we have sought to identify *(a)* whether there is a relationship between market structure and quality outcomes, and *(b)* how and to what extent customers have responded to variations in quality outcomes.

5.72 In our approach to assessing and comparing quality between banks, we have defined a set of proxy performance indicators, which encompass evidence from a range of sources (both subjective and objective in nature) including survey data, complaints volumes, and other parameters of the service offering. A more detailed discussion of the methodology and results is contained in Appendix 5.5.

Indicators of overall quality

5.73 Customer experience metrics such as customer satisfaction and advocacy ratings, can be useful as indicators of the overall quality of service received by customers.

5.74 We recognise that there are limitations to the use of these measures as a proxy for quality, and for this reason the results of such analysis should be interpreted carefully, especially when considering absolute levels of satisfaction. In particular, ratings are likely to reflect customers' expectations of quality, which may be bounded by the range of service offered by current market participants. It is also possible that perceived quality does not coincide with the actual quality of the service delivered, for example if the service is not well understood by the customer or due to brand taint effects.[252]

5.75 However, customer experience metrics have the benefit over alternative indicators (such as operational performance measures) of measuring service outcomes as perceived by the customer, as opposed to single inputs or components of the overall quality outcome. In this way they will reflect the implicit weighting attached by customers to the various attributes of service.

5.76 Customer-reported indicators of service quality are also the most appropriate measures to use in assessing the strength of competitive dynamics in the market, and in particular, how customers respond to perceived variations in service quality between providers.

5.77 We therefore consider customer satisfaction and advocacy measures to be a primary indicator of service quality outcomes, particular when making comparisons between providers or across geographic markets.

5.78 To augment the information provided by customer experience metrics we have also undertaken comparisons of objective indicators of quality along

[252] In particular a customer's reported net promoter score (NPS) and satisfaction ratings may be impacted by positive or negative publicity surrounding a bank over issues that are not relevant to the provision of the PCA product. For example, in its submission on measuring consumer outcomes in retail banking, RBSG noted the divergence in NPS scores received by its NatWest and RBS brands (despite the similarity of their service offerings). RBSG considered that this might be a result of the RBS brand being more readily associated by customers with the negative media coverage received by RBSG during and after the financial crisis.

specific dimensions of service (eg IT service failures and average branch opening hours).[253]

Comparisons with providers of other financial products

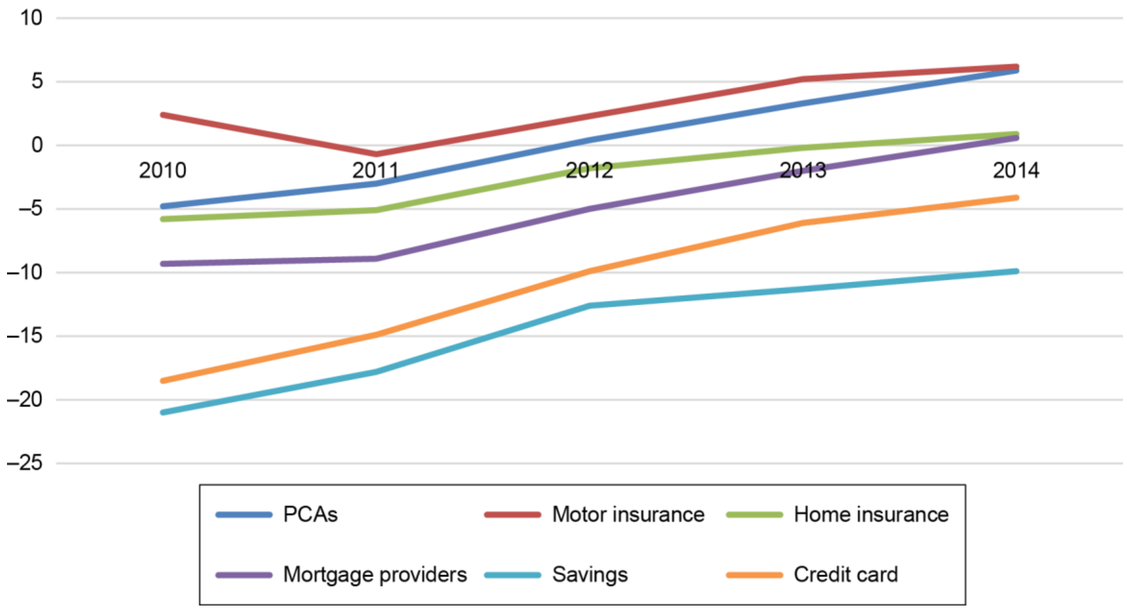
5.79 According to the results of the GfK PCA consumer survey, around 90% of UK PCA customers were satisfied or very satisfied with their PCA provider in 2015.[254] Similar proportions were observed for GB and NI respondents separately.

5.80 GB PCA providers appear to score relatively well on indicators of service quality compared with providers of other financial products.[255] For example, comparisons of NPS[256] across sectors between 2010 and 2014 show that PCA providers receive higher advocacy rates than providers of home insurance, credit cards, personal savings and mortgages respectively, and receive a similar rating to motor insurance providers by 2014 (see Figure 5.9).

5.81 A similar result is observed from comparisons of customer satisfaction ratings in GB,[257] which show that PCA customers are at least as satisfied with the quality of service received from PCA providers as with that received from providers of other financial products.

[253] See Appendix 5.5 for further details of this additional analysis.
[254] On a five-point scale from 'very dissatisfied' to 'very satisfied'.
[255] Due to data limitations it is not possible to perform a similar benchmarking of willingness to promote for PCA providers against providers of other personal finance products in NI.
[256] NPS is a customer experience metric derived from survey evidence in which customers are asked on a scale of 0 to 10, how likely they are to recommend their provider to friends and family. The NPS is then calculated as the percentage of customers reporting a score of 9 or 10 (ie 'promoters') less the percentage of customers reporting a score of 6 or less (the 'detractors').
[257] See Appendix 5.5.

Figure 5.9: Comparison of GB NPS across sectors, 2010 to 2014



Source: CMA calculations using the GfK FRS.
Note: Data does not include NI.

Comparisons of overall quality

5.82 We have undertaken comparisons across banking groups of various quality indicators to examine the strength of customer response to quality variations, and to determine whether there is evidence of a relationship between quality outcomes and concentration.

5.83 Comparisons of overall service quality using satisfaction measures from the GfK PCA consumer survey, GfK FRS and Which? show differing degrees of variation in satisfaction ratings (ranging from 87 to 96% from the GfK PCA consumer survey, 91 to 97% from the GfK FRS and 57 to 73% from the Which? satisfaction survey).

5.84 The banks with the highest scores across all three measures ([✂]) have experienced growth in market share, however the pace of growth has been slow ([✂] percentage points each in 2014). Similarly, although the worst-performing banks under each metric ([✂]) experienced a loss in market share, this was limited to between [✂] and [✂] percentage points in 2014.

5.85 The satisfaction ratings appear to be suggestive of an inverse relationship between quality of service and market share in GB (see Figures 5.10 and 5.11[258] below, and Figure 5 in Appendix 5.5). A similar pattern emerges in

[258] We note that the Which? satisfaction scores are derived using a much smaller sample compared with the GfK FRS. It has also not been possible for us to verify the representativeness of the sample and robustness of the survey methodology.

our analysis of satisfaction indicators by brand. However, the presence of this relationship appears to be driven by the performance of a small number of banking groups and we do not find the strength of this relationship to be significant under statistical testing. We observe similar results from a comparison of NPS.

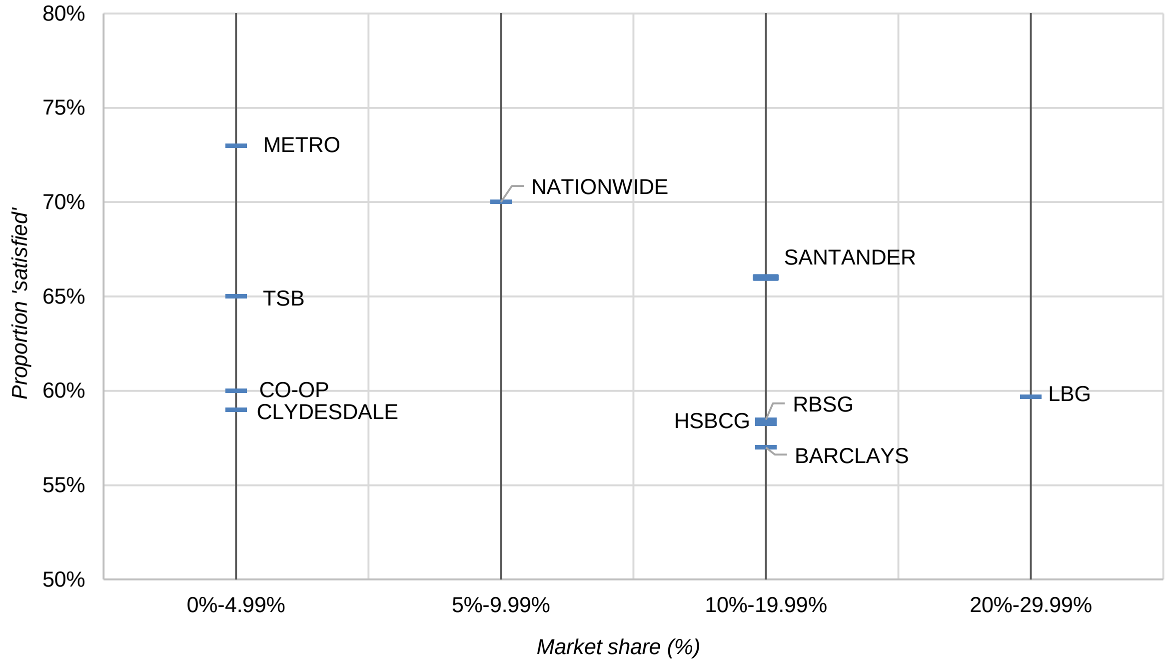
5.86 A corresponding analysis of satisfaction by bank against market share can be found for NI in Appendix 5.5. However, it is not possible to reach any firm conclusions from this analysis due to the small samples obtained for NI banking customers (and in particular for the smaller PCA providers).

Figure 5.10: Comparison of GB satisfaction scores in 2014 using GfK FRS

[✂]

Source: GfK FRS (GB only) and CMA calculations using data submitted by banks.

Figure 5.11: Comparison of satisfaction in 2015 using Which? satisfaction index



Source: Which? (June 2015) and CMA calculations using data submitted by banks.
Notes:
1. Market shares relate to the share of GB main accounts.

5.87 In addition to our analysis of indicators of overall quality of service, we have also undertaken comparisons of indicators relating to those specific attributes of service quality that customers have rated as most important.[259]

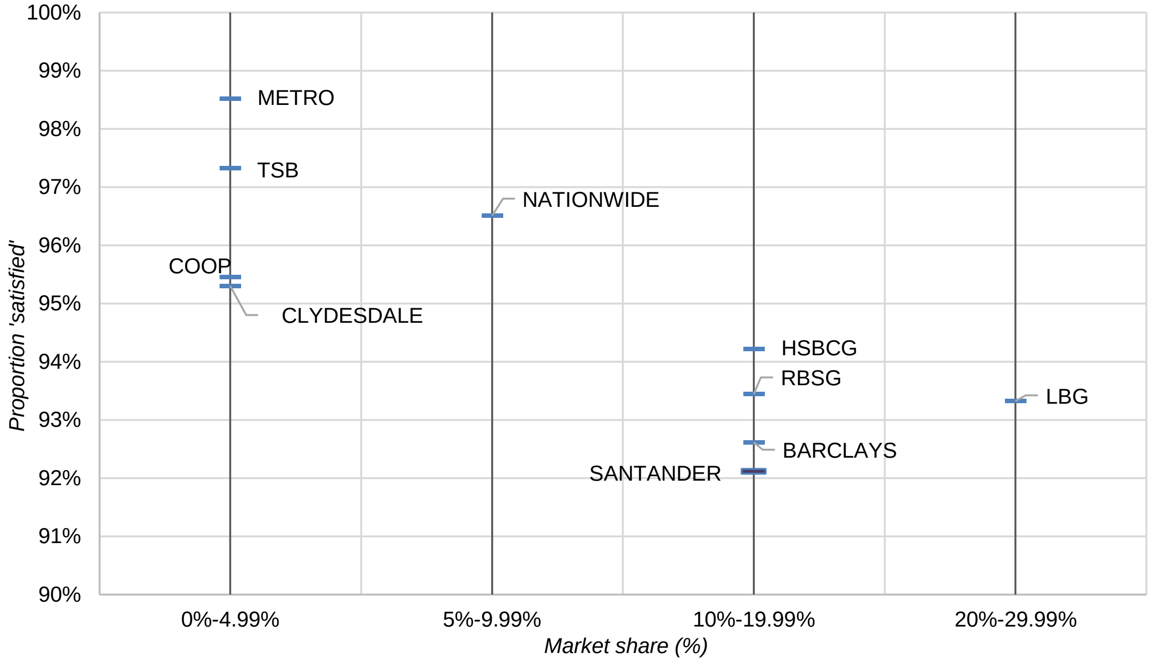
[259] From the GfK PCA consumer survey.

Comparisons of quality of staff and customer service

5.88 According to the GfK PCA consumer survey, 'quality of staff and customer service' was ranked as the most important feature of a bank account, with 83% of customers rating it as either 'essential' or 'very important'. We use customers' self-reported satisfaction with the quality of staff and customer service as a proxy for this quality dimension.

5.89 For the GB market, as set out in Figure 5.12, we find that banking groups with the highest reported levels of satisfaction are also the banks with the lowest market shares (Metro, TSB, Nationwide and Co-op), indicating a possible inverse association between market share and satisfaction with the quality of staff and customer service.

Figure 5.12: GB satisfaction with the quality of staff and customer service in 2015



Source: GfK PCA consumer survey and CMA calculations using data submitted by banks.
Note: Market shares refer to share of GB main accounts at year end.

5.90 An equivalent analysis for NI customers can be found in Appendix 5.5, Annex A, Figure A3. There does not appear to be an association between satisfaction with quality of staff and customer service and market share in NI. However, the small sample size limits the strength of inference that can be drawn from this data.

Comparisons of quality and speed of handling problems

5.91 The ‘quality and speed of handling problems’ is found to be the second most important feature of a bank for customers, with 83% rating it as ‘essential’ or ‘very important’ in the GfK PCA consumer survey.

5.92 We have collected data for GB and NI banks from the two primary sources of complaints data available:

(a) Banks are required to report all complaints that are not resolved within one working day to the FCA. These are known as FCA-reportable complaints.

(b) Customers who are not satisfied with the response from their bank can escalate their complaint to the Financial Ombudsmen Service (FOS).

5.93 Figure 5.13 plots each of these complaints series by banking group for 2014, normalised by the number of main accounts.

5.94 Performance between FCA-reportable and FOS complaints varies within banks. For example, while [✂] has the third largest volume of FCA reportable complaints, it also has the fewest complaints referred by customers to the FOS. This disparity between the measures may indicate that while the service offered by some banks may generate a higher volume of reportable complaints, some of these banks are relatively successful at resolving these complaints to the satisfaction of their customers. On the other hand we observe a reverse pattern for [✂] and to a lesser extent [✂].

5.95 We do not find evidence of clear association between market share and either measure of customer complaints.

Figure 5.13: Normalised customer complaints in 2014

[✂]

Source: FOS, and CMA calculations using data submitted by banks.
Notes:
1. FOS complaints relate to the April 2014–March 2015 reference period, complaints relating to overdrafts not included.
2. FCA-reportable complaints relate to 2014 H2 reference period.

5.96 We have also examined the extent to which variations in complaints performance are reflected in market dynamics. Some banks with higher comparative FOS complaints performance (such as TSB, Metro and Nationwide) have experienced an increase in market share, but in general the relationship between complaints performance and change in market share is relatively weak (see Figure 5.14).

Figure 5.14: FOS complaints and changes in market share in 2014

[✂]

Source: CMA calculations using data submitted by banks.
Notes:
[✂]

5.97 We also note that there have been a number of high-profile service failures affecting PCA customers over recent years. These are summarised in Table 5.8 below.

Table 5.8: Summary of recent PCA service failures

Date	*Banking group*	*Description of service failure*
June 2012	RBSG	An IT failure lasting several days left approximately 6.5 million RBSG customers unable to use online banking facilities or obtain accurate account balance information from ATMs. During the period incorrect credit and debit interest was applied to customers' accounts and inaccurate bank statements were produced. The IT failure lasted longer for Ulster customers (three and a half weeks) than for other RBSG customers. RBSG was later fined £42 million and £14 million, as part of enforcement action by the FCA and PRA, respectively. RBS provided £70.3 million in redress to UK customers affected.
March 2013	RBSG	A system failure left some NatWest PCA customers unable to withdraw cash, use online banking or make debit card payments.
December 2013	RBSG	Systems problems resulted in a proportion of RBSG customers were unable to make debit card payments or access their accounts using internet or mobile banking.
January 2014	LBG/TSB	A server failure left approximately [✂]% of LBG and [✂]% TSB customers unable to make point-of-sale debit card transactions for a 4-hour period. ATM cash withdrawal transactions were also declined for some customers.
February 2014	Nationwide	Some Nationwide customers were unable to make debit card payments for a number of hours due to an IT problem.
June 2015	RBSG	Around 600,000 RBSG customer payments were delayed for a number of days after an IT problem resulted in them going 'missing' overnight on the day they were scheduled to be paid.
August 2015	HSBCG	An IT problem resulted in approximately 275,000 Bacs payments originating from HSBC accounts being delayed by up to a day.

Source: FCA, Guardian (1), Financial Times, LBG, Guardian (2), Telegraph, Guardian (3).

5.98 One of the most significant of these was RBSG's IT failure in June 2012 which resulted in Ulster's IT systems being unavailable for three and a half weeks. We note that this failure appears to have led to Ulster losing [✂].[260]

Summary of evidence on pricing and quality outcomes

5.99 We have undertaken comparisons between banking groups of PCA revenues, pricing and quality indicators. While there are difficulties in the interpretation of such analyses, we do not find clear evidence of a relationship between market share and either pricing or quality outcomes. Nevertheless our analysis of PCA pricing shows substantial variation in PCA charges between banking groups and brands, for a given set of customer profiles.

5.100 The existence of large variations in pricing might indicate that customers of worse-performing brands would be better off switching away from their existing bank. However, it might also be reflective of differences in service quality where brands have placed themselves in different positions on the quality-price matrix. We have therefore interpreted the results of the pricing and quality analysis together (see Figures 5.15, 5.16 and 5.17 below).

Figure 5.15: Comparison of NPS and PCA Pricing by brand

[✂]

Source: CMA analysis and GfK FRS.
[✂]

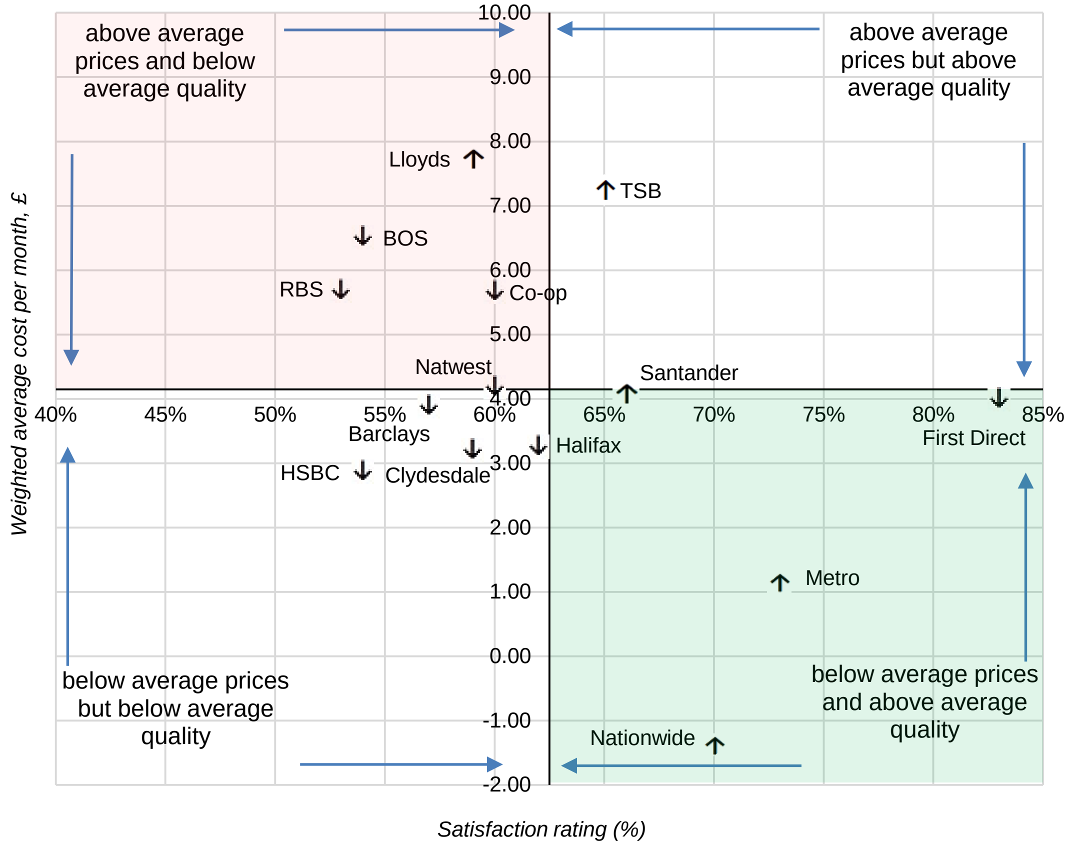
Figure 5.16: Comparison of GfK FRS Satisfaction ratings and PCA Pricing by brand

[✂]

Source: CMA analysis and GfK FRS.
[✂]

[260] See Appendix 5.5.

Figure 5.17: Comparison of Which? satisfaction ratings and PCA pricing by brand



Source: CMA analysis and Which? (June 2015).
Note: (1) ↑ denotes increase in bank's market share in 2014 and ↓ denotes decrease.

5.101 We find that some brands appear to offer a combination of below-average performance on both the quality and price indicators (Halifax, HSBC and Clydesdale). In these cases it is not possible to draw firm conclusions on whether customers would be better off switching away from or towards these brands.

5.102 However, we also observe some brands with both below-average charges and above-average satisfaction ratings (First Direct, Nationwide and Metro). Similarly there are brands with a combination of above-average prices and below-average satisfaction (BoS, Lloyds, RBS and NatWest). In this case we would expect customers to be unambiguously better off by switching from the 'high-price low-quality' providers to 'low-price high-quality' brands.

5.103 While it is the case that Nationwide and Metro – two of the three 'low-price high-quality' banks – have gained market share, the pace of change has been very slow (eg Metro's and Nationwide's combined share of GB PCAs increased by less than [✂] percentage points between 2013 and 2014).

5.104 Similarly, the rate at which 'high-price low-quality' banks are losing market share is also very low, for example RBS and Natwest experienced a combined reduction in market share of [✂] percentage points 2014.

Conversely BoS's share remained broadly stable between 2013 and 2014 and Lloyds experienced a small increase in market share. We provisionally interpret this as evidence of a weak customer response to variations in prices and quality.

Innovation in PCAs

5.105 Innovation can be a useful indicator of the level of competition in a market, as, in a well-functioning market, investment in innovation can bring benefits to customers in the form of diversity of choice, cost efficiencies and enhanced service levels. Conversely, a lack of innovation may suggest that firms are not subject to competitive pressure and therefore, have reduced incentives to innovate, or that there are barriers to innovation present in the market. See Appendix 5.6 for a more detailed discussion of the evidence on this subject.

Product innovation

5.106 Product innovation in the PCA market over recent years has primarily taken the form of the development of reward accounts, which offer benefits to customers such as credit interest or cashback on transactions, and the introduction of switching incentives, typically in the form of cash payments, in order to attract new customers. Such product innovation, which incentivises customers to make regular transactions and hold credit balances in their PCA, appears to have been driven by competition among banks for main banking relationships. For more details see Section 7.

5.107 Examples of reward accounts include the Halifax Reward Current Account (launched in February 2009), which pays £5 interest per month to customers who remain in credit throughout the month, and Santander's 123 account (launched in March 2012), which offers up to 3% interest on credit balances up to £20,000, and up to 3% cashback on household bills paid by direct debit. More recently introduced reward offers include Barclays Blue Rewards in April 2015, HSBC Advance relaunched in November 2014, Club Lloyds in April 2014, and TSB's Classic Plus account in April 2014.

Service innovation

5.108 Service innovation in the PCA market has been primarily driven by the digitalisation of retail banking. Many of the banks have made and continue to make significant investment in this area.

Internet and mobile banking

5.109 Although internet banking has been commonplace for some time, and has developed into a significant distribution channel, driven by increasing access to broadband and high-speed internet connections, mobile banking is also increasing at a rapid pace. For example, the British Bankers' Association estimates that customers now log into their mobile banking applications 10.5 million times a day and use them to transfer £2.9 billion each week.[261]

5.110 The UK has one of the highest rates of mobile banking adoption in the world (eg around one-third of customers use mobile banking applications),[262] and mobile banking is now available to PCA customers of all of the major banks. While there are differences in the sophistication and functionality of the mobile banking applications offered by the established banks in the UK (see Appendix 5.6, Table 1), customers are typically able to check their balance, set up personalised alerts, send payments to another account using a mobile number, and locate their nearest branch or ATM.

5.111 The development of mobile banking and the wider digitalisation of banking have also led to a number of other service innovations in the PCA market, such as contactless payment technology, mobile payment systems (PAYM) and SMS alerts and notifications.

5.112 However, only 27% of adults were using mobile banking in 2014,[263] and traditional distributional channels, particularly branches, continue to play an important role in the acquisition and retention of customers.

5.113 Although branches continue to represent the primary customer acquisition and retention tool, much of a customer's transactional activity is undertaken using digital channels, and the ease with which customers can access their accounts through these channels appears to be increasing customer engagement with their PCA, evidenced by increased customer interaction with internet banking platforms and mobile banking applications.

5.114 As mobile banking adoption is largely driven by smartphone adoption, which is greater among the younger population, mobile banking adoption is likely to increase over time, and is likely to be further enhanced by the greater functionality and broader integration of banking services within mobile applications. For example, the British Bankers' Association estimates that by 2020, customers will use their mobile phone to manage their current account

[261] See Deloitte innovation report, p4.
[262] ibid, p9.
[263] ibid, p9.

2.3 billion times, which will be more than internet, branch and telephone banking combined.[264]

Aggregators

5.115 Aggregators are services that collect and collate information from a number of sources. There are two main types of aggregators: (1) comparison aggregators (eg PCWs, which we consider in more detail in Section 7), and (2) account aggregators. The use of account aggregators in the UK has had limited penetration to date, although emerging services are being provided by banks, such as HSBCG, Barclays and LBG, and third parties, such as OnTrees. In contrast, they have developed at a faster pace in the USA, where existing market participants, such as Mint, Moven and Simple, allow customers to track their spending and saving patterns and manage bills and payments, and make use of the detailed financial data that they hold on customers to recommend new products and services.

5.116 There are a number of potential barriers to the development and uptake of account aggregation services, which include the difficulty of comparing across many banks the different services offered by a PCA; the need for third parties to gain access to account usage data held by banks; and concerns about data security and transparency.[265] To the extent that aggregation services become more widely used, they could raise financial awareness, increase customer engagement and provide an additional channel to reach customers.

Big data

5.117 The utilisation of 'big data', either in the form of proprietary transaction data held by banks or other third party sources, has the potential to facilitate increased competition in the provision of PCA accounts. Big data, for example, could be used by banks to:

(a) better differentiate between customers, which can be used for both customer acquisition and customer retention strategies;

(b) analyse patterns in large data sets, in order to rapidly identify security breaches and predict future violations;

[264] ibid, p15.
[265] Ongoing regulatory initiatives, such as the PAD, the government's Midata initiative, and the European Commission's Second Payment Services Directive (PSD2), are likely to play an important role in the future development of aggregation services. See Section 3 for further information.

(c) make use of centralised information, in order to ensure that regulatory reporting requirements are fulfilled while protecting customer privacy; and

(d) simulate future events, in order to become more capable of managing risk.

5.118 We have found evidence of banks using data on their customers to target customers and to better develop and cross-sell products. We consider in Section 10 whether access to such data is a barrier to entry and/or expansion. More generally, while the evidence suggests that 'big data' has the potential to facilitate increased competition, it is still in the early stages of development by banks and other providers.

New business models

5.119 We have observed entry into the PCA market by firms with an established presence in other areas of retail banking. For example, Tesco Bank, M&S Bank[266] and the Post Office[267] have expanded their financial product offerings to include PCAs. See Section 11 for further information.

5.120 We are also aware of a number of prospective entrants that are planning to enter the PCA banking market with online models and no (or very limited) branch presence. For example, Atom launched in 2015 as the UK's first full-service digital-only bank. Starling is also planning to enter with a purely digital business model, although with a niche PCA offering rather than as a full-service bank.

5.121 Although the rise of digital-only banks underlines the importance of technological innovation in facilitating entry into the market, the entry of banks with more traditional distribution models, such as Metro, suggests that branch-based banking has not yet been replaced by digital banking, and is unlikely to be in the short to medium term.

Digital wallets

5.122 Digital wallets have grown in prominence in recent years. For example:

(a) PayPal first appeared in the late 1990s, and now provides a variety of services including online payment services, mobile payment services, account services, deferred payment systems, money (including

[266] M&S Bank is a wholly owned subsidiary of HSBCG.
[267] The Post Office offers retail banking services under BoI's banking licence.

cheques) transfer services into PayPal accounts and in-store payment systems.

(b) In July 2015, Apple introduced Apple Pay to the UK market. Apple Pay allows iPhone and Apple Watch owners to use their devices to make payments at NFC-equipped terminals. As of June 2015, 19 high street stores and all of the major UK banks had signed up to Apple Pay.[268]

5.123 Online digital wallets have been around for some time, however adoption remains relatively low and credit and debit cards still account for significantly larger proportions of online payments. It appears that concerns about security and their ability to provide a more convenient payment experience than, for example, credit or debit cards have driven the limited adoption of digital wallets to date. However, a number of banks, including HSBCG, RBSG, Santander and Nationwide are offering Apple Pay as an additional payment method for their customers.

Summary conclusion on structure and outcomes in PCAs

Market structure and concentration

5.124 The PCA markets in both GB and NI are concentrated. In 2014 the four largest providers in GB had a combined market share of approximately 70% and an estimated HHI of about 1,550. In NI the combined share of main PCAs of the four largest banks is similar (69% in 2014).

5.125 Excluding the impact of mergers and divestments, shares in the GB PCA market have remained stable since 2005. While we find evidence of high rates of net account opening among smaller PCA providers such as Metro, Nationwide and Santander,[269] the absolute increase in their market share remains small and has not translated into a significant impact on the concentration of PCAs.

Pricing and quality outcomes

5.126 PCAs do not include charges for the most common sterling transactions and most PCAs do not have a monthly charge. Hence the majority of customers, who remain in credit, benefit from FIIC banking. Customers who go into overdraft do, however, incur charges.

[268] See Deloitte innovation report, p23.
[269] This is also reflected in the net switching data (see Appendix 7.1).

5.127 Our comparison of average prices shows considerable variation between banks in average price (defined as charges for services less interest and other payments to customers). It also suggests that banks whose customers have had their accounts for longer periods and with larger market shares tend to have higher average prices.

5.128 Our comparison of quality also shows some variation in quality, but we do not see any general tendency of quality variation to offset the pricing variation.

5.129 We find that banks offering lower average prices and/or better quality tend to have been gaining market share, but at a very slow pace. We provisionally interpret this finding as evidence of a weak customer response to variations in prices and quality.

Innovation

5.130 There have been a number of innovations in the PCA market in recent years. When assessed individually, there is a considerable degree of variation in the development of each innovation and the extent to which each innovation has impacted (or is likely to impact) the PCA market. Both the introduction of reward accounts and mobile banking (as part of the wider digitalisation of retail banking) are well established. In contrast, other innovations, such as the use of account aggregation services, big data, and digital wallets, are in the early stages of development, particularly when considering their application to the PCA and wider retail banking market. However, when these individual innovations are considered in aggregate, our provisional view is that there is a considerable level of innovation in the PCA market.

5.131 We consider the implications of these findings further in Section 7 on how banks compete for PCA customers, in Section 10 on new entrants and the ability of smaller banks to expand, and in Section 11 in our assessment of concentration.

6. Structure and market outcomes: SME banking

6.1 To develop our findings on whether or not features in the markets for SME banking products are harming competition, we have analysed information on the main characteristics of the markets, including on market shares and concentration.

6.2 We have also analysed information on the outcomes of the competitive process within the markets. Information of this nature, including on profitability, prices, quality and levels of innovation can provide important information on how well the market is functioning. Evidence on outcomes may also assist in the later consideration of possible remedies.

6.3 This section is structured as follows:

- An overview of structure and concentration in the markets for BCAs, business deposit accounts and SME lending products.
- An overview of our analysis of revenues by source for BCAs, business lending, business deposit accounts and other SME lending products.
- An analysis of the recent financial performance of providers' SME retail banking operations, including revenues and impairment margins.
- A comparison of BCA pricing, including the extent to which there is an identifiable relationship with market share.
- Analyses on the quality of service offered by SME banking providers.
- A summary of the available evidence on the degree of innovation within, and around, the SME banking markets, and our assessment of the potential impact of these innovations on competition.
- Finally, we set out our provisional conclusions on structure and outcomes in the markets for SME banking products and the implications for the wider investigation. Fuller details of our evidence and analysis is set out in the appendices.

6.4 In formulating our provisional findings in this area we have paid particular attention to the strength of customer response to variations in pricing and quality outcomes, and separately, whether there is evidence of a relationship between outcomes and market share.

Market shares and concentration

6.5 As set out in Section 4, we have defined separate product markets for each of BCAs, business loans, and business deposit accounts, as well as geographic markets for GB and NI.

6.6 The market shares presented in this section have been calculated mainly using data submitted by the banks in response to our information requests.[270] In some cases data is not available for all banks in all years. While we have sought to cross-check our findings against those obtained from the Charterhouse BBS (and find that results are generally very similar), we recognise that particular caution should be exercised in interpreting market shares where data on a market participant(s) is not available. Also, in some cases data limitations mean we have used UK-wide data.

6.7 Appendix 6.1 contains more detailed evidence on market structure.

Business current accounts

6.8 The total size of the GB BCA market has remained broadly constant since 2012 at around 5.5 million accounts (see Table 6.1), of which approximately 88% were active in 2014.[271] In 2014 about 12% of BCAs were opened and closed each year.[272]

Table 6.1: Summary of GB BCA market

	2012	*2013*	*2014*
Total accounts ('000s)	5,517	5,511	5,459
Active accounts (%)	86	87	88
Accounts opened ('000s)	733	699	642
Accounts closed ('000s)	748	780	652
Net account opening (%)	0	–1	0

Source: CMA calculations based on data submitted by the banks.

6.9 Similar levels of stability are observed in NI which in 2014 had approximately 190,000 BCAs, of which around 85% were active (see Table 6.2). The rate of account opening and closure was somewhat lower than in GB at about 8%.[273]

[270] An information request was sent to the following banking groups: AIB, Aldermore, Barclays, BoI, Clydesdale, Co-op, Danske, Handelsbanken, HSBCG, LBG, Metro, Santander, Shawbrook, TSB and RBSG. In the case of Aldermore, Co-op, Handelsbanken, Metro and Shawbrook a shorter version of the information request was submitted to reflect the relative size of these banking groups' operations and the disproportionate resource impact that a full information request may have created.
[271] Where an active account is defined as one which has had a least one customer-generated payment or transfer (including SO and DD, but excluding charges and interest on the account) coming into, or leaving, the account in the last 12 months.
[272] Calculated from the accounts opened and total accounts data in Table 6.1.
[273] Calculated from the accounts opened and total accounts data in Table 6.2.

Table 6.2: Summary of NI BCA market

	2012	*2013*	*2014*
Total accounts ('000s)	189	190	190
Active accounts (%)	N/A	86	85
Accounts opened ('000s)	16	17	16
Accounts closed ('000s)	17	16	17
Net account opening (%)	0	1	0

Source: CMA calculations based on data submitted by the banks.
Notes:
1. Active accounts data not available for Danske in 2012.
2. N/A = not available.

6.10 Smaller[274] SMEs account for the vast majority of BCAs held. In 2014, over 90% of GB active BCAs were held by SMEs with annual turnover of less than £2 million.[275] The equivalent figure for NI was around 85%. Smaller SMEs accounted for a smaller proportion of revenue than of number of accounts, but this was still nearly two-thirds (based on BCA revenue earned from interest and charges).[276]

6.11 The structure of the GB BCA market has remained broadly similar since 2000 with four large banking groups having the majority of accounts (see Figure 6.1). Comparison with figures in the CC's 2002 report[277] suggests that the GB share of the four large banking groups has declined from 87% in 2000[278] to 83% in 2014, though within this total [✂] has experienced a marked reduction in market share. Over the shorter term, the combined share of GB active BCAs of these four large banking groups has reduced by around one percentage point since 2012 (excluding the impact of the TSB divestment) (see Table 6.3).

Figure 6.1: GB market shares of BCAs (by number)

[✂]

Source: CMA calculations using OFT 2007 'Review of the Undertakings given by banks following the 2002 Competition Commission Report', for 2005 shares and Charterhouse BBS for 2010 onwards.

[274] SMEs with annual turnover below £2 million.
[275] CMA calculations using data submitted by the banks.
[276] CMA calculations using data submitted by the banks.
[277] CC (2002), *A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*.
[278] Figures in the CC's 2002 report relate to liquidity management services (BCAs plus instant access deposit accounts) but the figures for BCAs are likely to be similar.

Table 6.3: GB market share of active BCAs (by number)

%

Banking group	*2012*	*2013*	*2014*
RBSG	[20–30]	[20–30]	[20–30]
LBG	[20–30]	[20–30]	[20–30]
Barclays	[10–20]	[10–20]	[10–20]
HSBCG	[20–30]	[10–20]	[10–20]
Santander	[5–10]	[5–10]	[5–10]
Clydesdale	[0–5]	[0–5]	[0–5]
Co-op	[0–5]	[0–5]	[0–5]
TSB	N/A	[0–5]	[0–5]
Metro	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.

6.12 A significant proportion of GB start-ups holding a BCA take out a BCA with their main PCA provider (around 51% in 2014)[279] and in 2014 the four largest banking groups accounted for over 75% of the flow of new GB BCAs (see Table 6.4). Since 2012, [✄] and [✄] have experienced an increase in the flow of new accounts whereas [✄] and [✄] have seen a reduction.

Table 6.4: GB market share of new BCAs (by number)

%

Banking group	*2012*	*2013*	*2014*
RBSG	[10–20]	[10–20]	[20–30]
LBG	[20–30]	[20–30]	[10–20]
Barclays	[20–30]	[20–30]	[20–30]
HSBCG	[20–30	[10–20]	[10–20]
Santander	[5–10]	[5–10]	[10–20]
Clydesdale	[0–5]	[0–5]	[0–5]
Co-op	[0–5]	[0–5]	[0–5]
TSB	[0–5]	[0–5]	[0–5]
Metro	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.

6.13 Smaller providers such as [✄] and [✄] received among the highest volumes of net account opening in 2014.[280] Nevertheless the number of net accounts opened relative to the size of the market remains low such that the market shares (by number of active accounts) of [✄] and [✄] stood at only [✄]% each in 2014 (see Table 6.3).

6.14 The GB BCA market remains 'concentrated' in 2014 (according to the thresholds set out in our market investigation guidelines[281]) but not highly concentrated, with an Herfindahl–Hirschman Index (HHI) of around 1,800. Similar levels of concentration are obtained if concentration is calculated

[279] Charterhouse BBS. See Section 9 for a fuller discussion of the evidence on the link between PCA holdings and BCA account opening.
[280] See Appendix 6.1, Figure 7.
[281] See *CC3*, Annex A.

using the number of active accounts or the number of unique BCA customers.[282] Comparison with figures in the CC's 2002 report suggest there has been a reduction in concentration since 2000, largely due to the reduction in share of [✂] (see paragraph 6.11).[283] We consider the implications of this finding with regards to the relationship between outcomes and concentration in Section 11.

6.15 The combined market share of the four largest banking groups in NI was around 86% in 2014 (see Table 6.5) and the HHI in 2014 was around 2,000. The combined share of the four largest groups has reduced by around two percentage points since 2012 driven primarily by a reduction in the share of [✂]), whereas [✂] has experienced a corresponding increase in its market share over the same period. Over the longer term, the share of the four largest groups has reduced by around 10 percentage points since 2000, and the HHI concentration index has decreased.[284]

Table 6.5: NI market share of total BCAs (by number)

			%
Banking group	*2012*	*2013*	*2014*
RBSG	[30–40]	[20–30]	[20–30]
Danske	[20–30]	[20–30]	[20–30]
BoI	[10–20]	[10–20]	[10–20]
AIBG	[10–20]	[10–20]	[10–20]
Santander	[5–10]	[5–10]	[5–10]
HSBCG	[0–5]	[0–5]	[0–5]
Barclays	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]
Other	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.

6.16 Consistent with a small decline in concentration, the flow of new BCAs in NI appears less concentrated than the stock (see Table 6.6). The flow HHI stood at around 1,800 in 2014 and the four largest banking groups had a combined share of around 75%, representing a reduction of around four percentage points since 2012. This reduction in combined share was primarily driven by decrease experienced by [✂]. In contrast Santander, which had the second largest share of new accounts in 2014, has increased its share of flow by approximately [✂] percentage points.

[282] Unique BCA customers refers to the number of BCA customers held by each bank, such that a customer holding multiple BCAs at the same bank would be counted as a single unique BCA customer.
[283] The figures in the CC's 2002 report suggest an HHI based on the number of accounts for GB liquidity management services of about 2050.
[284] Based on figures for the number of liquidity management accounts in the CC's 2002 report.

Table 6.6: NI market share new BCAs (by number)

			%
Banking group	*2012*	*2013*	*2014*
RBSG	[20–30]	[10–20]	[10–20]
Danske	[10–20]	[10–20]	[10–20]
BoI	[20–30]	[20–30]	[20–30]
AIBG	[10–20]	[10–20]	[10–20]
Santander	[10–20]	[10–20]	[10–20]
HSBCG	[5–10]	[0–5]	[0–5]
Barclays	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]
Other	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.

6.17 To test the sensitivity of our concentration estimates to the definition of market share used, we have calculated market shares, on a UK basis, using the gross revenue earned by banking group (excluding the internal value to the banks of positive credit balances).[285] While we are unable to replicate this calculation on a GB and NI basis, we note that resulting measures of concentration for the UK market are similar to those obtained using the number of UK accounts.

6.18 We have also estimated market shares and the associated concentration measures for the markets segmented between SMEs with turnover above £2 million and those below £2 million[286] in GB. While we observe variation in the share of certain banking groups across each segment of the GB BCA market,[287] estimated levels of concentration are similar across the two size segments.[288]

Business loans

6.19 Business loans include general-purpose business loans and commercial mortgages, credit cards, asset finance, invoice finance and alternative lending platforms (see Section 4). As discussed in Sections 4 and 8, certain types of business loans are offered by a wider range of providers than others. We only have full data from the largest banks and certain smaller banks and we consider separately the different SME lending products, commenting as appropriate on the presence of other providers.[289]

[285] See Appendix 6.1, Figure 4.
[286] See Appendix 6.1, Figure 5.
[287] For example, in 2014 [✂] and [✂] had a notably larger share of the GB BCA market for SMEs with annual turnover ≥£2 million, compared to SMEs with turnover less than <£2 million, while the opposite was true of [✂] and [✂].
[288] For example, the HHI for BCAs for SMEs with annual turnover <£2 million was 1933 in 2014, compared to an equivalent figure of 1,923 for SMEs with annual turnover ≥£2 million. Equivalent data is not available for NI.
[289] Data for these products (except for credit cards) is not available separately for the GB and NI geographic markets and we have therefore estimated market structure indicators at a UK level.

General-purpose business loans (including commercial mortgages)

6.20 A total of £25 billion worth of general-purpose business loans (including commercial mortgages, but excluding residential property loans[290]) were granted in the UK in 2014, with an average loan value of £300,000.[291] The total stock of outstanding balances at year end stood at approximately £90 billion. Smaller SMEs (ie with annual turnover less than £2 million) accounted for around three-quarters of the number of new loans granted in the UK in 2014 but less than half the value of these loans. Approximately two-thirds of general-purpose business loan revenues from interest and charges were earned on loans to SMEs with annual turnover less than £2 million.

6.21 The combined share of the four largest banks of the value of outstanding loans was similar to that for BCAs, at around 80%.The HHI was about 1,800.

Table 6.7: UK general-purpose business loan market shares in 2014 (by value)

		%
Banking group	*Value of loans at year end*	*Value of new loans granted*
RBSG	[20–30]	[20–30]
LBG	[20–30]	[10–20]
Barclays	[20–30]	[30–40]
HSBCG	[5–10]	[5–10]
Clydesdale	[5–10]	[5–10]
Santander	[0–5]	[0–5]
BoI	[0–5]	[0–5]
Danske	[0–5]	[0–5]
Handelsbanken	[0–5]	[5–10]
TSB	[0–5]	[0–5]
AIBG	[0–5]	[0–5]
Co-op	[0–5]	[0–5]
Metro	[0–5]	[0–5]
Aldermore	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.
Notes:
1. Figures include commercial mortgages and are exclusive of residential property lending.
2. Loan data excluding residential property lending not available for LBG and AIB. Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks.

[290] Residential property loans are loans to SMEs for the purposes of residential buy-to-let, residential property development or investment in finished residential properties. Due to differences between banks in how these loans are reported, and in particular how they are classified as either personal or SME lending, we have asked all banks to exclude such loans from the submitted business lending accounts and value data. On the basis of the data provided by the banks, we estimate such loans to account for approximately 3% of business loan volumes and 8% of business loan values.
[291] See Appendix 6.1, Table 3.

6.22 The market for business loans to SMEs with turnover less than £2 million is more concentrated than that of business loans for SMEs with annual turnover greater than or equal to £2 million.[292]

6.23 The combined share of flow of the four largest lenders has remained stable at around 80% since 2012 (excluding the impact of the TSB divestment). While smaller banks such as [✂],[293][✂] and [✂] have experienced very high rates of growth in their share of new loans granted, the absolute changes in share remains very low.[294]

6.24 These figures do not include peer-to-peer lending which is another source of general-purpose business loans. However, figures from NESTA indicate that the total value of such lending in 2014 was about £1 billion,[295] around 1% of the outstanding general-purpose business loans to SMEs from banks. However, peer-to-peer lending is growing rapidly and accounts for a larger share of the flow of new general-purpose business loans (about 2.4%).

Invoice finance

6.25 Data from the Asset Based Finance Association (ABFA) shows that there were approximately 42,000 SMEs with invoice finance agreements in place at the end of the first quarter of 2015, with total outstanding balances of around £9 billion.[296]

6.26 Larger SMEs account for the majority of invoice finance lending. Data from ABFA shows that SMEs with annual turnover less than £1 million accounted for around 50% of SME invoice finance customers at the end of Q1 2015, but less than 15% of outstanding balances. Similar proportions for the end of 2014 are obtained from accounts and lending data submitted by banks to the CMA.[297]

6.27 Based on data from banks, we estimate similar levels of concentration in invoice finance to those observed for general-purpose business loans (including commercial mortgages). The combined share of UK outstanding

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[292] The HHI for the value of lending to SMEs with annual turnover <£2 million is around 2,700, compared with 1,680 for SMEs with turnover >£2 million (see Figure 14, Appendix 6.1).
[293] [✂]
[294] See Appendix 6.1, Figure 15.
[295] See NESTA (2014), *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*, p28. This is based on the estimated total advanced over 2012–2014 (the amount advanced before 2012 was very small). The great majority of peer-to-peer lending is to SMEs.
[296] These figures may include a limited number of SMEs holding import and/or export factoring, stock finance and asset-based lending facilities.
[297] Specifically, SMEs with annual turnover less than £2 million accounted for around 45% of SME asset finance customers but only 15% of the value of outstanding balances.

balances of the four largest providers was approximately 80% at the end of 2014. The corresponding HHI was around 2,000.

6.28 Nevertheless, we are aware of invoice finance providers that are not captured in the data used to estimate these concentration measures. The ABFA membership list includes over 30 providers for which customer and balance volumes were not available to the CMA.[298] This means our estimates of the level of concentration in the invoice finance market are over-estimates.

6.29 The ABFA figures do not include invoice trading on alternative finance platforms. Figures from NESTA indicate that the total value of invoice trading in 2014 was about £0.4 billion,[299] around 5% of the value of conventional invoice finance. Like other types of alternative finance, invoice trading is growing rapidly.

Asset finance

6.30 According to figures from the Finance & Leasing Association, over £25 billion worth of new asset finance loans (excluding high-value items)[300] were made in the 12 months to June 2015, representing growth of around 15%. Data on new asset finance lending submitted by the BCA providers shows a similar rate of growth for 2014.

6.31 The majority of asset finance lending by BCA providers is to larger SMEs. SMEs with annual turnover below £2 million account for less than 15% of the value of new asset finance loans in 2014.[301]

6.32 There is evidence that the provision of asset finance lending is less concentrated than of general-purpose business loans. The four largest asset finance providers had a combined share of around 65% of outstanding balances at the end of 2014[302] and the HHI was 1,550 (compared with around 1,800 for general-purpose business lending).

[298] See membership list on the ABFA website.
[299] See, NESTA (2014), *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*, p47. This is based on the estimated total advanced over 2012–2014 (the amount advanced before 2012 was very small). The great majority of invoice trading is in relation to SMEs.
[300] Data on the value of lending specifically to SMEs is not available. We have therefore sought to proxy this using asset finance lending excluding high value items.
[301] CMA calculations using data submitted by the banks.
[302] See Appendix 6.1, Figure 17.

Business credit cards

6.33 On the basis of the Charterhouse BBS, we estimate there to have been over 1.7 million business credit card or charge card accounts in GB in 2014. Over 90% of these accounts were held by SMEs with an annual turnover of less than £2 million. Estimated levels of concentration have remained constant since 2011 with HHIs of around 2,000 and a combined market share of the four largest providers of 87%.[303]

6.34 According to the Charterhouse NI BBS, there were approximately 44,000 business credit or charge card accounts in 2015. Over 95% of business credit or charge card accounts were held by SMEs with annual turnover less than £2 million in 2014.[304] Estimates calculated using the Charterhouse NI BBS suggest lower levels of concentration than observed in GB. The combined market share of the four largest banking groups was around 75% in 2015[305] and the HHI was around 1,700.

Total business loan market

6.35 As a result of data constraints, we have not been able to calculate market shares and HHI for all business loans, though we would expect that market shares of the largest four banks and HHI would be lower than for general-purpose business loans since their market shares of invoice and asset finance are lower than of general-purpose business loans. Furthermore the identity of the four largest providers also differs between products. We expect this to be the case both at the UK level as well as separately for the GB and NI geographic markets.

Bank business deposit accounts

6.36 On the basis of data submitted by banks, we estimate that approximately 1.7 million bank business deposit accounts were held with UK BCA providers at the end of 2014, containing a total of £82 billion worth of deposits. We note, however, that there are a number of participants in the business deposit account market that are not also BCA providers, and as such will not be captured in our market share estimates. While the total number of accounts held by BCA providers has remained broadly constant since 2012, the value of deposits has risen by around 15%. Smaller SMEs

[303] See Appendix 6.1, Figure 18.
[304] CMA calculations using data submitted by the banks.
[305] See Appendix 6.1, Figure 19.

account for nearly 90% of these accounts but only 50% of the value of funds deposited.[306]

6.37 On the basis of the subset of business deposit accounts held with BCA providers, the combined share of the four largest providers of the total value of UK deposits was approximately 85% in 2014,[307] with a corresponding HHI of around 2,100. However, given the exclusion of a number of providers, the true concentration figures would be lower than this.

Summary of evidence on market shares and concentration

6.38 Shares in the GB BCA market have remained broadly stable since 2005. The combined share of active BCAs of the four largest banking groups stood at around 83% in 2014. While the equivalent combined share in the flow of new BCAs is lower (around 75%) and smaller banking groups such as [✂] have experienced high proportionate rates of growth in market share, the overall rate of flow relative to the size of the market has been too small to have a material impact on overall markets shares. The GB market for BCAs therefore remained concentrated in 2014 with an HHI of around 1,800.

6.39 In NI, the combined market share of the four largest banking groups was around 86% in 2014. Although there is evidence of a small reduction in concentration since 2012, the market remained concentrated in 2014 with an HHI of around 2,000.

6.40 While we do not have data on revenues for each of the GB and NI BCA markets separately, our analysis of data for the UK produces similar levels of concentration whether calculated using either the number of BCAs or gross revenue earned from BCAs.

6.41 As a result of data constraints we have only been able to estimate business deposit account market shares for UK accounts held with BCA providers. On the basis of this subset of data we find that the share of the four largest providers of the total value of UK deposits was approximately 85% in 2014 with a corresponding HHI of around 2,100. However, given the exclusion of a number of providers, the true concentration figures would be lower than this.

6.42 Due to data availability constraints we have estimated UK market shares for separate SME lending products. The combined share of the four largest banks in the value of outstanding general-purpose business loans in 2014

[306] Equivalent data on a GB and NI basis is not available.
[307] See Appendix 6.1, Figure 20.

was similar to that of BCAs at around 80%. While the equivalent share of the four largest banks in the value of new loans granted similar and the absolute change in the market share of smaller banks since 2012 banks was low.

6.43 Based on data from the banks, we estimated similar levels of concentration in invoice finance to those observed for general-purpose business loans. We note, however, that not all invoice providers are captured in our data set which means our estimates of the level of concentration in this market are likely to be overestimates.

6.44 For asset finance we find evidence of lower levels of concentration than observed for general-purpose business loans, invoice finance and BCAs. The four largest asset finance providers had a combined share of around 65% of outstanding balances at the end of 2014 and the HHI was 1,550 (compared with around 1,800 for general-purpose business lending).

6.45 For business credit cards we have been able to estimate market shares separately for the UK and NI geographic markets. In GB the combined market share of the four largest providers was around 87% in 2014 and the HHI was around 2,000. We observed slightly lower levels of concentration in NI where the combined market share of the four largest banking groups was around 75% in 2015 and the HHI was around 1,700.

6.46 With regards to the total business loan market, we have been unable to calculate market shares and HHI for all business loans due to data constraints. Nevertheless, we expect that market shares of the largest four banks (and HHIs) would be lower than for general-purpose business loans since the share of these banks in invoice and asset finance are lower than that for general-purpose business loans.

Revenue analysis

6.47 In this section we summarise the main findings of our analysis of net revenues from BCAs and other SME banking products. Our analysis relates to banks' UK revenue, and includes results from banks operating across the UK (eg RBSG and Santander); from banks whose UK operations are primarily in GB (eg Barclays, HSBCG and LBG) and banks whose UK operations are primarily in NI (AIB, BoI and Danske). As such, we consider that the results are broadly applicable to both of the geographic markets we identified (GB and NI).

6.48 Further details on the analysis can be found in Appendix 6.2.

6.49 Table 6.8 summarises the results of our analysis of aggregate net revenue per active BCA. The most important sources of revenue in 2014 were arranged overdraft fees (accounting for around 20% of net revenue), transaction charges (accounting for around 15%) and the value of funds from net credit balances (accounting for about half of net revenue, or 45% if interest paid to customers is subtracted).

Table 6.8: Analysis of BCA revenue (£ per active BCA,* 2014 prices)

Type of revenue	*2011 (£)*	*2012 (£)*	*2013 (£)*	*2014 (£)*	*2014 (%)*	*Decomposition of ∆ net revenue since 2012† (%)*
Transaction charges	138	143	124	112	15	27
Arranged overdraft	194	219	171	156	21	57
Unarranged overdraft & unpaid item fees	48	54	42	36	5	17
Interchange fees (debit card)	0	4	5	5	1	0
Monthly account fees	26	30	28	32	4	0
Other receipts (net)‡	46	83	75	67	9	15
Total receipts from charges & interest	453	535	444	408	55	115
Interest payments to customers	–22	–23	–24	–25	–3	2
Other payments to customers	0	0	0	–3	0	3
Net value of funds§	434	334	398	356	48	–19
Net revenue	865	845	818	736	100	100

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
*Aggregate revenue is divided by average of number of active accounts at start and end of year (except for Danske data in 2013, when only number of accounts at end of year is available).
†Decomposition of change over time calculated relative to 2012, due to sensitivity of results to absence of Clydesdale from sample in 2011.
‡Other receipts consists of revenue from charges for failing to meet account criteria, revenue from occasional charges relating to cheques, revenue from occasional charges relating to payments, revenue from account management charges, other revenue from account holders and other revenue which is not from account holders
§Banks' own assessment of value of funds from BCA credit balances less cost of funding BCA debit balances (except for Danske, where the weighted average for the other banks has been used).
Note: Excludes AIB, HSBCG and RBSG, for which a full revenue breakdown is not available. Data is not available for Clydesdale and LBG in 2011, and for Danske and Santander for 2011–2012.

6.50 Overall we find that there has been a decline in net revenue per active BCA over time. A decomposition of the change in net revenue per account since 2012 is set out in the final column of Table 6.8. This shows that the decline has been driven by a reduction in revenues from the following sources:

- arranged overdrafts and buffers (arrangement, renewal and day-to-day usage);
- transaction charges;
- unarranged overdrafts (but to a lesser extent); and

- other receipts[308] (primarily as a result of a reduction in revenue from occasional charges relating to payments).

There has also been a decline in the net value of funds (ie the value of funds from credit balances less the cost of funding debit balances divided by the aggregate net credit balance), which has also been a primary driver of the reduction in net revenue over time. Nevertheless we find that the value assigned by banks to BCA credit balances in 2014 (industry-weighted average of 2.16%) remained significantly higher than the prevailing short-term interest rate (which was approximately 0.5%).

6.51 Table 6.9 sets out our estimate of the average net value of funds as a percentage of average net balances per account balances since 2011, as well as a comparison between banks in 2014. Also shown is the average net balance per main account which is also a driver of the net value of funds.

Table 6.9: Value and cost of funds applied to credit and debit balances of BCAs

By bank for 2014	*Value of funds (credit) (%)*	*Cost of funds (debit) (%)*	*Net value of funds (%)*	*Average net balance per active account, (£)*	*Number of active accounts*
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
By year*					
2011†			3.74		
2012‡			2.50		
2013			2.73	12,509	3,665,556
2014			2.16	14,795	3,648,750

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
*Weighted average for all banks except Danske, 2014 prices.
†Data not available for Clydesdale and Santander.
‡Data not available for Santander.
Note: The net value of funds is the absolute difference between the value and cost of funds as a percentage of net balances. So, the net value of funds is (vB–cD)/(B–D) where v is value of credit funds (%), B is average credit balance over the year, c is cost of debit funds (%) and D is average debit balance over the year.

6.52 We have also considered how net revenue per account differs by the size of SME served (see Table 6.10). Total net revenue per account is found to be substantially greater for BCAs held by SMEs with annual turnover in excess of £2 million in comparison to smaller SMEs. This reflects the more complex needs of larger SMEs, including the greater volume of transactions carried

[308] While revenue per active account from other receipts appears to have increased in 2014 relative to 2011, this is due to the absence of [✂] (which attributes around [✂]% of total net revenue to this source) from the sample in 2011. When measured over the entire period for which [✂] is present in the sample (ie 2012–2014), revenue per active account from other receipts declined by around 20%.

out and in relation to overdrafts the larger levels of borrowing. These are partially offset by greater payments to customers on credit balances held. It is more common for larger SMEs to negotiate charges with banks but such negotiations will reflect the costs to the banks of providing a greater depth of relationship management service to larger SMEs.

Table 6.10: Comparison of net BCA revenue (excluding value of funds) by size of SME, 2014

	SMEs with annual turnover <£2m		*SMEs with annual turnover >£2m*	
Type of revenue	*£ per active account*	*% of net revenue per account*	*£ per active account*	*% of net revenue per account*
Transaction charges	98	35	726	35
Arranged overdraft	93	33	832	41
Unarranged overdraft and unpaid item fees	35	13	83	4
Interchange fees (debit card)	4	1	3	0
Monthly account fees	37	13	49	2
Other receipts (net)	22	8	599	29
Total receipts from charges and interest	**290**	**102**	**2292**	**112**
Interest payments to customers	–7	–2	–243	–12
Other payments to customers	–2	–1	–9	0
Net revenue excluding value of funds	**283**	**100**	**2049**	**100**
(% average annual turnover)	0.16%	-	0.03%	

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
Notes:
1. Excludes HSBC, for which a full revenue breakdown is not available.
2. Breakdown by SME size is not available for AIB, Danske and TSB.
3. Average annual turnover calculated using midpoint of turnover bands in 2014 for GB SMEs from the Charterhouse BBS.

General-purpose business loans (including commercial mortgages)

6.53 Table 6.11 summarises our analysis of aggregate gross revenue by source from general-purpose business lending. Revenues are expressed as a proportion of average loan balances to control for differences in the size of lending.

Table 6.11: Analysis of general-purpose business loans (including commercial mortgages) revenue (% average loan balance)

					%
Type of revenue	*2011*	*2012*	*2013*	*2014*	*Percentage in 2014*
Interest received from SMEs	2.25	2.48	2.82	2.86	91
Arrangement fee revenue received from SMEs	0.09	0.10	0.10	0.11	4
Other revenue (including fee received from SMEs)	0.09	0.09	0.15	0.17	5
Total revenue from interest and charges	**2.43**	**2.67**	**3.08**	**3.14**	**100**

Source: CMA analysis of data submitted by banks.

6.54 We find that total revenue from interest and charges has increased since 2011. This increase is driven by growth in interest paid by SMEs as well as a rise in revenue from other sources (excluding arrangement fees). However, in interpreting this result, we note that we are unable to account for loan impairments and changes in the quality of banks' loan books over time. Similarly, we are also unable to include the revenue impact of differences in the cost of funding between banks.

Other SME lending products

6.55 A similar analysis of gross revenue has been undertaken for asset and invoice finance products (see Table 6.12 and Table 6.13, respectively). While total revenue has increased since 2011 for asset finance (due to an increase in interest received from SMEs), the reverse is true for invoice finance products.

6.56 Arrangement fee revenue has remained relatively stable over the period for both asset and finance products although there has been a reduction in other revenue from fees and charges. This is most notable in the case of invoice finance for which other revenue is the most important source of income (accounting for over half gross revenues in 2014).

Table 6.12: Analysis of asset finance revenue (% average loan balance)

					%
Type of revenue	*2011*	*2012*	*2013*	*2014*	*Percentage in 2014*
Interest received from SMEs	3.46	4.08	4.37	4.53	89
Arrangement fee revenue received from SMEs	0.22	0.24	0.22	0.20	4
Other revenue (including fee received from SMEs)	0.69	0.52	0.40	0.34	7
Total revenue from interest and charges	**4.38**	**4.84**	**4.99**	**5.07**	**100**

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
Note: Revenue data not available for Santander in 2011 and 2012 and Lloyds for 2011–2014. Revenues for Clydesdale and Ulster not included due to problems with the underlying data.

Table 6.13: Analysis of invoice finance revenue (% average loan balance)

					%
Type of revenue	*2011*	*2012*	*2013*	*2014*	*Percentage in 2014*
Interest received from SMEs	2.98	2.92	2.89	2.77	30
Arrangement fee revenue received from SMEs	0.21	0.19	0.17	0.17	2
Other revenue (including fee received from SMEs)	6.90	6.62	6.48	6.40	68
Total revenue from interest and charges	**10.09**	**9.74**	**9.55**	**9.34**	**100**

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
Note: Revenue data not available for Santander in 2011 and 2012.

Business deposit accounts

6.57 Net revenue from business deposits remains positive in 2014, at approximately £740 per account, despite the decrease of over a third since 2011 (see Table 6.14). This reduction has been driven by a decline in the value of funds which represent close to 100% of gross business deposit account revenues throughout the period analysed (ie before the interest paid to SMEs is subtracted). There has been a small offsetting reduction of around 10% in interest paid to SMEs.

Table 6.14: Analysis of business deposit account revenue (£ per account, 2014 prices)

				£	%
Type of revenue	*2011*	*2012*	*2013*	*2014*	*Percentage in 2014*
Fee revenue received	1	1	1	1	0
Interest paid to SMEs	–226	–272	–301	–197	–26
Net revenue from interest and charges	**–226**	**–271**	**–300**	**–196**	**–26**
Standardised value of funds	1417	944	1112	942	126
Net revenue*	**1191**	**673**	**812**	**746**	**100**

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
*Calculated by applying standardised % value of funds for BCA credit balances to the annual average business deposit account balance of each bank. Data for Danske excluded from calculation of standardised % cost of funding. BCA credit balances data not available for RBS, Co-op, Metro and Handelsbanken.

Summary of evidence on revenues

6.58 We have found that there has been a decline in net revenues per active BCA over time as a result of reductions in revenues from arranged overdrafts, transaction charges, unarranged overdrafts and other receipts[309] (primarily from occasional charges relating to payments). There has also been a decline in the net value of funds.

6.59 By contrast, for general-purpose business loan, we find that total revenue from interest and charges has increased since 2011 driven by interest charges and from other receipts excluding arrangement fees. While total asset finance revenue has increased since 2011, invoice finance revenue has, however, declined. Net revenue from business deposits has also declined.

SME financial performance

6.60 We examined the revenues and margins of the seven largest banks' SME banking businesses,[310] using the financial data collected from banks.

6.61 Because of issues surrounding the allocation of costs, we considered that examining a full profit and loss account for the SME operations would not be appropriate. We have therefore focused on an analysis of revenues, and an examination of impairments.

6.62 We were not able to undertake an analysis of the banks' SME banking businesses by devolved nation, or segment the analysis, for example

[309] While revenue per active account from other receipts appears to have increased in 2014 relative to 2011, this is due to the absence of [✂] (which attributes around [✂]% of total net revenue to this source) from the sample in 2011. When measured over the entire period for which [✂] is present in the sample (ie 2012–2014), revenue per active account from other receipts declined by around 20%.
[310] Barclays, HSBCG, LBG, RBSG, Santander, Co-op and Clydesdale.

between larger and smaller SMEs, because the banks did not collect, analyse or present the data to us, in this way.

6.63 In this section, where we refer to any named bank, we are referring to its SME banking business only, and not the whole of its UK banking operations or its UK retail banking operations.

6.64 For the reasons set out in Section 2 we did not undertake a market-wide profitability assessment.

Total revenues and number of accounts

6.65 Figure 6.2 shows total SME revenues[311] by bank, 2011 to 2014 for the seven largest banks.[312] There was a very small decline in total SME revenues over the period (approximately 0.6%).[313]

6.66 SME revenues for the seven largest banks totalled £7.1 billion in 2014.

6.67 [✂] can be seen as the largest provider of SME services with [✂] and [✂] second and third. [✂] are the smallest of the seven banks. Although [✂] shows an average annual decline of approximately 4%, the other banks' revenues do not show much change between years.

Figure 6.2: SME revenues by bank, 2011 to 2014, £m

[✂]

Source: CMA analysis based on data provided by the parties.

6.68 Figure 6.3 shows average number[314] of unique SME customers, for 2011 to 2014 for the seven largest banks.[315,316] With the exception of [✂] and [✂], and [✂] and [✂], whose respective ranks swap around, in 2014 banks' rankings by number of accounts were the same as by total revenues.

Figure 6.3: Average number of unique SME customers, 2011 to 2014

[✂]

Source: CMA analysis based on data provided by the parties.

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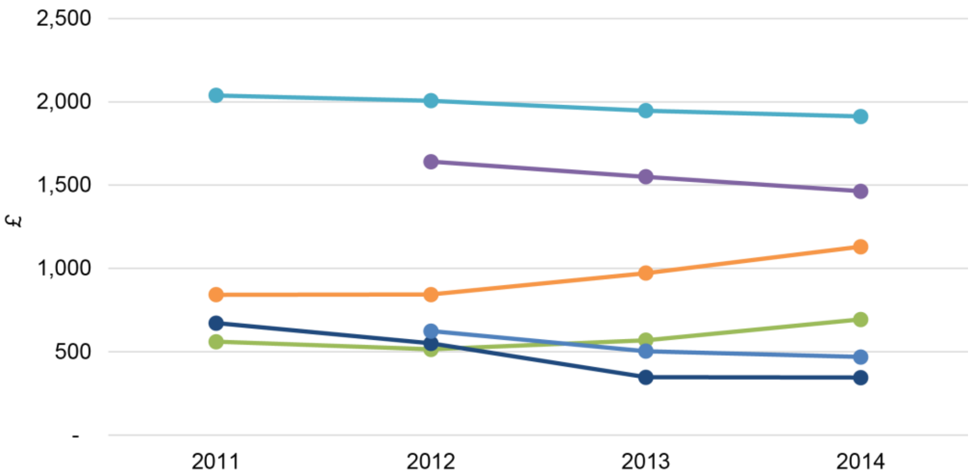
[311] Includes value of funds.
[312] Data missing for [✂] and [✂] in 2011 – [✂] data not provided to CMA as only one of the two underlying businesses had data for that period; [✂] data not provided to CMA due to systems limitations.
[313] 2011 to 2014 excluding [✂] and [✂] data; 2012 to 2014 including [✂] and [✂] data.
[314] Average number of unique SME customers.
[315] Data missing for [✂] in 2011 – data not provided to CMA as only one of the two underlying businesses had data for that period.
[316] [✂] data is not shown for 2011 to 2013 because the data provided was not internally consistent: [✂]

Average revenues per unique customer

6.69 Figure 6.4 shows average revenues per unique SME customer, 2011 to 2014 for the seven largest banks.[317,318]

6.70 Overall, average revenues declined over the period, although [✂] and [✂] showed an increase. [✂][319]

Figure 6.4: Average revenues per unique SME customer, 2011 to 2014, £



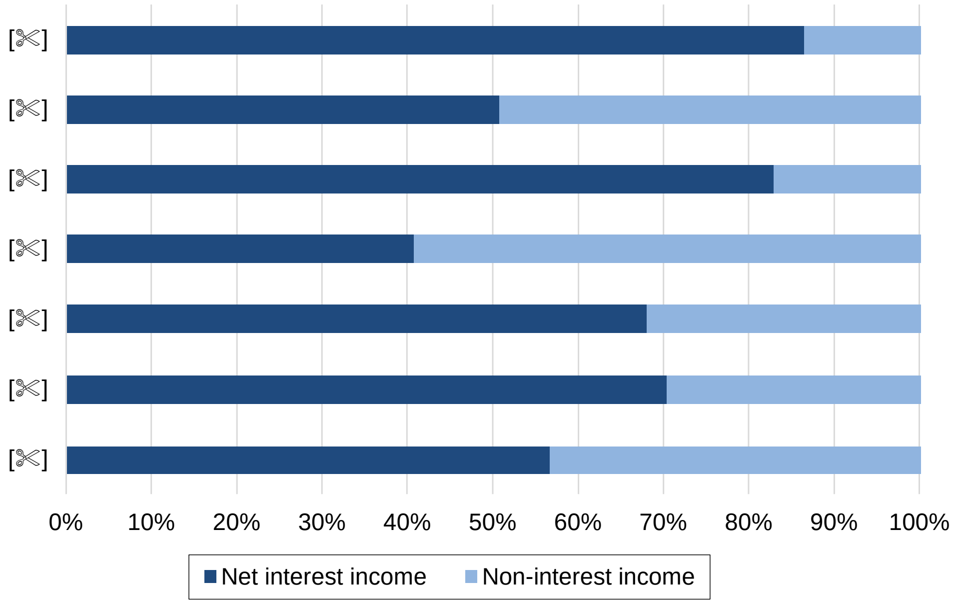
Source: CMA analysis based on data provided by the parties.
Note: One bank has been excised from this figure.

Total SME revenues by source

6.71 We looked at the split of revenues for each bank, between interest income and non-interest income. Net interest income is comprised of interest income less interest paid; non-interest income is comprised of fees from overdrafts, packaged accounts, returned items and VISA/ATM charges. We excluded amounts relating to the value of funds: we noted that funds transfer pricing arrangements are necessarily provider-specific and will reflect each provider's individual circumstances, including its balance sheet position, credit rating and possibly its business strategy. We totalled each bank's revenues over the four-year period (three years for [✂] and [✂], as 2011 data was not provided), and examined the split between net interest income and non-interest. Figure 6.5 shows the proportion of total SME revenues by source, for 2011 to 2014.

[317] Data missing for [✂] and [✂] in 2011 – [✂] data not provided to CMA as only one of the two underlying businesses had data for that period; [✂] data not provided to CMA due to systems limitations.
[318] [✂] data is not shown for 2011 to 2013 because the data provided was not internally consistent: [✂]
[319] [✂] told us that differences in average revenues may be driven by factors such as the profile of respective customer bases and the scope of service propositions; and [✂] told us that differences in average revenues may reflect variations in customer characteristics and their use of PCA and SME banking services.

Figure 6.5: Split of total SME revenues by source, 2011 to 2014



Source: CMA analysis based on data provided by the parties.

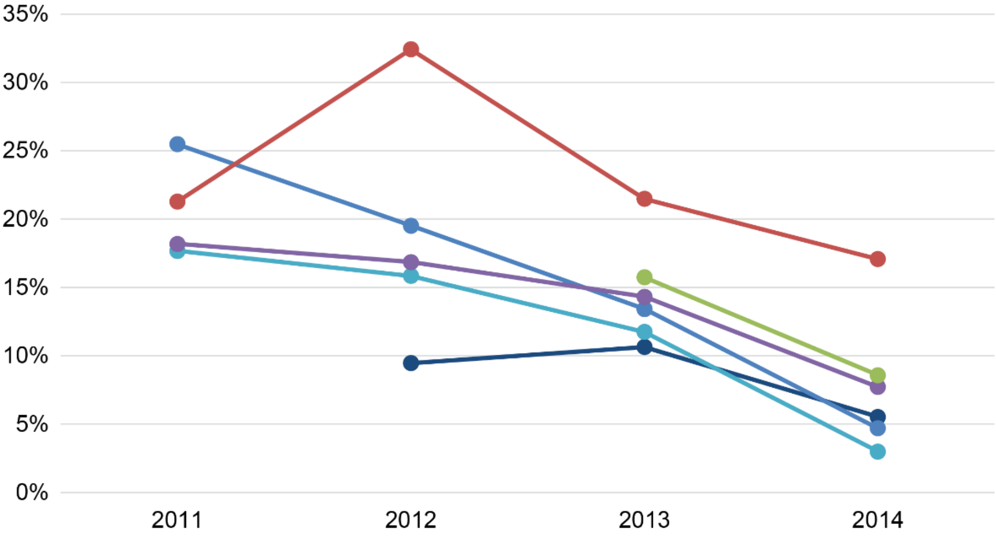
6.72 There appears to be no relationship between size of bank and proportion of net interest income from SMEs. Banks appear to treat net interest and non-interest income differently: for example, [✂] told us that it amortised overdraft fees to the balance sheet and released them to the profit and loss account in net interest income.

Impairments

6.73 We looked at impairments as a percentage of revenues, including value of funds. Figure 6.6 shows the impairment rate for five banks, 2011 to 2014.[320] There is an overall improvement in impairment rates, which appears to track the recovery of the UK economy. [✂] told us that the peak in impairment rate in 2012 mainly related to the loss crystallisation on loans arising from the prolonged downturn. It told us, in particular, that 2012 impairments were reflective of losses from loan vintages written before the financial crisis for 2008 which, typically, had an effective term of five years. Impairment losses in the years following 2012 have been lower, reflecting the actions taken by [✂] to work out, exit or restructure substandard and non-performing loans.

[320] [✂] (2012): data excluded as not representative; [✂] (all years): data unable to be reported due to business reporting limitations; [✂]: 2011 data not provided to CMA as only one of the two underlying businesses had data for that period.

Figure 6.6: SME impairments as a proportion of total revenues, 2011 to 2014



Source: CMA analysis based on data provided by the parties.

Summary of evidence on financial performance

6.74 We also note the following in relation to the financial performance of SME banking for the seven largest banks we examined:

(a) There was a very small decline in total revenues between 2011 and 2014.

(b) With the exception of [✂] and [✂], and [✂] and [✂], whose respective ranks swap around, in 2014 banks' rankings by number of accounts were the same as by total revenues.

(c) Average revenues per unique SME customer declined over the period, with the exceptions of [✂] and [✂].

(d) The [✂].[321]

(e) Overall, impairment rates improved over the period.

SME profitability: by customers and products

6.75 Similarly to PCAs, banks take different approaches in assessing the performance of BCAs and other SME banking products, and they do not all assess profitability in the normal course of business. Therefore, we do not have a comprehensive view of the SME products' profitability across all of the banks. As noted above, in paragraph 6.61, our ability to conduct our own

[321] [✂] told us that it could not rule out the possibility that differences in average revenues were driven by factors such as the profile of respective customer bases and the scope of service propositions.

analysis of the profitability of SME products is complicated by the difficulty and subjectivity of allocating a significant proportion of common or shared costs (eg branch costs, HR costs and marketing spend) to individual products and/or customers.

6.76 We have nevertheless collected information from the five largest UK banks (Barclays, HSBCG, LBG, RBSG and Santander)[322] on ways in which they assess the profitability of their SME operations, and to the extent possible, the profitability of individual products and customers. The details of our findings are included in Appendix 6.3 and can be summarised as follows:

(a) Through the economic cycle, for [✂] and [✂], BCAs are [✂], and for [✂], SME banking, including the provision of BCAs, is [✂].[323]

(b) As for PCAs, the main drivers for BCA profitability are the: number of active customers, level of fees charged for BCA usage, level of credit balances, income from overdraft fees and interest, and net interest margin (ie the difference between the interest income generated from the use of their BCA customers' credit balances to fund banks' lending businesses and the amount of interest paid out to those same customers, relative to the amount of their interest-earning assets). The impact of these drivers varies over time reflecting both the macro-economic environment, such as the base rate, and customer behaviour (eg transactional volume and channel usage).

(c) The volume and type of transactional activity undertaken by the customer is particularly important in the case of BCA customers. For example, [✂] told us that it made a loss on serving charities, clubs, associations and societies, because these customers were typically provided core banking services (eg BCAs and key payment services) free of charge, and had a relatively high cost to serve, as they were particularly likely to use cheques (rather than process transactions electronically) and frequently required change in mandates.

(d) Start-ups or new BCA customers often receive free core banking services for a limited period (typically 12 to 18 months) and therefore generate less income in the early stages of their operation. [✂] told us that BCAs provided to start-ups or switchers, which were introductory

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322 We focus our analysis on the SME banking activities of the five largest banks in the UK, as together they had a combined UK market share (by number of active BCAs) of [✂] in 2014. Our assessment is based on financial data provided by the banks and generally reflects accounting (and not economic) profits.
323 [✂] and [✂] provided stand-alone profit and loss forecasts for their BCA businesses, whereas [✂] provided forecasts for their SME banking businesses, which includes the provision of BCAs and other SME banking products.

products, were not expected to cover their incremental costs in the short term, but it expected these customers to make a contribution in excess of incremental costs over the lifetime of their relationship with [✂]. Therefore, the provision of free banking for a limited period is effectively a cost of customer acquisition.

BCA pricing

Background

6.77 The comparisons in this section have been derived by applying banks' current BCA charging tariffs to a set of representative SME customer profiles.

6.78 The BCA pricing data was obtained from the Business Moneyfacts website in January 2015. The customer profiles were submitted by four banks in response to an information request to the five largest banking groups.[324] SMEs with annual turnover greater than £2 million were excluded from the analysis because of the prevalence of negotiated pricing among this segment of larger SMEs.

6.79 In applying the tariffs to the transaction profiles we have assumed that SMEs choose the cheapest tariff available given their pattern of transactions and have only applied tariffs which are valid to the turnover band of the SME profile.

6.80 A fuller discussion of the methodology and results is contained in Appendix 6.4.

6.81 The bespoke nature of SME loan pricing, which will typically reflect the specific risk associated with a given SME customer, means that it is difficult to carry out an equivalent analysis of prices for SME lending products. In particular, in the absence of external data on credit risk for all SMEs we would need to estimate the default risk of each SME by controlling for a range of characteristics. Given the significant data requirements and corresponding complexity of such estimation, and in light of the subsequent limitations to the interpretation of any results, we have not undertaken a formal analysis of SME loan pricing.

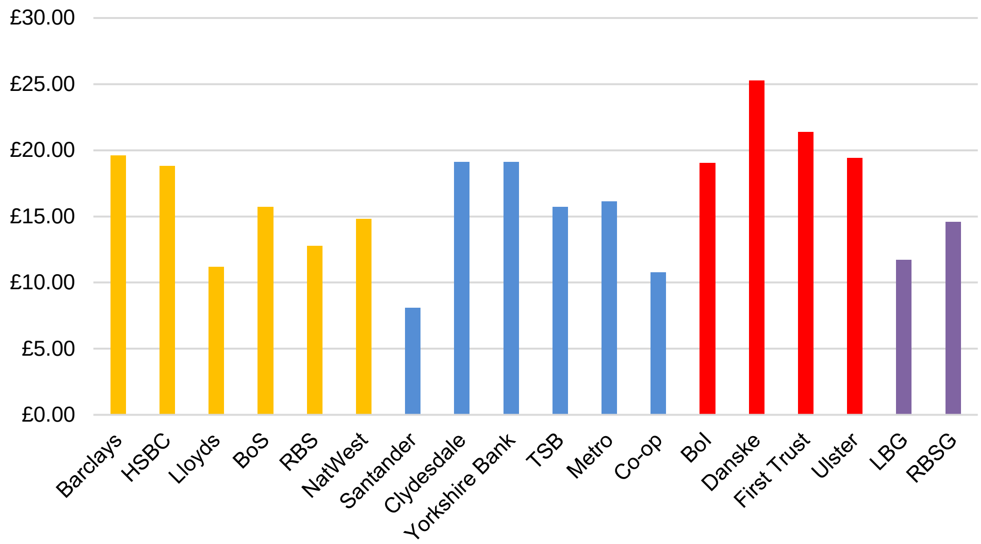
[324] Five usable customer profiles were received from Barclays and four each from RBSG, HSBCG and Santander. LBG did not submit any customer profiles as it did not consider that any meaningful representative profiles could be derived given the diversity in cost-to-serve, risk, balance holdings, transaction volumes and channel preferences amongst its SME customers.

Comparisons between banks

6.82 We observe significant variation in monthly charges between banks. For GB BCA providers, the difference between the highest and lowest monthly cost was over 100% for 15 out of 17 customer profiles. For five of the customer profiles, the highest monthly cost was over three times as large as the lowest monthly cost. Similar results were observed for the NI BCA providers.

6.83 Figure 6.7 provides a comparison between banking groups of the weighted average monthly charges across each of the Barclays customer profiles. The variation in charges and relative position of each bank are broadly similar under the other available profiles (those submitted by HSBCG, RBSG and Santander).

Figure 6.7: Weighted average monthly price by bank



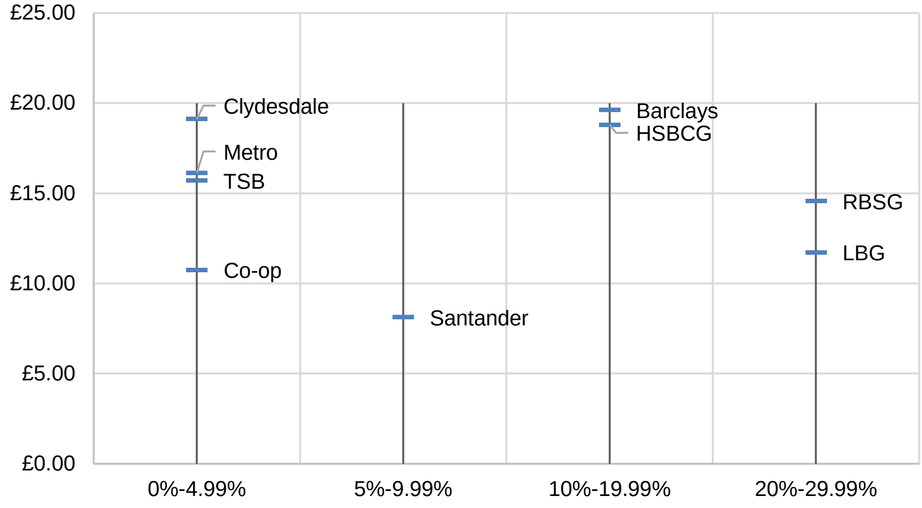
Source: CMA analysis.
Notes:
1. Bars 1–6 (yellow) show larger banks, bars 7–12 (blue) show smaller banks, bars 13–16 (red) show NI banks and the final two bars (purple) show weighted averages for the two banking groups whose constituent banks have different weighted average prices.
2. Monthly prices calculated using customer profiles submitted by Barclays.

6.84 We note that the monthly prices of the NI banks are generally higher than those of the GB BCA providers.

6.85 Although Santander is consistently among the lowest-priced banks across the profiles, we did not find evidence of a clear association between price and market share (as demonstrated in Figure 6.8 for GB providers using the Barclays customer profiles, a similar result is observed for NI[325]).

[325] See Appendix 6.24, Annex D, Figure 4.

Figure 6.8: Weighted average monthly price and market share by bank



Source: CMA analysis.
Note: Monthly prices calculated using customer profiles submitted by Barclays.

6.86 Interpretation of the results is subject to limitations:

- There are a number of pricing dimensions which are not taken into account such as overdraft charges, interest on credit balances and other incentives.
- The analysis is limited to SMEs with annual turnover less than £2 million and even within this segment customer profiles may not be fully representative of the diversity of SMEs' BCA usage. Nevertheless, we note the similarity in results (in terms of relative prices) across the range of customer profiles submitted by the banks and have weighted the customer types using the actual proportion of customer accounts in each category.
- Differences in banks' prices may reflect differences in the quality of service provided to SME customers (which we are unable to directly control for in our pricing analysis).

6.87 In formulating our provisional findings with respect to market structure and outcomes, we recognise that both price and quality need to be considered together. We have therefore considered the implications of these results alongside our analysis of quality outcomes (as summarised in the following part of this section).

SME banking quality

6.88 In this section we set out evidence on overall service quality and on the quality of relationship management. We then consider the strength of customer response to quality differences. A more detailed discussion of the methodology and results is contained in Appendix 6.5.

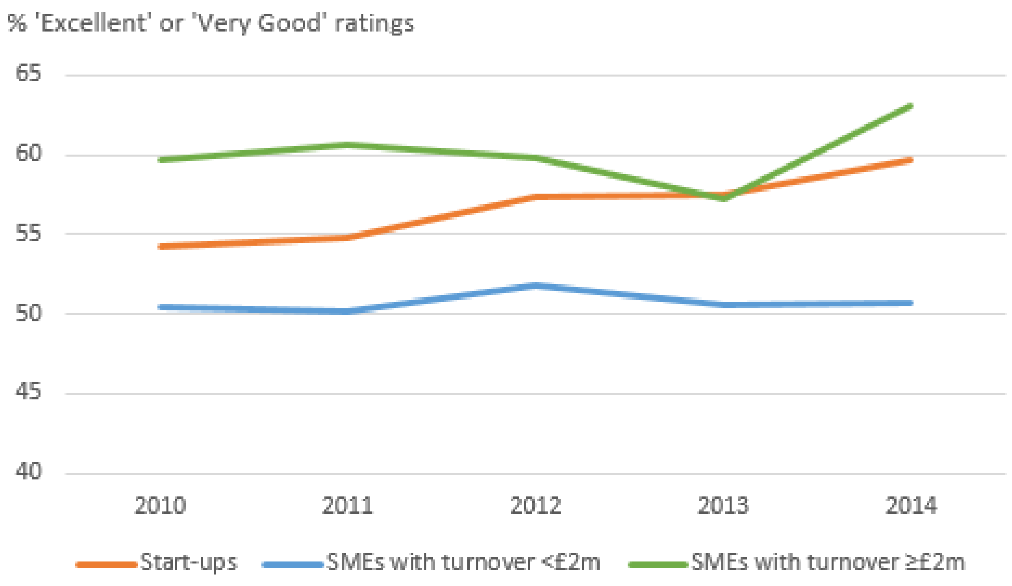
Indicators of overall service quality

6.89 As a measure of overall service quality we have analysed customer satisfaction ratings from the Charterhouse BBS (for GB customers) and the Charterhouse NI BBS.

6.90 In interpreting the results of customer satisfaction ratings, we recognise that the same caveats apply as discussed in Section 5 for the equivalent analysis of PCA customer satisfaction scores.

6.91 Overall satisfaction for GB customers as indicated by the proportion of customers rating their bank as either 'very good' or 'excellent' has remained at around 50%[326] throughout the period 2010 to 2014. We find some evidence that smaller SMEs (ie those with annual turnover less than £2 million) are less satisfied than start-ups or larger SMEs (see Figure 6.9). The overall proportion of NI SME banking customers with positive satisfaction ratings in 2015 was around 56%.[327]

Figure 6.9: Rating of GB overall quality of service for main bank, by size of SME



Source: Charterhouse BBS.

[326] Note that SMEs with turnover <£2 million (excluding start-ups) account for nearly 85% of the weighted number of SMEs in the Charterhouse sample, therefore the overall results are similar to those for SMEs with <£2 million.
[327] Satisfaction ratings before 2015 are not available for NI and there are insufficient observations in the Charterhouse NI BBS to segment the results by size of SME.

Comparisons across banking groups

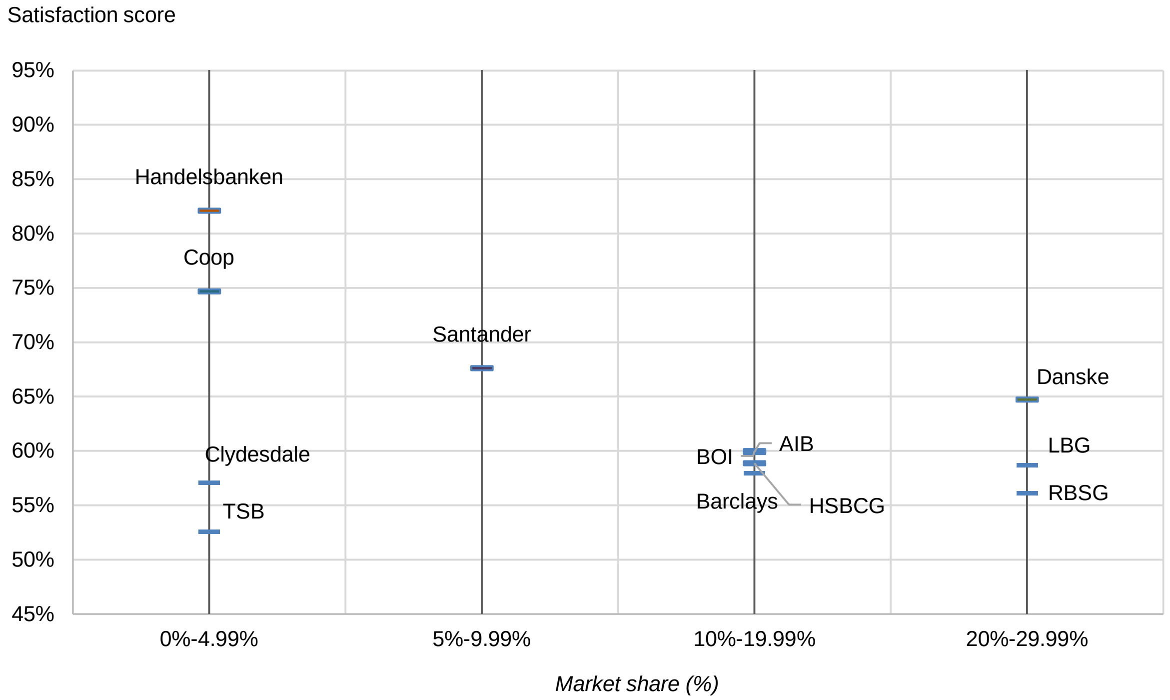
6.92 We have undertaken comparisons between banking groups of the following indicators of the overall quality of service:

- satisfaction ratings (from Business Banking Insight survey).
- net promoter score (NPS) (from Charterhouse BBS); and
- satisfaction ratings (from Charterhouse BBS).

6.93 In general we find that there is little variation in the performance of the four largest banking groups in GB, which are rated average or below average under each of the indicators (for example, see Figures 6.10 and 6.11 below). Some banking groups such as Handelsbanken and Co-op appear to deliver considerably higher levels of satisfaction than other providers in our analysis. While Handelsbanken has experienced an increase in market share, which is consistent with customers responding to this variation in service quality, the rate of gain has been relatively low in absolute terms ([✂]). Furthermore Co-op, in comparison, has experienced a slight reduction in market share over the same period.

6.94 We do not find evidence of a clear relationship between BCA market share and satisfaction with overall service quality. While we observe that Handelsbanken and Co-op (banking groups which each have less than a [✂]% share of GB active BCAs) receive above average ratings for each of the three indicators, the relationship between satisfaction and market share in the remainder of the sample is relatively flat.

Figure 6.10: Comparison of satisfaction with BCA provider in 2014



Source: BBI 2014 and CMA calculations using data submitted by banks.
Notes:
1. Data for Metro not displayed as sample < 30 respondents.
2. Market shares relate to NI for AIB, BoI and Danske, and GB for all other banking groups.

Figure 6.11: Comparison of GB NPS by banking group in 2014

[✄]

Source: Charterhouse BBS and CMA calculations using data submitted by banks.
Notes:
1. Data not available for NI.
2. Market shares relate to share of GB active BCAs at year end.
3. Data not available for Metro.

6.95 Equivalent data results for SME banking customers in NI can be found in Appendix 6.5. Due to small sample sizes for some banks it is more difficult to interpret the results of the analysis. Notwithstanding these limitations, the relationship between market share and the indicators of overall service quality appears relatively flat with [✄] and [✄] performing comparatively well and [✄] comparatively worse.

Quality of relationship management

6.96 The results of the Charterhouse BBS survey show that concerns with the quality of relationship management service are one of the primary reasons cited by SME switchers for moving away from their previous BCA provider. To analyse any variations in quality in this dimension of service we have undertaken comparisons of customer satisfaction with their relationship manager as well comparisons of the proportion of each banking group’s customers that receive a relationship management service (segmented by size of SME).[328]

6.97 Almost universally across the banking groups, close to 100% of SME customers with annual turnover greater than £2 million receive a relationship management service.[329] Among smaller SME customers the relationship between relationship manager coverage and market share is not clear-cut. For example, of the smaller banks, [✂] has an above-average proportion of relationship-managed customers, while [✂] does not offer a face-to-face relationship management service to any of its BCA customers.

6.98 We also recognise the difficulties in interpreting such comparisons as observed differences between banks reflect differences in the customer base of the banks. For example, banks with a higher proportion of smaller SME customers (and therefore with less complex needs) may have lower rates of relationship management. Differences in the definition of a relationship manager, and the number of customers each relationship manager is assigned, also limit our ability to compare between banks.

6.99 As with relationship manager coverage, we do not find evidence of a clear association between market share and satisfaction with relationship managers (for example, see Figure 6.12).

Figure 6.12: GB satisfaction with relationship manager in 2014

[✂]

Source: Charterhouse BBS and CMA calculations using data submitted by banks.
Notes:
1. Data not available for NI.
2. Market shares relate to share of GB active BCAs at year end.
3. Data not available for Metro.

Summary of evidence on pricing and quality outcomes

6.100 We have undertaken comparisons between banking groups of revenues, pricing and quality indicators. While there are difficulties in the interpretation of such analyses, we do not find clear evidence of a relationship between market share and either pricing or quality outcomes.

6.101 Nevertheless our analysis of BCA pricing shows substantial variation in BCA charges between banking groups, for a given set of customer profiles.

6.102 The existence of large variations in BCA pricing might indicate that customers of worse-performing banks would be better off switching away

[328] See Appendix 6.5, Figures 11, 12 and 13.
[329] CMA calculations using data submitted by the banks.

from their existing bank. However, it might also be reflective of differences in service quality where banks have placed themselves on difference positions of the quality-price matrix. We have therefore interpreted the results of the pricing and quality analysis together (see Figures 6.13 to 6.15).

Figure 6.13: Comparison of BCA satisfaction and weighted average prices using Charterhouse data

[✂]

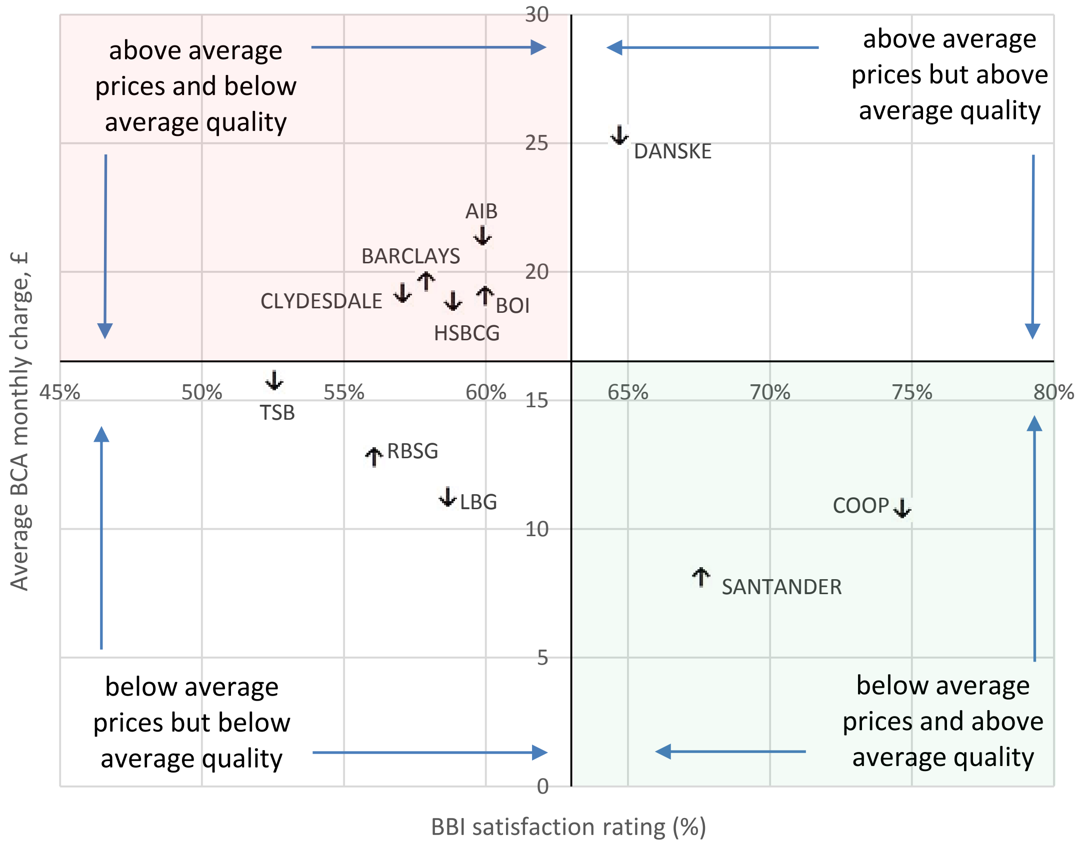
Source: CMA analysis, Charterhouse BBS and Charterhouse NI BBS.
Notes:
1. ↑ denotes increase in bank's market share in 2014 and ↓ denotes decrease.
2. Pricing data not available for Handelsbanken.

Figure 6.14: Comparison of BCA NPS and weighted average prices using Charterhouse data

[✂]

Source: CMA analysis, Charterhouse BBS and Charterhouse NI Banking Survey.
Notes:
1. ↑ denotes increase in bank's market share in 2014 and ↓ denotes decrease.
2. Pricing data not available for Handelsbanken.

Figure 6.15: Comparison of BCA satisfaction and weighted average prices using Business Banking Insight data



Source: CMA analysis of data submitted by banks, Business Banking Insight survey.
Note:
1. ↑ denotes increase in bank's market share in 2014 and ↓ denotes decrease.
2. Pricing data not available for Handelsbanken.

6.103 We find that some banks appear to offer a combination of above-average performance on both the quality and price indicators (eg Danske), while others are below average on both indicators (eg LBG). In these cases it is not possible to draw firm conclusions on whether customers would be better off switching away from or towards these banks.

6.104 However, we also observe some banks with both below-average charges and above-average satisfaction ratings. Similarly there are banks with a combination of above-average prices and below-average satisfaction. In this case we would expect customers to be unambiguously better off by switching from the 'high-price low-quality' providers to 'low-price high-quality banks.

6.105 Instead, however, we find examples of 'high-price low-quality' banks gaining market share (Barclays and BoI) and 'low-price high-quality' banks failing to increase market share (Co-op). Furthermore while some high-price low-quality' banks are losing market share at the expense of banks positioned higher up on the price-quality matrix, the pace of change appears to be very slow. For example, the market share of Santander has increased by only [✂] since 2012. Similarly, Clydesdale and AIB have experienced a reduction in market share of [✂] since 2012.

Innovation

6.106 Innovation can be a useful indicator of the level of competition in a market, as, in a well-functioning market, investment in innovation can bring benefits to customers in the form of diversity of choice, cost efficiencies and enhanced service levels. Conversely, a lack of innovation may suggest that firms are not subject to competitive pressure and therefore, have reduced incentives to innovate, or that there are barriers to innovation present in the market.

6.107 This section provides a summary of our findings on the impact of innovation on competition in the SME banking market. See Appendix 6.6 for a more detailed discussion of the evidence on this subject.

Product innovation

6.108 Recent product innovation in the PCA market has primarily taken the form of rewards accounts and switching incentives. However, there do not appear to have been similar levels of product innovation in the SME banking market, where recent activity has reflected price competition rather than product innovation. Further details on product innovation is contained in Section 9.

Service innovation

6.109 Service innovation in SME banking has primarily taken the form of the digitalisation of banking.

Mobile banking

6.110 Mobile banking was initially developed in the PCA market and then expanded into SME banking. Usage of this channel has grown considerably in recent years, but mobile banking in the SME banking market has not yet reached the levels observed in the PCA market. For example, LBG's mobile banking service for business customers currently attracts [✂]% to [✂]% of its base of SME internet banking customers. This is in contrast to the PCA market where we observe rates of mobile banking adoption of close to 30%.[330] Some banks, such as TSB, do not currently offer a mobile banking application for their BCA customers.

6.111 The development of mobile banking and the wider digitalisation of banking had also led to a number of other service innovations in the SME banking market. However, many of these innovations, such as PAYM; cheque imaging; video banking; and online account opening, have first been initiated in personal banking and then developed in the SME banking market.

6.112 Although the digitalisation of banking in the SME market has resulted in the decline in the branch as the main channel for many SMEs, branches remain important in this market, both for customers, who have a continued need to pay in cash or cheques, and for the banks, who continue to use the branch for customer acquisition and retention. See Section 10 for further information.

6.113 As mobile banking adoption is largely driven by smartphone adoption, which is greater among the younger population, mobile banking adoption is likely to increase over time. However, given the pattern of mobile banking development to date, it is likely that any such innovation and the resulting increase in mobile banking adoption will first take place in the PCA market and will be observed in the SME banking market at a later date.

[330] Expressed as the proportion of UK adults that used mobile banking in 2014 (see Deloitte innovation report, p9).

Aggregators

6.114 The use of account aggregators in the UK is limited, particularly when compared to their development in other countries. For example, Commonwealth Bank in Australia recently launched Daily IQ, which gives its business customers access to information about their cash flow, sales and the market in which they operate,[331] and Bode Tree, a US company, provides specific financial services, such as forecasting, access to a network of banks and alternative bank lenders, on top of general account aggregation.[332]

6.115 To the extent that account aggregation services are more widely used in the UK, they could raise financial awareness and promote greater shopping around and switching, and could also provide an additional channel to reach customers.

'Big data'

6.116 The use of 'big data' for the purposes of credit and risk assessment could facilitate the entry of new SME lending providers by reducing the informational asymmetry between them and the established banks, which will also improve customer access to credit.

6.117 In the UK, the vast majority of lending to SMEs is based on traditional credit assessment checks based primarily on transactional data, which favours the established banks that hold a significant proportion of BCAs. However, there are international examples of the use of big data in this area, particularly by non-banks, which are not inconvenienced by inflexible legacy systems, and can potentially integrate such data into their systems more easily and at a lower cost. For example, Kabbage, an SME lender with operations in both the UK and the USA,[333] applies big data analysis techniques to data from both social media pages and online market places, such as eBay, to determine the credit score of a small business.[334] We have also seen evidence of established companies, such as Amazon and PayPal, beginning to enter the lending market on this basis. However, our overall view is that 'big data' is still in the nascent stages of development.

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[331] See Deloitte innovation report, p42.
[332] See Deloitte innovation report, p76.
[333] Kabbage launched in the UK in 2013 and remains relatively small scale. In the USA, where it has operated since 2009, it was lending $1 billion a year within four years of launch.
[334] See Deloitte innovation report, p52.

New business models

6.118 There are likely to be a number of prospective entrants to the SME banking market in the coming months, and many of these banks, such as Atom, Civilised Bank and OakNorth, intend to enter the market as online banks with limited (or no) branch presence. See Section 10 for further information.

6.119 The rise of digital banks underlines the importance of technological innovation in facilitating entry into the market. However, some digital banks provide counter services to their customers through agency banking relationships; Inter-Bank Agency Agreements (IBAAs); use of the Post Office network; and/or cash collection and delivery services agreements. Similarly, the entry of banks with more traditional distribution models, such as Metro, suggests that branch-based banking has not been replaced by digital banking.

6.120 We also found in Section 4 that the development of digital wallet products such as PayPal, Apple Pay and Google Wallet cannot be used to effectively substitute for the full set of features of a BCA. Digital wallets compete directly in the upstream payment systems market, with, for example, PayPal increasingly competing with banks in merchant acquiring for SMEs (which is outside our ToR) and may be impacting on banks' BCA income. However, we have not seen evidence that digital wallet providers have yet had a significant impact on banks' BCA supply or of a competitive response from BCA suppliers.

Summary of conclusion on structure and outcomes in SME banking

Market structure and concentration

6.121 We find the BCA market in both GB and NI to be concentrated with the four largest providers having a combined market share of over 80% of active and total BCAs and an HHI of around 1,800 in GB and 2,000 in NI. Excluding the impact of mergers and divestments, shares in the GB and NI BCA markets have remained relatively stable since 2010.

6.122 We find that levels of concentration in general-purpose business lending (including commercial mortgages) in the UK are similar to that of the BCA market, though concentration in business loans as a whole is expected to be lower than in BCAs, reflecting the lower share of the largest banks in invoice finance.

Price and quality outcomes

6.123 We have considered how far variations in pricing and quality are associated with banks gaining and losing market share. We find evidence of some banks gaining market share despite appearing to offer a combination of below-average quality and above-average prices. Conversely there are banks offering below-average prices and above-average quality that are either losing market share or gaining market share at a very slow pace. We provisionally interpret this finding as evidence of a weak customer response to variations in prices and quality.

Innovation

6.124 When the various innovations in the SME banking markets are assessed individually, there is a considerable degree of variation in the development of each innovation and the extent to which each innovation has impacted (or is likely to impact) the SME banking markets. In contrast to mobile banking, which has progressed significantly in recent years, innovations – such as the use of account aggregation services, 'big data' and digital wallets – are in the early stages of development. In relation to SME-specific innovations, these have tended to focus on the digitalisation of banking and reducing customer reliance on branches. When these individual innovations are considered in aggregate, our provisional view is that the extent of innovation in the SME banking markets has lagged behind the levels observed in the PCA markets. This is perhaps best represented by the slower adoption of mobile banking and penetration into the SME banking markets. However, this is likely to be explained, at least in part, by the size of the respective markets rather than any specific bar to innovation.

7. Personal current accounts

Introduction

7.1 As set out in Section 4, we have defined PCAs (with and without overdraft facilities) as a relevant product market, and concluded that GB and NI should be considered as separate geographic markets.[335]

7.2 In this section, we analyse how competition works in the PCA market, and in particular present our assessment of the degree to which there is effective engagement by PCA customers and demand-side response, and how this affects the banks' incentives to compete.

7.3 The remainder of this section is set out as follows.

- First, we present a relevant background and a summary of our analysis of outcomes in the PCA market.
- Second, we summarise indicators on the overall level of customer engagement.
- Third, we consider potential explanations for low customer engagement and assess whether there are barriers to shopping around and switching accounts within the access, assess and act framework.
- Fourth, we investigate whether there are particular segments of customers who are more engaged and what their characteristics are.
- Fifth, we summarise our findings on customer engagement and set out how this might affect banks' incentives to compete.
- Sixth, we consider the banks' competitive strategies.
- Seventh, we discuss whether PCAs act as a gateway product.
- Finally, we present our provisional conclusions.

7.4 In addition, the following appendices support the analysis described in this section.

- Appendix 7.1: PCA switching process and multi-banking.

[335] In this section we consider both geographic markets together as our analysis is similar for both GB and NI, and we did not identify any significant differences.

- Appendix 7.2: Quantitative analysis of searching and switching in PCAs.
- Appendix 7.3: PCA transparency.
- Appendix 7.4: Actual versus perceived behaviour of PCA customers.
- Appendix 7.5: PCA overdraft customer characteristics.
- Appendix 7.6: Banks' competitive PCA strategies.
- Appendix 7.7: Cross-product holdings.
- Appendix 7.8: Dutch retail banking market case study.

Background and outcomes

7.5 There were approximately 67 million active PCAs in GB in 2014, and 1.7 million in NI. Around 70% of active accounts in both GB and NI received average incoming monthly payments of more than £500. New account opening in the UK has remained broadly constant since 2011. In 2014, approximately 5.9 million accounts per year were opened in GB and 130,000 per year in NI. The majority of these were standard and reward accounts.

7.6 The most common charging structure for PCAs in the UK is the FIIC model, whereby customers pay no monthly or yearly fees for their PCAs or for the main transactions provided by the PCA such as receiving money, with-drawing cash or making payments. Under this pricing structure, customers are therefore not charged directly for usage of PCAs as long as they remain in credit, but they pay indirectly through interest foregone on credit balances, and payment for other services, beyond main transactions, such as fees for overdraft usage (arranged and unarranged), paid and unpaid items fees (when overdrawn) and foreign transaction fees.

7.7 As we set out in Section 5, there has been product innovation in PCAs over recent years through the development of reward accounts, which offer benefits to customers such as credit interest, cashback on transactions or one-off switching incentives. Reward accounts sometimes charge monthly fees, thereby departing from the traditional FIIC pricing model. Nevertheless, FIIC remains the most common form of charging structure accounting for 74% of active PCAs in 2014.[336]

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[336] This excludes packaged accounts. The figure comprises 62% standard accounts and 12% reward accounts. We note that some reward accounts charge a monthly fee. This fee may be reimbursed on some accounts. Two-

7.8 In addition to the development of fee-paying reward accounts, there have also been developments in overdraft charges in recent years. Some banks have made changes to their arranged overdraft fee structures, and some to their unarranged overdraft fees. Regulatory intervention has played an important role in this area, for example the OFT unarranged overdraft charging scenarios.[337]

7.9 In summary, and as detailed in our analysis of outcomes in Section 5, there have been some positive developments in the PCA market in recent years:

(a) The recent developments in product innovation in PCAs (details in paragraphs 5.107 to 5.108).

(b) The level of innovation in PCA markets, notably around mobile banking and internet banking (details in paragraphs 5.110 to 5.115).

(c) The entry by firms with new business models in the PCA market (details in paragraphs 5.120 to 5.122).

7.10 However, despite these positive developments, we also found that PCA markets in GB and NI remain concentrated with the four largest providers in GB and NI having a combined market share of around 70% in 2014 and an estimated HHI of about 1,550 both in GB and NI. Market shares in the GB PCA market have remained relatively stable during the ten-year period to 2014. Although the largest four banks have collectively been losing market share and other smaller banks have been gaining market share, the absolute increase in market share of the smaller PCA providers remains small.

7.11 The relative stability in market shares is not explained by a lack of differentiation between the banks. Our analysis of how banks compare on quality of service and pricing shows some differences between banks on both measures. As set out in Section 5, we found that banks which deliver a higher quality of service, or those which offer the lowest prices on average, have tended to gain market shares, but at a slow pace.

7.12 Despite positive developments in the PCA market, the relative stability of market shares in response to differences in prices and quality across banks

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thirds of new accounts opened in the UK in 2014 were either standard or reward accounts; nearly 15% were BBAs; and around 2% were packaged accounts. The remainder of new accounts opened were either youth or student/graduate accounts (see Section 4 for further details).

[337] In 2009, an OFT report recommended initiatives to help customers understand and control their own PCAs. In response to the recommendations, the major banks agreed that they would publish information showing how much would be charged in a series of unarranged overdraft scenarios. Further details on this and other aspects of PCA transparency are included in Appendix 7.3.

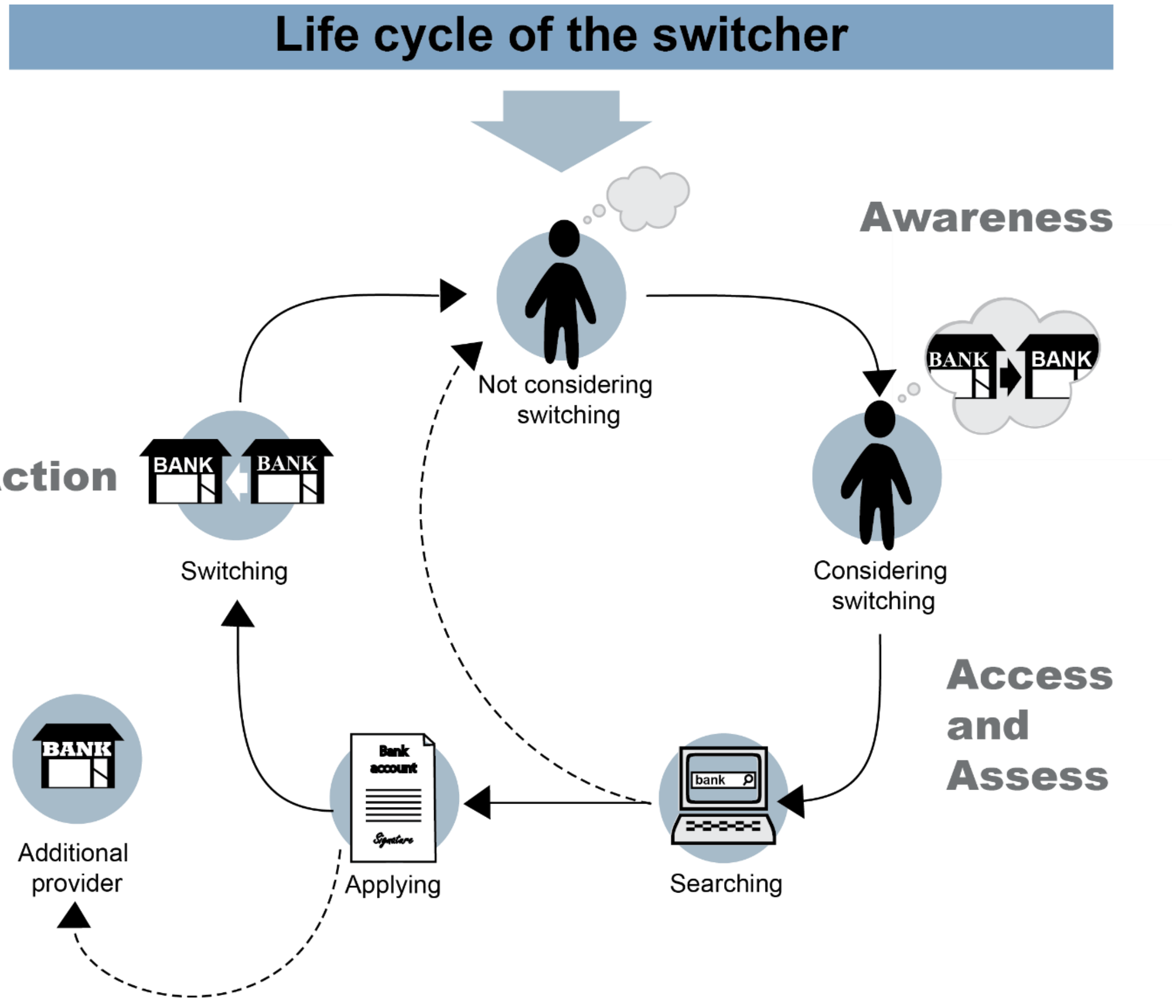
indicates that there is a lack of responsiveness by PCA customers, who would otherwise drive more significant changes in market shares. In a market in which competition is working effectively, many customers are engaged and respond to changes in the price and/or quality of service, which incentivises firms to keep their prices down and the quality of service high because if they do not do so, customers will choose an alternative supplier. If there are barriers that prevent customers from engaging, firms may be able to exploit these barriers and the competition is weakened.[338]

Indicators of PCA customer engagement

7.13 Customers may engage in various ways, from understanding the PCA product they currently hold (eg checking their balance or whether they are overdrawn), to engaging in the market by shopping around (ie accessing information on and comparing various PCAs) and eventually either staying with the current provider or applying for a new account and either switching providers or multi-banking. This is illustrated in Figure 7.1.

[338] *CC3*, paragraph 295.

Figure 7.1: Customer engagement with PCAs



Source: CMA.

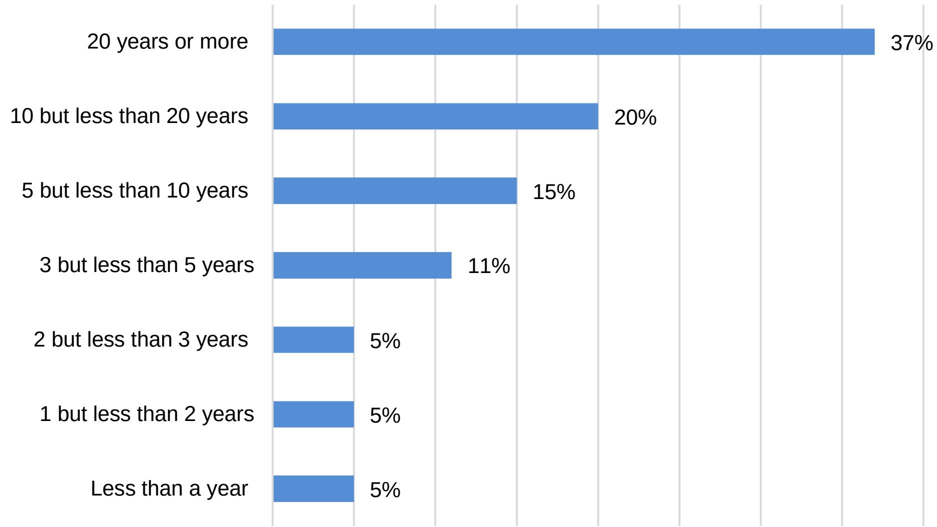
7.14 It is the engagement, searching and switching that we are particularly interested in. We first examine the main indicators of PCA customer engagement and then consider what the reasons for the observed level of engagement are.

Length of relationships with banks

7.15 PCA customers tend to stay with their banks for many years: the GfK PCA consumer survey found that 37% of respondents had been with their main PCA provider for more than 20 years and a further 20% for between 10 and 20 years[339] (see Figure 7.2 below).

[339] GfK PCA consumer survey. Base = all (4,549). B1: 'For how long have you been using this account as your main current account?'

Figure 7.2: Length of time account used as main current account



Source: GfK PCA consumer survey.

Switching and searching rates

7.16 Consistent with this, we also found that rates of switching the customer's main account between banks were low. Appendix 7.1 includes a series of evidence on the annual rate of PCA switching based on volume and value measures, and all of these indicated annual switching rates of around 3%.

7.17 The GfK PCA consumer survey found that, over the past three years, 8% of PCA customers had switched banks. The annual switching rate between banks in 2014 was around 3%. As can be seen in Figure 7.3, the GfK PCA consumer survey found that, in 2014:

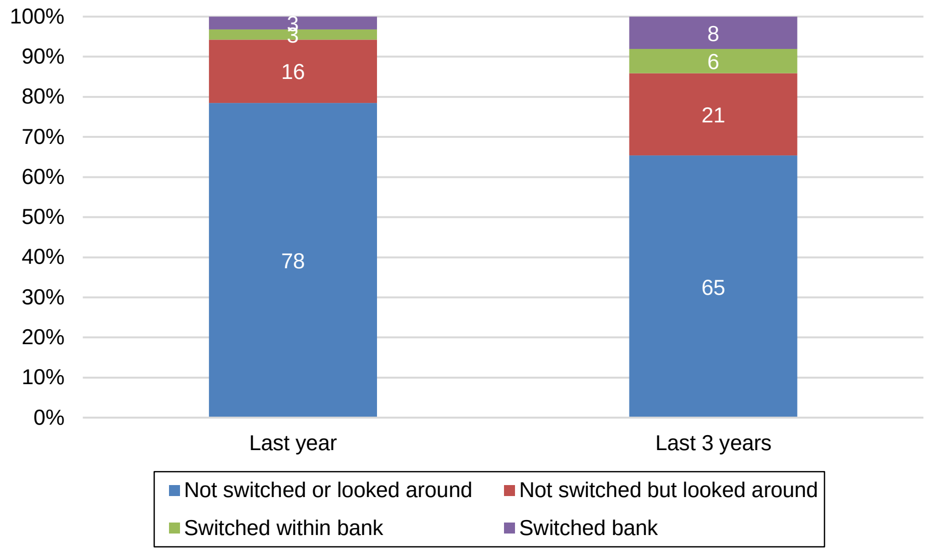
(a) 78% of PCA customers had neither searched around nor switched;

(b) 16% of PCA customers had searched but did not switch;

(c) 2.5% of PCA customers had switched PCA accounts within their existing bank;

(d) 3% of PCA customers had switched PCA accounts to a different bank.

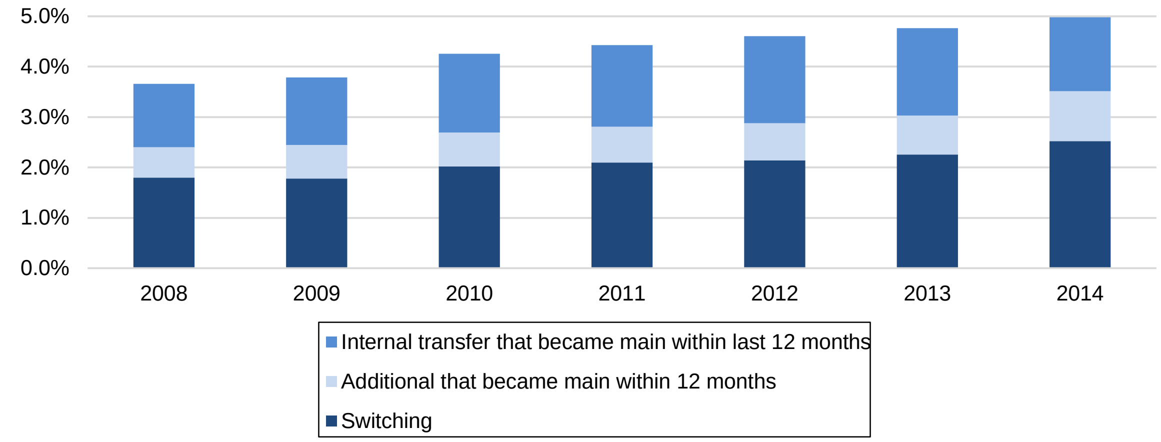
Figure 7.3: GfK PCA consumer survey – summary of searching and switching behaviour



Source: GfK PCA consumer survey.
Note: Figures calculated from F1–F4. Base=All (4,549).

7.18 The GfK FRS provides switching data in GB over time. As shown in Figure 7.4, the annual rate of switching for GB main accounts has increased over time, but at a slow pace. GfK FRS data shows that switching rates (not including internal transfers or opening additional accounts) increased from 1.8% in 2008 to 2.5% in 2014.

Figure 7.4: GfK FRS data: percentage of main accounts over time – GB



Source: CMA analysis based on GfK FRS data.
Note: GfK FRS asked customers who had a current account opened in the last 12 months which of these statements best describes what they did when they opened their account: (i) 'I switched my main current account from another bank or building society'; (ii) 'It replaced an existing account held with the same bank/ building society'; (iii) 'It was taken out as additional to my main current account'; (iv) 'It was my first ever current account'; (v) 'Although I had had a current account in the past I no longer held one at the time I opened my account'; (vi) 'Other'; 'Don't know'. Data is reported for all accounts and those which customers classify as their main account. We report figures in relation to customers' 'main' accounts.

7.19 Some banks submitted to us that:

(a) there was no benchmark against which to assess whether switching rates were low;

(b) switching rates between banks underestimated the overall constraint imposed by customers on PCA providers, because internal switching should also be taken into account; and

(c) many customers were multi-banking, defined as holding a number of PCAs with different banks, which often represents a form of 'hidden switching' and increases the competitive pressure on banks.

7.20 We consider these arguments below.

Lack of a benchmark

7.21 While we acknowledge that there is no obvious benchmark against which to compare switching rates in banking, the GfK PCA consumer survey showed that switching rates in the last three years in PCAs (8%) were low compared with other areas such as savings (13%) and energy (31%).[340] A European Commission study from 2012 asked customers how many had switched within the last two years and found that UK switching rates were in line with the EU average of 4%.[341]

Internal switching

7.22 The GfK PCA consumer survey found that, in 2014, approximately 2.5% of customers switched internally. This internal switching may be indicative of competitive pressure if banks are improving their offers to existing customers in order to retain them. However, the GfK PCA consumer survey indicated that the large majority of internal switchers did not search prior to doing so (73%), whereas the large majority of those who switched to another bank did search (72%). Since many of the customers will not have searched for the best deal before switching internally, and this switching does not result in banks losing customers, internal switching is likely to impose weaker competitive constraints on banks than switching to other banks.

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[340] See Appendix 7.1 for more details.

[341] A 2012 study by the European Commission found that the number of UK customers switching in the previous two years was close to the EU average. Directorate-General for Health and Consumers (2012), Bank fees behaviour study. Statistics based on switching rates in the UK (4%), Germany (3%), Italy (5%), Spain (6%), France (3%), Ireland (4%), Latvia(2%) the Netherlands (2%), Romania (8%) and Sweden (4%). It is important to note that different member states operate under different banking structures and markets may have changed since 2012.

Furthermore, even taking into account internal switching, switching rates are less than 6%.

Multi-banking

7.23 Some banks have argued that many customers, rather than switching, are increasingly opting to 'multi-bank' and this should be taken into consideration as it will often represent a form of 'hidden' switching.[342] The GfK PCA consumer survey found that a considerable proportion of UK customers (22%) hold more than one PCA account with different providers and actively use them. GfK FRS data shows that multi-banking has increased since 2008 from 18% to 21% in 2014[343] (see Appendix 7.1, Figure 9), although the level of multi-banking has remained stable since 2010.

7.24 We agree that multi-banking is relevant in the context of understanding overall switching levels and customer engagement. Multi-bankers may exert a competitive constraint on banks if they are using this activity to shop around for the best deal and open new accounts to 'try them out' with a view to potentially switching in the future. Those GfK PCA consumer survey respondents who used at least one other account with a different bank were asked 'Why do you use more than one current account'. The most common reason given was 'to have different PCAs for different purposes' (62%) followed by 'to get better rates, products and deals' (16%) and to have a sole and joint account (15%).[344] When the same sample of GfK respondents were asked a subsequent question on 'Why do you have more than one bank for your current accounts',[345] 26% said it was to get better rates, products and deals.

7.25 The GfK PCA consumer annual switching rates of approximately 3% per year also capture some customers who are multi-banking. We asked whether a customer has switched their main account so the results include customers that still operate an existing account.

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342 Barclays, BoI, HSBC, [✂] and RBS. The volumes of switching must be considered in this context of increased multi-banking which will often represent a form of 'hidden switching'.

343 GfK provided us with data from 2005 to 2014, but told us that there was a step change in the data between 2007 and 2008 as a result of a methodology change in the survey. Therefore, GfK suggested to compare data from 2008 to 2014.

344 Sample base: All who actively use at least one other account with a different bank (1,009). B8a 'Why do you use more than one current account?' We interpreted the response 'to have different PCAs for different purposes' as meaning that customers have different accounts to hold money for different purposes, such as personal spending, household bills, or saving, such as holidays, mortgages, children or other big spending.

345 Sample base: All who actively use at least one other account with a different bank (1,009). B8 'Why do you have more than one bank for your current accounts?'

7.26 Multi-banking was recently investigated by the Social Market Foundation (SMF report)[346] commissioned by LBG. The SMF report considered two types of multi-banking: narrow multi-banking where customers have more than one PCA at two or more banks; and broad multi-banking where customers buy financial services from more than one provider.[347] The report recognises that narrow multi-banking can be expected to have a more immediate impact on levels of competition in the current account market.[348]

7.27 The results from this report on the prevalence and reasons for multi-banking were broadly similar to our own. The SMF report found that 25% of customers have current accounts with more than one bank and 20% of customers use them actively, compared with 31% and 22% of GfK PCA consumer survey respondents.[349] The SMF report found that the most common (57%) reason for using more than one current account provider was to manage finances, compared with the GfK PCA consumer survey finding that 16% of active multi-bankers use more than one bank for their accounts, because they have accounts for different purposes.[350] The SMF report found that over a third of customers are using more than one account to seek value,[351] which compares to the GfK PCA consumer survey's 26% of active multi-bankers who were using multi-banking to take advantage of good offers.[352]

7.28 We agree with the SMF conclusions that multi-banking may lead to benefits for customers by allowing them to observe directly differences between the price and service levels of banks.[353]

7.29 Multi-banking also reduces barriers to searching and switching. When customers hold more than one account, it increases the transparency of price and service attributes across different banks. Customers will be more

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[346] Social Market Foundation (July 2015), *Playing the Field: Consumers and Competition in Banking*, consulted 28 September 2015.
[347] ibid, p8.
[348] ibid, p8.
[349] ibid, p9.
[350] ibid, p9. The collective term 'Managing finances' refers to consumers who use current accounts at multiple providers for at least one of the following reasons: to help keep track of payments or direct debits; to keep household and personal expenses separate; one is a shared account with a partner or housemates; one is for my business; one is for a club or charity; one is a betting account. This includes a wider range of possible responses from surveyed customers than the collective term used in the GfK PCA consumer survey. We interpreted the response 'to have different PCAs for different purposes' as meaning that customers have different accounts to hold money for different purposes, such as personal spending, household bills, or saving, such as holidays, mortgages, children or other big spending. The difference in defining these collective terms may explain the difference in the reported figures in the SMF report and the GfK PCA consumer survey.
[351] SMF report, p9.
[352] The statistics are based on active multi-bankers, who are customers that actively use at least one additional PCA with a different provider. The statistics of the SMF report are based on a wider sample of customers who have additional PCAs with more than one PCA provider.
[353] SMF report, p8.

familiar with the products and services offered by other banks, particularly where these cannot be experienced without being a customer. Customers can also more easily move between different banks when they already have a relationship with more than one provider. This is because identification verification and credit references may be reduced.

7.30 In summary, we agree that multi-banking can be used by customers to shop around for the best deals and to 'try before you buy'. Multi-banking is also likely to reduce some barriers to searching and switching, however we consider that currently the competitive impact may be limited because:

(a) most multi-bankers have additional accounts in order to use them for different purposes;[354]

(b) less than a third (26%) of multi-bankers use different banks to take advantage of better deals;[355] and

(c) multi-banking rates appear to have levelled off in recent years.

Potential explanations for low customer engagement

7.31 There are many possible explanations for the observed low levels of customer engagement in the market and the associated low levels of searching and switching, and they can all, individually or in combination, drive customer behaviour. Customers may be less engaged with PCAs because they:

(a) lack natural trigger points to do so;

(b) are satisfied with their bank and see no reason to change;

(c) believe that there is not much to be gained from switching as:

(i) PCAs are free or low cost for many customers;

(ii) customers cannot estimate the potential gains, as they lack awareness of their own usage of PCAs; or

(iii) they believe that there is no or small difference between banks;

[354] GfK PCA consumer survey. Sample base: All who actively use at least one other account with a different bank (1,009). B8a: 'Why do you use more than one current account?'.
[355] GfK PCA consumer survey. Sample base: All who actively use at least one other account with a different bank (1,009). B8: 'Why do you have more than one bank for your current accounts?'.

(d) encounter barriers to accessing the relevant information and assessing which offer is best suited to their usage; and/or

(e) encounter barriers to switching accounts.

Lack of natural trigger points

7.32 PCAs are ‘evergreen’ products (ie there is no contract end date), which means that there are few, if any, natural trigger points for customers to consider searching for and switching PCAs. Some parties have submitted that life events, such as moving house and getting a mortgage are potential triggers increasing the probability for customers to search and switch.[356] Our quantitative analysis of searching and switching behaviour (presented in Appendix 7.2[357]) found no evidence that such life events had a significant effect on customers’ propensity to search and switch.

Satisfaction

7.33 Low rates of switching may not be a concern if they reflect the fact that customers are already getting good outcomes. If customers do not switch because they are satisfied with their banks in an informed manner (ie because they have sufficient information to lead them to think that they are indeed getting good value from their bank), low levels of switching may not reflect a lack of customer engagement and may be consistent with a well-functioning market. In such a market the threat of switching (should customers find that they are not getting good value for money any more, or that they could get better deals elsewhere) is sufficient to impose a strong competitive constraint on banks.[358]

7.34 A high proportion of respondents to the GfK PCA consumer survey said that they were satisfied with their main current account provider, with 52% and a further 39% stating that they were ‘very satisfied’ and ‘fairly satisfied’ respectively. Customers who had not switched were asked an unprompted question about the reason why they had not considered switching supplier. The most commonly mentioned reason was that they were happy with their

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[356] [✂]

[357] We used anonymised customer information from two sources: the results of the GfK PCA consumer survey and current account usage data provided by the banks. We also used information on branch locations provided by the banks. This information allowed us to compare searchers and switchers with non-searchers and non-switchers on a variety of dimensions including their demographic characteristics, their beliefs and perceptions, and their use of their PCA.

[358] Many banks told us that the observed low switching rates should be seen in the context of high levels of reported customer satisfaction, and that the low switching rate was entirely consistent with a well-functioning market. However, Nationwide told us that undue emphasis should not be placed on high levels of reported customer satisfaction.

current supplier (51%), while ‘no reason to change’ (22%) was mentioned as the second most common reason.[359] These results could therefore suggest that customers are already getting good outcomes, and the threat of switching is sufficient to impose a constraint on banks.

7.35 However, there is evidence that, even though many customers said that they did not switch because they were satisfied, they may simply not be aware of alternatives available to them and therefore be able to verify whether indeed they have the best product and service for them:

(a) The low level of searching (with only 18% searchers in the GFK PCA survey sample) suggests that many customers may not necessarily be aware of the alternatives that are available to them.

(b) Our analysis of financial benefits from switching (see Appendix 5.4), which need to be interpreted carefully, shows that there are financial gains from switching for PCA customers. It found that the average monthly saving per customer from switching would be approximately £6 for standard accounts.[360] Heavier overdraft users gain more from switching: a monthly saving of approximately £11 per month for customers in overdraft for 8 to 14 days a month and approximately £22 for 15+ days in overdraft a month.[361] The saving for customers in credit is lower than the average, ranging from just over £2 to over £4 per month. Although we do not expect that all financial gains from switching can be realised in a well-functioning market, in particular given that quality of service is also important to PCA consumers, the magnitude of the potential financial gains from switching does cast doubt as to whether most consumers have sufficient awareness of alternatives available.

Perception of limited or no gains from switching

7.36 As noted above, there are a number of factors that may limit customers’ incentives to engage in the market and stop them considering searching and/or switching. We consider them in more detail below.

[359] GfK PCA consumer survey. Base = All those who have not changed accounts and not looked around (2,781). F9: ‘You said that you have not changed your account. Why have you not considered changing your current account in the last three years?’
[360] These figures include switching incentives and assume the accounts are held for five years. Based on the average of the five best products.
[361] A monthly saving of approximately £5 for those in overdraft for 1 to 7 days a month.

PCAs are free or low-cost

7.37 PCAs are a low-cost product for many customers: the majority of PCA providers operate a FIIC pricing model and do not charge for the most common sterling transactions. Based on the anonymous transaction data from the banks we estimated that 54% of PCA customers did not incur charges for usage of their PCA in the last quarter of 2014 and 46% incurred charges.[362,363] The most common source of charges were overdraft charges: 28% of customers paid for an overdraft in the last quarter of 2014.[364]

7.38 Figure 7.5 shows the proportion of customers who have incurred different types of account charges.

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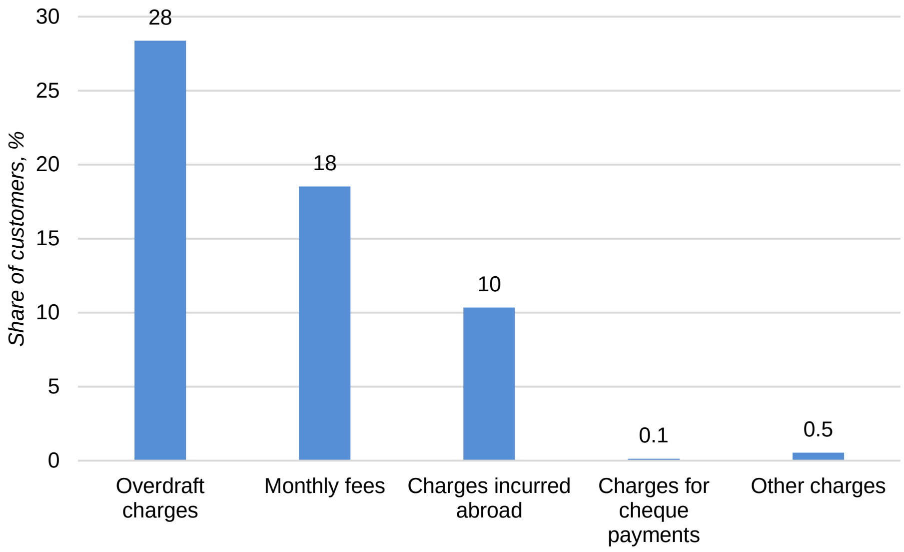
[362] CMA analysis based on banks' transaction data (sample base: 70,798) in Q4, 2014. The estimate includes interest and non-interest charges paid for an overdraft, interest and non-interest charges paid for usage of debit cards and ATMs abroad, charges relating to cheque payments, charges relating to other payments, and monthly account fees as at the end of 2014. The point in time when charges have been paid may differ from the point in time when charges have been incurred. We excluded observations where the account was opened past December 2013 and observations with missing values for any of the charges in the transaction data. Banks for which a full data set of charges was available include BoI, BoS, Clydesdale, First Direct, Halifax, HSBC, Lloyds, Nationwide, RBS, Santander, TSB, NatWest, Yorkshire, and M&S Bank. We refer here to 'customers' for simplicity when considering transaction data. However, transaction data contains a sample of accounts rather than customers. Therefore, for customers who hold more than one PCA, we do not observe all their activity but only that associated with the account included in our sample. For example, a customer may have two accounts and only incur charges on one of them, while the chances for any of the two accounts being in the sample are the same. As the transaction data includes accounts that are used as secondary accounts, we sensitivity-checked the results by considering only the main accounts as indicated by surveyed customers. The sensitivity results were broadly the same as the results in the main analysis.

[363] We could only conduct this analysis for Q4 2014 due to data limitations. On an annual basis, the percentage of consumers incurring charges would be higher, as some consumers will make fee paying transactions (eg overdrafts, use of debit card abroad) only in certain months. For instance, some banks have provided us with data on overdraft charges for the whole of 2014. Using the whole year data for this sample of banks we find that 41% of customers incurred overdraft charges in 2014 in contrast to 29% in the last quarter. Therefore it is likely that, over a whole year, the overall proportion of consumers incurring some charges would be substantially higher than 46%.

[364] CMA analysis based on banks' transaction data (sample base: 71,093) in Q4 2014.

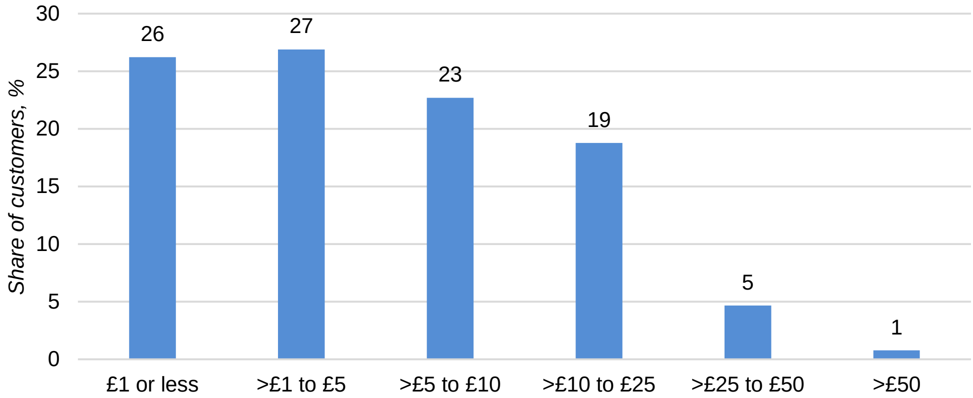
Figure 7.5: Distribution of customers who incurred different types of charges in Q4 2014



Source: CMA analysis based on banks' transaction data.
Sample base: Overdraft charges (71,093); monthly fees, charges incurred abroad, charges for cheque payments, other charges (70,823).

7.39 Figure 7.6 below shows the distribution of the 46% of customers who incurred charges in the last quarter of 2014. Most of these customers (76%) paid low or very low fees, of less than £10, to use their PCA in the analysed three-month period.

Figure 7.6: Distribution of customers who incurred charges in Q4, 2014



Source: CMA analysis based on banks' transaction data (sample base: 32,379).

7.40 Some parties submitted to us that the FIIC pricing model reduced engagement and transparency. We therefore examined whether the FIIC model reduces customers' incentives to shop around.

7.41 Examples of what the parties told us are as follows:

(a) Community Investment Coalition told us that FIIC led to lack of genuine transparency and comparability, thus discouraging people from engaging with switching process.

(b) RBSG told us that the FIIC model reduced the incentive to switch by giving rise both to customer perception that there is little to gain from switching and to a lack of actual gain from switching (particularly in a very low interest environment).

(c) Santander told us that 'free' banking potentially perpetuated lower customer engagement as customers might not perceive the cost of forgone interest, for example, as an expense in the same way as paying a monthly fee and therefore how much they would lose or gain by switching accounts.

(d) Tesco told us that FIIC prevented a real assessment of value.

7.42 In contrast, Barclays told us that the FIIC model promoted multi-banking, which might increase consumer engagement and LBG asked whether FIIC might give customers an ability to 'try before you buy' and so remove some of the uncertainty about different providers, which could encourage multi-banking. Consistent with this, multi-banking levels are lower in the Netherlands, where customers typically pay a fee for their account. In the Netherlands there are 1.16 PCAs per adult[365] whereas the level of multi-banking in the UK, as indicated by the GfK PCA consumer survey, is 1.8 per adult.[366]

7.43 We considered comparative evidence on switching levels to examine whether the FIIC model was related to lower switching levels. The evidence was mixed.

7.44 The GfK PCA consumer survey found that more customers who pay a monthly fee looked around for a PCA in the last three years (35%)[367] and in the last year (24%)[368] compared with customers who have an FIIC PCA (25% and 18% respectively). Additionally, more customers who pay a

[365] Appendix 7.8, paragraphs 21 & 22.
[366] CMA analysis of GfK PCA consumer survey. 52% of consumers have one PCA, 29% have two PCAs, 12% have three PCAs, 5% have four PCAs, 2% have five or more PCAs (sample base: 4,510). Note that this statistic only contains consumers with at least one PCA, and excludes consumers who do not have a PCA, which may be part of the reason why we observe a higher number of PCAs per adult in the UK than in the Netherlands.
[367] Sample base: PCA with monthly fee (792), FIIC PCA (3,581), whole sample (4,373).
[368] Sample base: PCA with monthly fee (788), FIIC PCA (3,576), whole sample (4,364).

monthly fee (21%) switched in the last three years compared with customers with an FIIC PCA (12%).[369]

7.45 However, the increased searching and switching activity of customers who pay a monthly fee may relate to these customers being considerably less satisfied with their account than customers of FIIC PCAs. Table 5 in Appendix 7.3 shows that the majority of the most common fee-paying accounts per bank are packaged accounts. According to data from the Financial Ombudsman Service (FOS), complaints in relation to packaged accounts have increased from 5,667 in March 2014 to 21,348 in March 2015 by 278%. In comparison, complaints about all types of current accounts increased by only 78% from 19,878 in March 2013 to 35,344 in March 2014.[370]

7.46 As we set out above, in the Netherlands, customers typically pay for their account. However, switching rates do not appear to be higher in the Netherlands compared with the UK. The Authority for Consumers and Markets (ACM)[371] commissioned a survey, which found similarly low engagement levels in the Netherlands. For example, that 73% of all Dutch consumers who are 18 years old or older have never voluntarily switched banks, while 24% have done so only once.[372]

7.47 Research submitted by Barclays, which was conducted in 2013, showed that the UK was unique in offering FIIC standard current accounts in 2012; only US credit unions and one major player in Australia offered FIIC PCAs. It concluded that switching rates in the UK were 'amongst the lowest in the world' in 2012.[373] However, it found that different switching rates were affected by the degree of labour mobility and marketing intensity in the country.

7.48 In addition, 2012 data from the European Commission did not suggest that the UK switching rates are consistently lower than other EU countries despite other EU countries not operating a FIIC model: EU commissioned research found that the percentage of UK customers switching was close to the EU average of 4%.[374]

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369 Sample base: PCA with monthly fee (794), FIIC PCA (3,587), whole sample (4,381). Note that the sample size for customers who pay a monthly fee was too small to analyse differences in 'switching within the last year' to make statistically meaningful comparisons between the two subsamples.
370 Financial Ombudsman (2015), Annual review of consumer complaints, p46.
371 ACM is the primary competition authority in the Netherlands, providing consumer protection and market oversight.
372 ACM (2014), p76. See Appendix 7.8 for more details.
373 [✂]
374 Bank fees behaviour study conducted by TNS at the request of Directorate-General for Health and Consumers.

7.49 Overall, therefore, there is no strong evidence to suggest that the FIIC model, in itself, is the reason for low switching rates and other countries where customers pay for their accounts also experience similarly low rates. Whether or not through FIIC, PCAs are generally low cost to customers, which impacts on low customer engagement.

Awareness of own usage

7.50 Even for those who do pay for PCAs, such as overdraft users, lack of awareness of their usage of overdraft may limit incentives to shop around as they cannot estimate the potential gains. Customers may not even think about searching for a product offering better terms for overdraft users if these customers think that they do not use an overdraft or believe that they use it much less than they actually do. We conducted an analysis comparing overdraft users' perceptions of their usage of overdraft with their actual usage, a summary of which is discussed in detail in paragraphs 7.12083 to 7.84, and a full analysis included in Appendix 7.4. This analysis indicates that 39% of overdraft users were not aware that they had gone into overdraft or of the charges applied to their account. This discrepancy between actual and perceived usage suggests that there is a lack of understanding and engagement among overdraft users. With limited awareness of the fact that they use overdrafts, these customers will have limited incentives to shop around, even though they incur charges for overdraft usage and are those who would potentially have the strongest financial gains from switching (see Appendix 5.4 for more details).

Perception of no or small difference between banks

7.51 Along with the lack of awareness of potential gains from switching, the perception by customers that there is no differentiation between banks may also reduce incentives to engage. PCA customers, in order to consider switching, need to expect benefits from switching, either by receiving a better quality of service or a cheaper service (or a combination of both).

7.52 The GfK PCA qualitative research found that some respondents viewed PCAs as generic products that had little differentiation.[375] Tesco research found that 43% of current account holders thought that PCAs were all the

[375] The GfK PCA qualitative research was intended to amplify the quantitative findings, and in particular to get in-depth opinions from groups of particular interest. It was not designed to represent the whole population of PCA holders in the way that the GfK PCA quantitative survey was, but instead to concentrate on a small number of key demographic and behavioural groups. Forty-three 1-hour face-to-face interviews were conducted.

same, and a further 42% saw only small differences between them. Research undertaken for RBSG in 2013 also stated that '[✂]'.

7.53 In the GfK PCA consumer survey[376] 49% of respondents agreed with the statement that 'There are real differences between banks in the current accounts that they offer',[377] with the other half of respondents either disagreeing or being indifferent. In 2012 the European Commission found that 'there is low awareness of the potential savings to be made by switching.'[378] [✂].[379]

Barriers to accessing and assessing information

7.54 Lack of customer engagement and low levels of searching and switching may also be caused by actual barriers to shopping around and switching. In this section we consider:

(a) past, current and future initiatives aimed at improving PCA transparency and comparability;

(b) transparency of PCA pricing;

(c) information on customer's own account usage;

(d) transparency of PCA service quality; and

(e) the role of PCWs.

Transparency and comparability initiatives

7.55 The issues of relative complexity of PCA pricing structures and the overall lack of transparency have been raised before. A brief overview of the UK and EU initiatives is provided below.

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[376] GfK PCA consumer survey. Base = all (4,549). H1: 'I am going to read out a number of statements, and I'd like you to tell me how much you agree or disagree with each using the following scale?' Just under half of respondents agreed with the statement (21% agreed strongly and 28% tended to agree) while 22% disagreed (7% disagreed strongly and 15% tended to disagree) with a further 17% neither agreeing nor disagreeing.
[377] This result was similar for overdraft users: 17% neither/nor and 22% disagreed.
[378] Bank fees behaviour study conducted by TNS at the request of Directorate-General for Health and Consumers, p6.
[379] [✂]

- *UK government initiatives and actions*

7.56 The OFT's 2009 report recommended initiatives to help customers understand and control their own PCAs.[380] The initiatives were to introduce an annual summary of the cost of their account for each customer; make charges more prominent on monthly statements; provide average credit and debit balances; and produce illustrative scenarios showing unarranged overdraft charges.

(a) The FCA Occasional Paper on banking behaviour (2015) showed that annual summaries, as designed by the banks, had no effect on consumer behaviour when considering whether they incurred overdraft charges, altered balance levels or switched to other current account providers.[381]

(b) The OFT unarranged overdraft charging scenarios have been introduced by most PCA providers. The 2014 CMA PCA market study found that the charging scenarios did not give a full picture of how charges could be applied, and relatively few consumers used these scenarios to choose between PCAs.[382] Further, our current research has found that some banks' information on the OFT profiles is easier to locate online than others.

7.57 The Consumer Credit and Insolvency Review (2011) recommended initiatives to help customers control their PCAs. These included *(a)* providing customers with text or email alerts; *(b)* increasing customers' awareness of grace periods;[383] and *(c)* introducing a small buffer zone:[384]

(a) The CMA 2014 market study stated that all major PCA providers and a number of smaller providers offered some form of text alert service.[385]

(b) The FCA Occasional Paper on banking behaviour found that signing up to text alerts or mobile banking apps reduced the amount of unarranged overdraft charges incurred by 5% to 8%, and signing up to both services had an additional effect, resulting in a total reduction of 24%. In addition,

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380 These were intended to help consumers: better understand the costs of their PCA, enabling them to make informed choices about how to use their existing PCA more efficiently; and better understand the potential costs of other competing PCAs against the benefits offered, allowing them to assess which provider is the best one for them.
381 FCA (2015), Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour.
382 PCA market study update, pp67 & 68.
383 Where customers can avoid charges by transferring money to balance the account before a set deadline.
384 Where charges are only incurred once a customer has become overdrawn by a certain amount.
385 PCA market study update, p57.

text alerts and mobile banking apps decreased average current account balances by 17% to 24%.[386]

(c) As shown in Appendix 7.3 most banks had implemented the buffer zones (within which unarranged overdraft charges were not levied).

7.58 The Lending Standards Board (2011) report considered opt-outs from unarranged overdraft facilities.[387] The code now set standards for those banks that provide this opt-out. Banks' policies vary on opt-out facilities. Many banks provide this facility but a monthly charge applies.[388] At present only three banks provide this service free of charge.[389]

7.59 The OFT super complaint (2011) on travel money looked into charges for the use of debit and credit cards abroad. The OFT secured the following: consistent terminology; improved presentation of foreign use charges in credit card and personal current account summary boxes; clearer presentation of when charges were cumulative; changes to call centre processes; improvements to website travel pages;[390] clearer presentation of the sterling amount of the exchange rate fee on monthly statements; and annual statements to show the GBP amount of foreign use charges that had been applied.

7.60 The Midata project[391] is a programme of work being carried out by the UK government to give consumers more control over, and better access to, personal data that companies hold about them. More details on the initiative are included in Appendix 3.1 and discussed in paragraphs 7.94 to 7.96 below.

7.61 As set out in Section 3 and Appendix 3.1 the government will set out a detailed framework for an open Application Programming Interface (API) standard by the end of 2015.[392] Using APIs banks could give customers the

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386 FCA (2015), Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour.

387 The Lending Code is a voluntary code of good practice overseen by the Lending Standards Board, which endeavours to monitor credit products.

388 Barclays: customers are able to opt out of Barclays' Agreed Emergency Borrowing facility free of charge; Clydesdale: 'Current Account Control' offers this facility. A £7.50 monthly fee is applicable to Current Account Control; HSBC: Bank Account Pay Monthly only £10 monthly fee; LBG: 'Control' facility £10 monthly fee. Customers in financial difficulties may be given this facility for free.; Santander: £10 monthly fee for Choice current account; TSB: 'Control' facility £10 monthly fee

389 AIB, Nationwide and RBS.

390 Such as accessible links to foreign use charges, worked examples of how foreign use charges apply, and links to historic exchange rate information.

391 Midata.

392 The aim is to increase consumer engagement by making it easier for customers to see where they could get a better deal. It also aims to increase competitive intensity by supporting the growth of technology that can be adopted by banks and non-bank providers to compete to offer new products.

ability to share their transaction data with third parties such as PCWs.[393,394] Some parties told us that they broadly supported the objectives of an open API standard in UK banking.[395] Some believed it would have an impact on the market.[396] However, a number of potential issues have been raised by the industry.[397] In addition, some PCWs have told us they had not factored API development into their business plans[398] and we acknowledge the issues surrounding coordination between banks and implementation of this scheme.

- *EU initiatives*

7.62 Details on EU directives aimed at improving transparency are provided in Section 3 and Appendix 3.1, and we provide a brief summary here.

7.63 The Payment Accounts Directive (PAD) requires EU member states to implement its terms by 18 September 2016. PAD requires member states to give effect to the following provisions:

(a) Fee information – banks will potentially have to provide more detailed information on fees to consumers than is presently the case, and will have to do so in a standardised format.[399]

(b) Comparison website – PAD requires member states to ensure that consumers have access, free of charge, to at least one independent PCW. In the UK, this will be operated by the Money Advice Service.[400]

(c) Payment account switching – banks must put in place a switching service. The UK CASS[401] exceeds the PAD requirements for a switching service.

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[393] Data Sharing and Open Data for Banks: A report for HM Treasury and Cabinet Office, September 2014.
[394] APIs allow two pieces of software to 'talk to' one another and exchange information directly in a secure way, without the need for human input each time.
[395] HSBC, LBG, Payments Council.
[396] LBG, HSBC, Payments Council.
[397] These include data protection – individuals (to whom that data belongs) may not have meaningful control over the exchange of the data between third parties and financial institutions and when publishing more open data it may still be possible to identify individuals from anonymised or aggregated personal data HMT (2015) API – Call for evidence, pp5 & 6.
[398] Defaqto, money.co.uk, Moneyfacts, uSwitch.
[399] The PAD requires each member state to create a standard list of 10 to 20 of the most representative services for which a fee might be applied. These services have to be those that are most commonly used by consumers, or which generate the highest costs for consumers. In June 2015 the FCA published a call for input setting out the UK's submission for the most representative terms.
[400] The UK's independent body charged with enhancing the public's understanding of financial matters.
[401] More details on CASS are included in paragraphs 7.102–7.110.

7.64 The CMA 2014 PCA market study[402] considered PAD to be a positive development but did not believe it would go further than any existing or planned developments in the UK.

7.65 The Payment Services Directive[403] (PSD) established a set of common rules for the payment service providers on the form, content and manner of provision of pre-contractual and ongoing information on payment services. The Directive on Payment Services 2 (PSD2) proposals are aimed at facilitating the use of third party payment service providers, increasing the scope of the current framework and improving transparency and security of payment services.

7.66 PSD2 proposes to introduce new rules aimed at increasing competition by facilitating the use of third party payment services providers. The proposals include an obligation on banks to allow customers who have an online account to use new payment initiation[404] and account information[405] services provided by third party payment services providers. Banks will also be required to provide appropriate access and information to third party payment services providers acting for payers, and to treat payment orders transmitted through the services of third party payment service providers in a non-discriminatory way.

7.67 PSD2 will require all framework contracts to include a condition that the payer may require the information to be provided or made available periodically at least once a month free of charge and in an agreed manner.

7.68 We consider that PSD2, particularly the condition to provide appropriate access and information to third party payment services, will positively impact on the transparency of PCAs.

Transparency of PCA pricing

7.69 The GfK PCA consumer survey asked customers how easy it was to *(a)* find information about the features of different accounts; *(b)* understand the

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[402] PCA market study update, p99.
[403] Payment Services Directive (2007/64/EC).
[404] A payment initiation service is defined as a 'payment service enabling access to a payment account provided by a third party payment service provider, where the payer can be actively involved in the payment initiation or the third party payment service provider's software, or where payment instruments can be used by the payer or the payee to transmit the payer's credentials to the account servicing payment service provider' (the account holder's bank).
[405] An account information service is defined as a 'payment service where consolidated and user-friendly information is provided to a payment service user on one or several payment accounts held by the payment service user with one or several account servicing payment service providers'. This includes services that enable users to have a consolidated view of their online bank accounts.

different current account options available; and *(c)* make comparisons between accounts.[406] Between 65% and 78% of respondents who had not looked around said they expected that it would be very or fairly easy, indicating that consumers considered the searching process to be relatively easy.[407] These particular results should be interpreted with some caution, as we asked consumers to speculate about something that they do not have any experience of.

7.70 The GfK PCA qualitative research provided somewhat different insights stating that when asked about comparability between PCAs 'it became clear that some participants would not know how to go about comparing PCAs (this was discussed theoretically as so few participants had compared PCAs).'[408] Research by Tesco also found that PCA comparisons proved really difficult.

7.71 We carried out a review of the websites of PCA providers to understand the availability of pricing information, finding that in general information on overdraft charges, interest rates, monthly fees and rewards[409] was available. Information on other charges such as foreign transaction charges was less prominent and we had to search for these in leaflets and terms and conditions. Information on unarranged overdraft charges was also less prominent and could be difficult to find.

7.72 Despite the general accessibility of information, we found that customers' ability to assess this information and identify the best-value PCA for their needs was likely to be impaired by the complexity involved in comparing different PCAs. We consider the evidence for this conclusion below.

- *Transparency of account charges*

7.73 Appendix 7.3 provides an explanation of all PCA account charges. The main fees are overdraft fees (representing 34% of PCA revenue), monthly account fees (representing 12% of PCA revenues) and foreign transaction fees

[406] Those who had not looked around were asked how easy or difficult they thought it would be to find about the features of different accounts, to understand the differences between them, and finally to make comparisons between accounts. F11: 'I am now going to read out different aspects of shopping around for current accounts, and I'd like you to tell me how easy or difficult you think each aspect would be if you were to shop around for banks (IF NOT LOOKED AROUND)/you expected it would be before you started looking around to compare different accounts (IF LOOKED AROUND IN LAST 3 YEARS)?'

[407] Between 75% and 78% of respondents who had looked around said they expected that it would be very or fairly easy.

[408] GfK PCA consumer survey report, p61.

[409] Terms and conditions, and overdraft charges. Foreign exchange charges varied with some being contained within terms and conditions.

(representing 5% of PCA revenues). For more information on PCA revenues see Section 5.

- *Overdraft fees*

7.74 Overdraft fees have a complex structure:

(a) Overdraft fees can take a number of different forms which may hinder a customer's ability to calculate the cost. Banks levy a package of charges which may include daily fees, monthly fees and debit interest charged on daily balances. In addition banks may charge an unpaid[410] and/or paid items fee.[411]

(b) Banks apply different pricing structures, making a like-for-like comparison across providers difficult. As shown in Table 7.1 below banks have different approaches to their overdraft charging and different combinations of fees. This variation across providers applies to both arranged and unarranged overdrafts structures.

(c) Banks have different fee policies in place, adding further complexity. Banks vary in whether they provide buffer zones, whereby charges are only incurred once a customer has become overdrawn by a certain amount; grace periods to balance the account before a set deadline to avoid charges; and fee caps on paid and unpaid item fees.

(d) Overdraft charging structures have also changed over time. Appendix 7.3 provides details on how banks amended their overdraft proposition between 2011 and 2014.

7.75 More detail on the complexity of the banks' different overdraft charging structures is provided in Table 7.1 below.

[410] Unpaid item charges charged for each item that is returned unpaid by the PCA provider.
[411] Charged for each item that is paid by the PCA provider that leaves the customer in, or extends the overdraft.

Table 7.1: PCA providers’ overdraft charging structure*

		Arranged overdraft			*Unarranged overdraft*				
	Account name	***Daily fee***	***Monthly fee***	***Debit interest (EAR)***	***Daily fee***	***Monthly fee***	***Debit interest (EAR)***	***Unpaid item***	***Paid item***
UK/GB PCA brands									
Barclays	Bank account	£0.75 if >£15–£1,000, £1.5 if £1,000–2,000, £3 if £3,000–£5,000. Emergency Borrowing†: if more than £15, first 7 days £5, then £0.75–£3 as for an arranged overdraft	–	–	–	–	–	£8	–
Clydesdale	Current account plus	–	£6	18.85%	£6‡	–	–	£15	–
Co-op	Standard current account	–	–	18.9%	£10	£10	18.9%	–	–
HSBC	Bank account	–	–	19.90%	£5	–	19.90%	–	–
First Direct	1st account	–	–	15.9% if >£250	£5	–	15.9% if >£250	–	–
M&S Bank	Current account	–	–	15.9% if >£100	–	–	–	–	–
Lloyds	Classic	–	£6	19.94% if >£25	£5 if >£10–£24.99 £10 if >£25	£6	19.94%	£10	–
BoS	Classic	–	£6	19.94%	£5 if >£10–£24.99, £10 if >£25	£6	19.94%	£10	–
Halifax	Current account	£1 if >£10–£1,999.99, £2 if £2,000–£2,999.99, £3 if >£3,000	–	–	£5	£10	–	£10	–
Metro	Current account	–	–	15%	–	–	15%	£10	£10
Nationwide	Flex Account	–	–	18.9%	–	–	18.9%	£15	£15
RBS	Select	–	£6	19.89%	£6	–	–	£6	–
NatWest	Select	–	£6	19.89%	£6	–	–	£6	–
Santander	Everyday	£1 if >£12	–	–	£6	–	–	£10	£10
TSB	Classic		£6	19.94% if >£25	£5 if £10–£25, £10 if >£25	£6	19.94%	£10	–

	Account name	Arranged overdraft			Unarranged overdraft			Unpaid item	Paid item
		Daily fee	***Monthly fee***	***Debit interest (EAR)***	***Daily fee***	***Monthly fee***	***Debit interest (EAR)***		
NI-focused brands									
AIB/First Trust Bank	Classic account	–	£15	base rate + 12%	–	£15	Arranged overdraft debit interest rate + excess interest 1.5% a month (minimum £2)	£25	£22
BoI/Post Office	Standard account	–	–	14.9%	–	–	14.9%	£15	£15
Danske	Choice	–	£12 if >£100	16.06%	–	£25 if >£5	22.54%	£28	£25
Ulster¶	Current account	–	–	14.88%	–	£20	21%	£10. £15 'Paid Referral Fee' if transaction >£15#	–

Source: Information provided by banks.
* Charges listed in the table may differ for certain subgroups of customers (eg for student, graduate, higher education or staff accounts).
† Barclays does not offer an unarranged overdraft, but offers Emergency Borrowing. Emergency Borrowing lets customers borrow an extra arranged amount if they need to go over their overdraft limit once in a while.
‡ Please note that the unarranged overdraft fee is only charged per working day (ie Monday–Friday excluding weekends and bank holidays).
§ TSB Unauthorised Borrowing Fee (UBF): the first time a customer enters an unarranged overdraft by £50 or more, a UBF of £15 is chargeable. After that, the UBF is chargeable every time the customer increases the unarranged overdraft by £50 or more from the previous day's closing balance, unless a higher limit is agreed, or until the account is within its existing limit or in credit. The UBF is charged a maximum of once a day.
¶ Ulster Bank is in the process of aligning its product offering with RBS.
#I f the transaction (of whatever amount) creates an unarranged excess of more than £15 at the end of the day in question the fee will be levied. This is also a 'per day fee' with a cap of £90 per charging period.

7.76 This complexity is reflected in the FCA Consumer Credit research.[78] It found that, despite the introduction of transparency initiatives, the terms set by PCA providers for overdrafts can be so complex and opaque that 'even the most astute customer could struggle to understand what they are paying for.' Qualitative consumer research commissioned by the FCA as part of that work found that there was a lack of understanding about overdrafts and widespread confusion about what happens when customers exceed their arranged overdraft. It found that there was a widespread perception that, as long as customers remained within the agreed limit, then the overdraft was free, with little or no understanding of interest being charged on any balance.[79]

- *Monthly account fees*

7.77 A relatively small proportion of PCAs charge a fee. Packaged accounts typically charge monthly fees for additional benefits such as travel insurance, breakdown cover and mobile phone insurance. Some reward accounts also charge a monthly fee, some of which are waived if the customer meets specific conditions. Table 5 in Appendix 7.3 provides details on these charges. Our research showed that monthly fees were relatively transparent and well-advertised.[80]

- *Foreign transaction fees*

7.78 Foreign transaction charges comprise cash and transaction fees, with different banks levying different minimum and maximum charges (see Appendix 7.3). Foreign transaction charges are not prominently advertised, which hinders comparability.

- *Transparency of account rewards*

7.79 The number of reward accounts being launched on the market has increased and the GfK PCA consumer survey showed that 28% of respondents stated that benefits were an important feature of their account. Customer rewards can take different formats, including higher rates of interest, joining incentives and cashback. Table 7 in Appendix 7.3 provides a

[78] FCA press release (10 April 2014): FCA research shows many customers paying too much for overdrafts.
[79] FCA (7 April 2014), Consumer Credit Qualitative Research: Credit Cards & Unauthorised Overdrafts, pA20.
[80] While the initial price is transparent customers may not necessarily know whether these will change. For example, Santander's 123 account monthly fee will increase from £2 to £5 from January 2016. Santander announced this change in September 2015. Santander announcement, consulted 19 October 2015.

comparison of some reward accounts on offer and a comparison of different incentives in place.

7.80 Although rewards appear to be well advertised, we found that there were three main factors that could hinder comparisons between PCAs offering rewards:

(a) Eligibility criteria for rewards differ between banks. For example, some accounts require customers to have minimum inflows into the account and a minimum number of direct debits.

(b) Where interest rates apply, the rate received can vary for different income ranges.[81] In addition a minimum balance may be required. The variation in interest rate thresholds and rates makes it particularly difficult for customers to compare. This feature is particularly relevant for customers with high credit balances.

(c) There is a wide range of other offers available such as switching incentives, cashback on various items and interest on balances. Switching incentives are changed by banks over time and may be only applicable for a full account switch when using CASS. In regard to cashback incentives, their levels vary depending on the third party (eg utilities) and such variation can make it difficult to calculate expected benefits.

7.81 Overall, although rewards appear to be well advertised a comparison requires complex calculations on account usage to work out which PCA offers the best value for the customer.

Information of customer's own usage

7.82 In order for a customer to choose the best-value PCA product they need not only to understand the account charges and rewards that will be applied, but also to be able to access and assess their expected account usage. For example, customers who use overdrafts will need to assess the expected likelihood, length and size of future overdrafts, and customers who travel abroad will need to assess their expected foreign exchange charges.

7.83 We examined customers' perceptions of their account usage, using the results of the GfK PCA consumer survey, and their actual behaviour using transaction data provided by the banks in order to help assess whether

[81] Interest rates can also vary in relation to the length of time applicable. For example, high interest rates are sometimes only introductory offers.

customers were aware of their account usage and the associated charges and benefits. Further details are provided in Appendix 7.4. We found the following:

(a) 39% of overdraft users were not aware that they had gone into overdraft.

(b) Many customers did not assess their usage of overdrafts correctly and more often underestimated than overestimate their usage. Approximately half of the customers who used overdrafts correctly estimated the number of months they used overdrafts; 38% correctly estimated the average number of days in overdraft; and 27% correctly estimated the range within which their debit balance lay.[82]

(c) 50% of customers estimated their overdraft charges correctly within +/- £5, with a slight tendency, for the 50% of customers who did not estimate overdraft charges correctly, towards underestimating their charges. Only a small percentage of customers, however, stated that their charges were considerably different from what they were.[83]

(d) Most customers (approximately 90%) knew whether they had an overdraft limit, and 57% of overdraft users who had an arranged overdraft limit knew exactly what their limit was. Customers who did not know their limit tended to underestimate rather than overestimate their limit.

(e) 60% of customers correctly knew whether they received any revenues on their credit balances, while over one-third falsely thought that they received revenue while they actually did not.

(f) There was no evidence to suggest that customers with particular characteristics were consistently better at evaluating their usage, limits, charges and credit interest.

7.84 As a result of this, some customers may be incurring costs inadvertently or perceiving the overall cost of their PCA to be lower than it actually is. This discrepancy between actual and perceived overdraft usage suggests that there is a lack of understanding and engagement among overdraft users. With limited awareness of their overdraft use, these customers will have

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[82] The reported share of customers who correctly estimate the number of months and average number of days in overdraft is within a margin of error of two months and three days respectively. The bands were: £50 or less, £51–£100, £100–£200, £200–£500, £500–£1,000 and £1,000 or more.

[83] Due to a larger measurement error in responses to the survey question about charges, the findings on charges are less reliable than other findings. See further details in Appendix 7.4.

fewer incentives to shop around, and even if they do shop around, it may make it more difficult to assess the different offers and identify the best PCA.

7.85 Banks told us that among certain customer groups the increasing digitalisation of banking had already increased levels of customer engagement with their own account.[84] Customers can currently access information on their account transactions, therefore assess their usage, by different distribution channels including through internet and mobile banking.

7.86 Appendix 5.6 provides details on the development of internet and mobile banking. For example, the British Bankers' Association estimated that there were 9.6 million daily logins to internet banking services in March 2015.[85] The use of mobile banking is also increasing at a rapid pace, however the overall usage still remains limited (eg 27% of UK adults were using mobile banking in 2014).

7.87 Mobile banking applications are provided by all of the largest banks in the UK (Barclays, HSBCG, LBG, RBSG and Santander). The core services provided by mobile banking applications (apps) typically include account checking services; money transfer and payment services; ATM location services; personalised alerts; and loan and service requests. The FCA Occasional Paper on banking behaviour[86] found that mobile banking apps positively affected how customers manage their money and found, for example, that they reduced unarranged overdraft charges by 8% on average, while using text alerts and mobile banking apps together led to an average decrease by 24%.[87] Furthermore, the FCA found that mobile banking apps reduced monthly average current account balances by 17%.

7.88 We consider that the increasing digitalisation of banking, through internet and mobile banking, has indeed facilitated access to information on customers' account usage, and this continued trend will enhance customer engagement with their own account.

Transparency of PCA service quality

7.89 The GfK PCA consumer survey suggests that customers value service attributes, with approximately 80% of respondents citing 'quality of staff and

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[84] [✂], HSBC, Danske, LBG, RBS, TSB.
[85] See Deloitte innovation report, p4.
[86] FCA (2015), Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour.
[87] Based on data from a sample of customers from one bank analysed by the FCA.

customer service' and 'handling problems' as essential or very important features of their account.[88]

7.90 However, our research showed that there was limited readily available information on this topic beyond reports from Which?[89] and MoneySavingExpert.com, for example.

7.91 In addition, 85% of respondents to the GfK PCA consumer survey told us that they trusted their own bank to treat people in a fair and honest way, while less than half trusted other banks.[90] This suggests that the perception of a bank's trustworthiness stems mainly from direct experience of the bank as a customer. Further, this perceived lack of trustworthiness of other banks, relative to own banks, could suggest that customers indeed lack awareness or information on service quality at other banks.

The role of price comparison websites

7.92 We considered the role of PCWs and their ability to aid consumers with accessing and assessing the relevant information to identify the best PCA for them.

7.93 The evidence we have collected indicates that so far the use of PCWs has been limited, compared with other sectors such as motor insurance. We reviewed the PCWs that do feature current accounts, and it appeared difficult to make an accurate comparison of both account rewards and charges, especially overdraft charges.[91] Further, the ability to incorporate service attributes into the comparison appears more limited. Appendix 7.3 summarises the variables by which products can be ranked in the comparison tables and highlights what information is displayed.

7.94 In an attempt to address this issue, the UK government launched its Midata initiative in 2015. Customers can download their own transaction data (eg list of transactions, interest paid, charges incurred) from the previous 12 months for their current account in a single file. This gives customers access to their personal data in a portable, electronic format which can then be uploaded to a PCW, to compare PCAs and identify the best-value account for them,

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[88] GfK PCA consumer survey. Base = All (4,549). E3: 'You've told me about satisfaction with various features. Now can you tell me how important each feature is to you personally, using the following scale. Other service attributes reported as essential or very important. Internet banking = 62%; Branch = 60%; Mobile banking = 32%.'
[89] Which? Has produced a report on customer service.
[90] GfK PCA consumer survey. Base = All (4,549). J2 'To what extent do you trust or distrust the following types of organisation to treat you in a fair and honest way?'
[91] Only headline overdraft charges (debit interest charged and/or daily fee) are typically advertised on PCWs while exact charges are generally contained within 'more detail' links or linking through to provider's websites.

given their usage. The aim is for individuals to be able to use this data to make more informed choices about products and services, and to manage their financial lives more efficiently.

7.95 Currently, only Gocompare.com provides a Midata comparison tool, which it launched in March 2015.[92] Customers can upload their Midata file on to Gocompare.com's website to compare current accounts using a customer's PCA usage profile.

7.96 A number of limitations to the Midata initiative have been reported to us. For example, Midata files do not present reward and service quality dimensions.[93] LBG told us that Midata did not offer a seamless customer journey as it required customers to download a CSV file and upload to a third party, and had limited compatibility with some tablet and mobile devices. Although we consider Midata to be a positive development, we acknowledge issues around its current implementation.

Barriers to switching

7.97 Once a customer has decided to switch there are two separate processes to act on this decision, namely the account opening process and the account switching process. In this section we consider:

(a) barriers to account opening;

(b) barriers in the switching process; and

(c) specific issues for overdraft users.

7.98 Similarly to the transparency initiatives, there have recently been developments in the switching process, most notably the introduction of CASS.[94] We have considered the impact of CASS below in our analysis of barriers to switching as appropriate. While there has been discussion of other initiatives that could facilitate switching, including account number portability, we do not consider these in this section as they have not been implemented.[95]

[92] [✂]
[93] [✂], LBG, Nationwide, AIB, Metro.
[94] CASS was launched in September 2013. It is a voluntary scheme set up as part of an industry-wide programme by the Payments Council and owned and operated by Bacs. It makes switching current accounts simpler and quicker for customers. Some 40 bank and building society brands participate, accounting for over 99% of the current account market. Customers using CASS to switch accounts are covered by the 'Switch Guarantee', which includes the automatic closure of their original account. More details can be found in Appendix 7.1.
[95] Further detail on account number portability is provided in Appendix 3.1.

Account opening

7.99 In September 2014, the FCA launched a review of the effectiveness of CASS.[96] The FCA's CASS report identified the perception of a 'hassle' around the account opening process as impacting customers' perception of switching and specifically found that this perceived hassle was related to issues such as 'a need to go to a branch'.

7.100 In relation to the application process itself we have seen some survey evidence of customer dissatisfaction with this process.[97] We note, for example, that the online application process is quicker, approximately 10 minutes,[98] compared with the branch process, which ranges from 15 to 40 minutes.[99] We have been told, however, that a high proportion of online applicants fail to complete the process.[100] LBG told us that failed or referred identification and verification checks contributed to this high refusal level.

7.101 Overall, we found some evidence that the account opening process is perceived by some customers to be inconvenient, although we are also aware that banks are increasingly investing in enhancements to their account opening processes, including their handling of customer due diligence (CDD) checks, with online account opening and electronic verification becoming more widespread. One bank, for example, is launching a project to allow customers to submit photo identification and verification documents online or via a smartphone.[101]

The switching process (including CASS)

7.102 The account switching process can be another potential barrier to switching. This is the process by which payments in and out of one account are transferred over to a new account. Customers can switch accounts manually by handling all the arrangements themselves (for example, by changing direct debits and standing orders), or through CASS.

7.103 55% of respondents to the GfK PCA consumer survey either 'agreed' or 'strongly agreed' that 'Switching current accounts is too much hassle'. 42%

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[96] FCA CASS report.
[97] [✂] survey found that [✂]% of customers agreed with the statement that the process of opening would be complicated, and [✂].
[98] LBG.
[99] Metro only accepts branch applications, which it told us could take as little as 15 minutes to complete. LBG told us – supported by internal documentation – that it took around 40 minutes to open an account in the branch. Nationwide's research found that [✂]. Santander [✂].
[100] LBG told us that currently over 50% of all online applicants could not complete their online journey and were referred to the branch for identification and verification. Of these only 20% actually visited the branch. HSBC [✂].
[101] LBG.

of respondents either 'agreed' or 'strongly agreed' with a statement 'I worry that if I switch my current account that things will go wrong'.[102] Customers interviewed as part of GfK's qualitative research also indicated that one of the key reasons for not switching providers was 'a fear that a problem could arise in the process of switching PCAs'.

7.104 Banks' research supported the view that the 'hassle' factor was prevalent. Research undertaken for RBSG in 2013 stated that '[✂].' A survey undertaken for LBG examined attitudes to switching, and found that [✂]% of respondents agreed that switching would be too much hassle. Research undertaken for [✂] in 2013 found that 'the biggest barrier to switching is the "hassle factor" meaning most stick with their bank for 16 years on average.'

7.105 The risk of error in the switching process was also raised as a significant concern from customers, as noted in the FCA CASS report.[103]

7.106 The FCA CASS report also found that CASS addressed the main concerns expressed by customers about switching;[104] however, customers lacked awareness of CASS and confidence in the service remained low. While figures published by the Payments Council reflected fairly high levels of awareness of CASS (69% of consumers aware of CASS in December 2014), the FCA research found much lower levels of awareness, with only 41% of consumers having heard of CASS prior to completing its survey. These results were lower than the target of 75% awareness set by HMT for June 2015. The FCA CASS report also found that consumers' confidence in CASS was also currently below HMT's target of 75% of consumers confident by June 2015. The FCA report states that the Payments Council regularly reports a score for consumer confidence that reflects survey responses to five measures of confidence (ease of switching, effort, speed, control and risk of error). The average score in December 2014 was 65%. However, the FCA consumer research found that consumers' biggest fear when switching was something going wrong and that, in line with Payments Council findings, the measure for confidence in an error-free process was much lower than the average score. For example, in December 2014, when the average score was 65%, the Payments Council reported that less than 50% of consumers were confident CASS would complete their switch without error. Given that an error-free switch is the biggest concern for consumers, the

[102] GfK PCA consumer survey. H1: 'I am going to read out a number of statements, and I'd like you to tell me how much you agree or disagree with each using the following scale?'
[103] FCA CASS report, p34.
[104] FCA CASS report.

FCA said that confidence in CASS was likely to be better reflected by this measure and was therefore still relatively low.

7.107 There were also a small number of operational issues associated with CASS, for example:

(a) the risks arising when the redirection service ended;

(b) access to CASS to providers offering alternatives to traditional current accounts;

(c) issues with using CASS for customers requesting overdrafts or with overdrafts that they were unable to repay through a debt management company; and

(d) the use of continuous payment authorities.

7.108 Almost all banks supported the view that CASS was a positive development. Nationwide, for example, considered that CASS made switching 'as easy as possible'. In contrast, TSB told us that the limitations of CASS, including the loss of customers' transaction histories, lack of customer awareness, the fact that it compelled the switcher to close their old account in order to benefit from guarantees, and a lack of functionality around overdrafts were still a concern. Some banks also told us that more should be done to increase awareness of and confidence in the service.[105] In particular, HSBCG stated that increasing awareness of and confidence in CASS would remove discrepancies between perceived and actual costs of switching.

7.109 Further, the CASS process requires an old account to be closed and as such does not facilitate multi-banking. If a customer would like to keep their old account open they do not receive the switching guarantee.[106] In addition, not all banks will transfer payments for a customer if their previous account remains open.

7.110 Overall we consider that CASS eases the switching process for full account switching as it provides a guarantee to the customer. Nevertheless we agree with concerns raised by the FCA and some banks that there is a lack of

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[105] Barclays, Clydesdale, Nationwide, LBG, RBS and Santander.

[106] The Switch Guarantee: It will only take seven working days. The service is free to use and customers can choose and agree a switch date; the bank will take care of moving all payments going out and those coming in; if money is in an old account, the bank will transfer it to the new account on the switch date. For 36 months, the bank will arrange for payments accidentally made to the old account to be automatically redirected to the new account. The bank will also contact the sender and give them the new account details. If there are any issues in making the switch, they will contact the customer before the switch date. If anything goes wrong with the switch, they will refund any interest (paid or lost) and charges made on either the old or new current accounts as a result of this failure.

awareness and confidence in the service which may hinder its success. We also consider that the process of CASS, whereby a customer's old account needs to be closed to secure the guarantees, may act as a barrier to switching as we acknowledge that many customers may choose to multi-bank and may not want to close a previous account.

Overdraft users

7.111 We found that there were specific additional barriers for overdraft users, relating to both account opening and account switching. Our quantitative analysis of searchers and switchers suggested that overdraft users were as likely to search, but less likely to switch than others, see paragraph 7.119.

7.112 Overdraft customers could be deterred from applying to open a new account because they may fear that the same overdraft facility as they currently hold would not be offered to them by a new provider. The GfK PCA qualitative research[107] found that some heavy users of arranged overdrafts[108] felt that PCA choice would be constrained by their overdraft. The following issues were raised:

(a) Perceptions that customers were 'locked' into their current bank until the overdraft was paid off.

(b) Perceptions that a new bank would want to see the PCA in credit, ie no overdraft usage.

(c) Concerns that a new bank may not offer the same overdraft amount.

(d) Banks would not say in advance of the application whether they will offer the same overdraft conditions as the current bank.

7.113 The FCA CASS qualitative research also suggested that there was a lack of clarity about whether it would be possible to move accounts when the account is in overdraft but this did not emerge as a primary concern.[109]

7.114 We asked banks whether their overdraft users would be offered the same overdraft limit if they applied as a new customer today. Evidence showed that the percentage of overdraft customers who would not be offered the same overdraft terms if applied as new customer varied between 3% and

[107] GfK PCA consumer survey, pp64 & 65.
[108] Where heavy overdraft users are taken to be those customers who use overdrafts in at least nine months of the year, and make up just over 5% of the sample.
[109] Optimisa research (March 2015), *Engagement with current accounts and the switching process*, p36.

29%.[110] One bank noted that customers with higher overdraft limits were less likely to be offered the same overdraft limit.[111] One potential reason for this was a change in the customer's personal circumstances, for example a reduction in income. Another potential reason was the lack of access to historical customer transaction data, since the banks assessed the overdraft limit assuming the customer was new to the bank.

7.115 We considered reasons why banks may not be able to match an existing customer's overdraft facility. The FCA rules require banks to assess the creditworthiness of a customer before entering into a credit agreement.[112] The FCA rules specify that a bank offering an arranged overdraft needs to consider any adverse impact on the customer's financial situation and the ability of the customer to make repayments as they fall due or within a reasonable period. The creditworthiness assessment must be based on sufficient information obtained from the customer or, where necessary, from a credit reference agency. Consequently, any bank offering an overdraft has to assess the borrower's creditworthiness before concluding a credit agreement and therefore an acquiring bank cannot guarantee to match existing overdrafts. We consider that the lack of access to transaction data may act as a barrier to switching.

7.116 We also found that in some circumstances a customer who had applied to a new provider would not know whether they would be granted overdraft facilities until a later stage of the application process,[113] by which time their old account may have been closed.[114] Furthermore, some overdraft customers may be referred to branches. Both factors increase the time and inconvenience of the switching process for overdraft users.

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[110] LBG told us that as many as [✂]% of its overdraft customers and as many as [✂]% of its full facility PCAs were credit-constrained. LBG provided analysis segmented by overdraft balance that demonstrated the proportion of credit-constrained customers' increased with the size of the overdraft balance. Santander told us [✂] would be account inactivity or a change in circumstances, for example the customer becoming bankrupt or accruing adverse credit information. This analysis was based on the observed customer account usage (for example, credits to the account and conduct of the account) and external customer data which will be different to that when the overdraft was originally allocated. HSBCG told us that [✂]% of existing HSBC customers, [✂]% of existing First Direct customers and [✂]% of M&S Bank customers utilising their overdraft would be offered the same or a higher credit limit if they applied as a new customer today. In order to try to replicate any decision HSBCG would make at account opening, it has compared the average value of overdraft limits provided to its new customers against existing customers with the same risk score and the actual overdraft limit these customers held with it in May 2015.

[111] LBG.

[112] FCA Consumer Credit sourcebook 5.2.1.

[113] [✂]: it is not possible to apply for an overdraft online at the account opening stage, although [✂] does aim to make this available later in 2015.

[114] The FCA CASS report found evidence of a problem experienced by some consumers requesting an overdraft on a new current account to which they planned to switch. CASS is designed so that a switch starts once the account opening process is complete, hence once the consumer has been informed whether their application for an overdraft on the new account has been successful. However, the FCA found that at some banks this did not happen and a switch could be initiated before a decision on an overdraft was made.

Characteristics of engaged customers

7.117 We analysed whether there are any particular customer groups who are more or less likely to search, switch or multi-bank, considering reasons for their engagement and their characteristics.

7.118 According to the GfK PCA consumer survey[115] the most cited reasons for those who switched in the last year were related to better terms offered by competing banks and these included: better interest rates elsewhere (25%) and better products/deals/account conditions elsewhere (25%). Other reasons for switching related to the terms and service offered by current bank, namely poor customer service (19%), charges/fees too high (12%) and branch was closing/no local branch (15%).

7.119 We conducted a quantitative analysis in order to compare the characteristics of searchers and non-searchers, and switchers and non-switchers, with the aim of understanding the relevant differences between these different groups of customers. We carried out this comparison through both a descriptive analysis of the data and an econometric analysis. Detailed analysis is set out in Appendix 7.2. We found the following:

(a) Customers who searched, whether they switched or not, had on average higher income and higher education levels than customers who did not. We found that having confidence in the use of the internet had a positive effect on the probability of searching. Moreover, customers who used internet banking were more likely to search than those who did not. We also found evidence of an impact of confidence in the use of the internet on switching but the results were less robust than for searching.

(b) Customers holding higher credit balances are more likely to search, while no significant effect is found on switching.

(c) PCA customers who also hold other financial products with a bank other than their main bank are more likely to search and switch.

7.120 We examined the demographic profile of multi-bankers and found that multi-bankers are more likely to be middle-aged, have a degree and be in employment. More multi-bankers are financially literate in comparison with customers banking only with one bank and they tend to have higher incomes. More details on the characteristics of multi-bankers can be found in Appendix 7.1.

[115] Question F7: 'When you last changed your main current account/when you last looked around, what made you think about doing that? OPEN ENDED.'

7.121 We also specifically looked at the characteristics of overdraft users and their engagement levels. Our quantitative analysis of searching and switching suggested that overdraft users were as likely to search, but less likely to switch, than others. The banks provided mixed evidence on overdraft users' propensity to switch:

(a) [✂][116]

(b) HSBC provided data on switching rates for its customers, according to which [✂].[117]

(c) TSB provided data showing that those customers who most heavily use an overdraft facility are less likely to switch, and it told us that this was because the lack of support within CASS for switching overdraft facilities might deter customers who relied on their overdraft to manage their day-to-day finances from switching.[118] Finally, LBG provided data analysis that showed a smaller proportion of overdraft users had switched away than customers who were in credit.[119]

7.122 We examined the demographic profile of PCA customers based on the type of overdraft they used, namely non-users, arranged-only overdraft users and unarranged overdraft users.[120] As Appendix 7.5 shows, overdraft users are on average more likely to be younger and are more likely to be in employment.[121] Customers who use an arranged overdraft only are on average more likely to be in a higher income group, have a degree-level education and be financially literate.[122] Finally, we do not observe a higher proportion of unarranged overdraft users in lower-income thresholds compared with non-users.

7.123 Overall, therefore, our analysis of the characteristics of customers who search, switch or multi-bank suggests that the customers who are more

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[116] [✂]
[117] HSBCG provided data showing the switching-out rate by overdraft usage: the switching rate for those with 'no overdraft' was [✂]%; those in overdraft for 1–10 days: [✂]%; 11–50 days: [✂]%; 51–80 days: [✂]%; and more than 80 days: [✂]%.
[118] [✂]
[119] LBG told us that customers who were a lower credit risk and were in credit were more likely to consider switching.
[120] We define the following PCA customer groups: *(a)* non-users – customers who did not use an overdraft in 2014; *(b)* arranged only – customers who only used arranged overdrafts in 2014; and (c) unarranged – customers who used unarranged overdrafts in 2014. This group includes both those who used unarranged only and those who used arranged and unarranged overdrafts. Further details are provided in Appendix 7.5.
We have also compared characteristics of heavy overdraft users (those who used overdrafts for nine or more months) with light overdraft users (those who used overdrafts for eight or fewer months). Apart from regular users being less likely to receive low inflows, we do not find any other substantial differences.
[121] We do not find any substantial differences in terms of gender.
[122] We use inflows into the account (defined as total value of payments and transfers into the account) as a proxy for customer income.

likely to engage with PCAs tend to have higher income and higher education levels. They also tend to have higher credit balances. We find strong results on usage of internet banking and confidence with the use of the internet as being associated with more engagement.

7.124 For overdraft users, our quantitative evidence showed that they were as likely to search but less likely to switch. The evidence from banks was less representative and had mixed results. Some evidence showed that overdraft users were more likely to switch, while other evidence showed they were less likely to switch. A consistent message was that heavy overdraft users were less likely to switch.

Summary on customer engagement and potential impact on banks' incentives to compete

7.125 The overall level of PCA customer engagement, while having increased in recent years, remains low as demonstrated by levels of searching and switching.

7.126 Alongside considerations of switching main accounts between banks, we also considered other potential competitive constraints on banks. Internal switching, for example, may indicate that banks are encouraged to improve their offers to existing customers in order to retain them. However, internal switching has limitations, as the propensity to search by this group of customers is lower and the primary bank still maintains the relationship with them. Multi-banking, when PCA customers hold one or more additional PCA(s) with different providers, may contribute to increased customer engagement as it reduces searching and switching barriers with customers being exposed to different banks' offers. Nevertheless, we do not consider that taking into account multi-banking significantly impacts competitive constraints on banks because the main reason for holding multiple accounts is to manage finances rather than to arbitrage between banks.

7.127 We analysed whether there are any barriers for customers to access and assess on information about available PCA products, which may deter them from engaging. We found the following:

(a) Information on PCA pricing is easily accessible but difficult to assess due to the complexity of charging structures. This is particularly true for overdraft charges.

(b) Our actual versus perceived analysis demonstrated that many overdraft users lack awareness of their overdraft usage. The lack of awareness makes it more difficult for them to assess which PCA offers best value

for them given their overdraft usage. However, we consider that the increasing digitalisation of banking through internet and mobile banking has facilitated customer engagement with their own account.

(c) Information on the quality of service provided by different banks is difficult to access and compare, despite the fact that service quality is very important for many PCA customers.

(d) The availability of PCWs to ease comparisons has been limited and underdeveloped. The exception is the Gocompare.com Midata initiative which we consider to be a positive development.

7.128 We considered barriers to switching and found that customers perceive the application and switching process to be ‘a hassle’ and there are issues relating to the uncertainty and timing of overdraft acceptance. CASS has improved the switching process but there are still concerns relating to awareness of and confidence in the system, and a number of operational issues.

7.129 Our analysis of the characteristics of customers who search, switch or multi-bank suggests that the customers who are more likely to engage with PCAs tend to have higher income and higher education levels; they also tend to have higher credit balances. We found that confidence in usage and the intensity of usage of internet banking is associated with more engagement.

7.130 We also found in our quantitative analysis of searching and switching that overdraft users, while as likely to search as other customers, are less likely to switch.

7.131 The low level of customer engagement may affect the banks’ incentives to compete. Our analysis is set against the competition framework where a low level of customer engagement may reduce the incentives for banks to improve their offers (lower the price and/or increase service quality) and compete with each other. If banks that improved their offers only gained a small amount of custom (due to low customer engagement), and this lowered the profitability of their existing customers, they would have reduced incentives to improve their offer.

7.132 Low engagement levels may also facilitate price discrimination. If banks are able to set different terms to their customers, they may be able to set higher prices to those customers who are less likely to switch, potentially generating higher profits. The prospect of potential higher profits once customers have chosen a PCA may give rise to increased incentives on banks to compete for these customers in the first place. So, if banks can price discriminate, we may expect to see more intense competition between banks for new-to-banking and engaged customers.

7.133 Without an overall strong customer engagement, because PCAs offer a range of different services, banks may have incentives to set lower prices/ perform better on only those aspects that are more likely to trigger switching and engagement, and higher prices/worse terms on those that are less likely to trigger switching.

7.134 The following sections are structured as follows:

(a) we first consider banks' competitive strategies related to how they target different customer groups; how they compete on price, quality of service and innovation; and how they market their offers;

(b) we then analyse whether PCAs play a role as a gateway product which facilitates the sale of other financial products.

Banks' competitive strategies

Targeting of different customer groups

7.135 In this section we consider the evidence we received on the ways banks are attracting new customers and retaining existing customers. More details on banks' strategies are included in Appendix 7.6.

Acquisition of new customers

7.136 A common theme in the responses we received from the banks was that they were focused on targeting the primary banking relationship, rather than secondary relationships or multi-bankers. For example, TSB said that it sought to attract customers who would be 'main bankers' with TSB and use their TSB PCA as their primary account. Barclays, BoI, Co-op, HSBCG, LBG, Nationwide RBSG and Santander expressed similar views.

7.137 There was variation in the types of customers the banks told us they were targeting, but two general themes emerged.

- First, banks were specifically targeting more affluent customers, although the definition of affluent varied among banks. For example, [✂]. HSBCG told us that HSBC targeted 'emerging affluent' customers, who it defined as those earning more than the UK average (£27,000 or more a year) and turning over at least £1,750 per month in their PCA, and 'affluent customers', who earned a minimum of £100,000 a year.

- Second, banks were targeting students and younger customers (ie those opening their first bank account). For example, RBSG told us that it targeted students by its simplified overdraft proposition, offering accounts to international students and simplifying its sales process to make it easier to open accounts, particularly online.

7.138 A different approach to this overall theme is that of Virgin Money, which told us that its Essential Current Account was originally designed to cater for the financially excluded, but was ultimately positioned more broadly as an account that enabled customers to take better control of their finances, since it did not offer an overdraft.

7.139 The conditions attached to new accounts launched by the banks, which often require customers to have minimum inflows into the account and a minimum number of direct debits, are consistent with the banks' aims to attract primary banking relationships with more affluent customers. Examples of these are below.

- The Barclays Blue proposition requires at least two direct debits and customers to pay in a minimum of £800 per month. The monthly charge for this account is £3, in return for £7 in reward.[123]

- Clydesdale and Yorkshire Bank Current Account Direct require customers to pay in a minimum of £1,000 per month. This account does not have a monthly charge.[124,125]

- The Halifax Reward account requires at least two direct debits and customers to pay in a minimum of £750 per month. Customers receive £5 per month with this account, if they meet this criteria, and it does not have a monthly charge.[126]

- The HSBC Advance account requires customers to pay in a minimum of £1,750 every month. This account does not have a monthly charge.[127]

- The Club Lloyds account pays interest if the customer has at least two direct debits per month and charges a monthly fee of £5 if the customer pays in less than £1,500 per month.[128,129]

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[123] Barclays Blue account, consulted 8 September 2015.
[124] To receive a £150 cash incentive a customer is required to have at least two direct debits. A customer can open a Current Account Direct product without two direct debits but just will not qualify for the £150 incentive.
[125] Clydesdale Current Account Direct and Yorkshire Bank Current Account Direct, consulted 8 September 2015.
[126] Halifax bank accounts, consulted 8 September 2015.
[127] HSBC Advance account, consulted 8 September 2015.
[128] LBG stated that over [90–100]% of customers did not pay this fee.
[129] Club Lloyds account, consulted 8 September 2015.

- To benefit from cashback and interest, the Santander 123 account requires customers to have at least two direct debits, pay in a minimum of £500 per month. The account pays interest on balances between £1,000 and £20,000, and cashback is paid on certain types of expenditure including utilities payments. The monthly charge for this account is £2, rising to £5 in January 2016.

7.140 In addition to the evidence on whom the banks were targeting, we considered banks' submissions on the types of customers they were gaining and losing through CASS switching. There were varying responses, but the responses suggested that, of the customers who were switching, Santander was attracting the relatively affluent, while the relatively less affluent customers were switching to Halifax. For example, HSBCG told us that the HSBC customers it was losing were typically: [✂].

Retention of existing customers

7.141 We also examined to what extent banks were seeking to retain their existing customers to reduce switching to competitors. As discussed below, some improvements to existing accounts, such as lower arranged overdraft charges or improving quality of service and innovation, will benefit existing customers. However, if banks introduce new accounts and only offer these to new customers, or to those existing customers who are more likely to switch, then this could give them the ability to discriminate between new and old customers, potentially leading to existing customers receiving a worse deal than new customers or internal switchers.

7.142 The evidence in Figure 1 in Appendix 5.4, which considers the average length of time customers have been with each bank and the average price, suggests that banks which have had customers for longer tend to charge higher prices than banks whose customers are newer on average. This is consistent with banks' ability to set higher prices to existing customers than to new customers through price discrimination.

7.143 There was varied evidence from banks on their approaches when launching new accounts. Some of the banks did advertise new accounts to existing customers, but it was unclear how extensive this was:

- HSBCG told us that when it launched the HSBC Advance account the advertising was aimed at acquiring new customers because existing PCA customers who qualified would be automatically upgraded to HSBC Advance.

- LBG told us that it marketed its Club Lloyds account to existing customers and 800,000 actively switched to the new account. Customers were not automatically upgraded because Club Lloyds had a monthly fee and some existing customers would not qualify for the Club Lloyds account. However, internal documents also recognised that existing Vantage customers would lose out when Lloyds reduced the interest rates, although these customers would still receive credit interest of 1.5% on balances up to £5,000. An LBG paper stated '[✂]'.

7.144 Our analysis of financial benefits from switching (see Appendix 5.4), which should be interpreted carefully, provides some evidence relevant to this issue.[130] Table 7.2 below shows that customers could make an average saving of £1.8 per month if they were to switch internally, within the same bank, to the best account for them.

Table 7.2: Monthly savings from switching to best-value product from existing supplier (£ per month)

	1 month (excluding switching incentives)
Matched records – using current Runpath price data for customer's PCA*	
Internal switching	£1.81
– Standard/reward PCAs	£1.85
– Packaged PCAs	£1.11

Source: CMA calculation using Runpath data.

Overdraft users

7.145 As discussed above in paragraphs 7.1111 to 7.116 overdraft users face additional difficulties when switching PCA, and our quantitative analysis of searching and switching in PCAs also found that these customers were less likely to switch.[131] We saw no evidence that banks were specifically targeting overdraft users with their marketing, but some of the banks told us that they were taking specific actions to facilitate switching by overdraft users. For example, TSB told us that it offered a fee-free overdraft for three months for switchers (subject to eligibility).

7.146 [✂]

Pricing strategies

7.147 The GfK PCA consumer survey found that 'better interest rates elsewhere' and 'better products/deals/account conditions elsewhere' were the top two

[130] These results include all banks, including those with only one type of bank account. This will reduce the average benefits. Since many of these single account banks like Metro and Danske have a small market share the effect is expected to be limited.
[131] See Appendix 7.2.

reasons customers switched PCA and therefore we could expect pricing to play an important role in competition in the supply of PCAs.

7.148 There have been many developments in PCA pricing and examples of these are summarised below.[132]

- **Arranged overdraft fees**. Banks have made changes to their arranged overdraft fees. For example, Barclays updated its charging structure in June 2014, moving from charging interest on the overdraft amount to a tiered daily amount of 75 pence per day for overdrafts up to £1,000, £1.50 per day for £1,000 to £2,000 and £3 per day for £2,000 to £5,000.[133]

- **Unarranged overdraft fees**. There have also been changes to unarranged overdraft fees, although we recognise that regulatory intervention has played an important role in this area, for example the OFT unarranged overdraft charging scenarios. Appendix 7.3 provides more detail on this topic. Some of the banks told us that they had reduced unarranged fees in response to competition. For example, Santander told us that following [✂], a review was undertaken of San UK tariffs. Changes were introduced in August 2014 for 123, Everyday, Premier and Premier Direct Current Accounts.

- **Financial switching incentives**. Some of the banks offer switching incentives. For example, Clydesdale and Yorkshire Bank offering £150 for switching.[134]

- **Interest rates**. Interest rates on credit balances has also been an area of competition, with banks introducing new accounts paying higher interest rates. For example, Santander's 123 account paying interest of 3% on balances up to £20,000.[135]

- **Rewards**. Some of the banks offer financial rewards to customers.[136] For example, Tesco's bank account offers Tesco Clubcard points.[137]

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[132] Further evidence on price competition is provided in Appendix 7.6.
[133] Barclays PCA overdraft fees, consulted 12 August 2015.
[134] Clydesdale Bank current accounts consulted 18 August 2015.
[135] Santander 123 current account, consulted 12 August 2015. 3% interest is paid when the account contains more than £3,000.
[136] Further evidence on the development of reward accounts is provided in Appendix 7.3, Table 7.
[137] Tesco Bank rewards, consulted 18 August 2015.

- **Other financial benefits**. Some banks have begun offering other financial benefits. For example, Metro offers fee-free use of its debit card for purchases or withdrawals in Europe.[138]

Service quality and innovation

7.149 The GfK PCA consumer survey found that 'poor customer service' was the third most common reason for customers switching and therefore we could expect competition on service to play an important part in banks' competitive strategies. As part of this we looked at innovation, since many of the banks' innovations were designed to improve customer service.[139]

7.150 The banks provided us with examples of improving the quality of service, and examples of digital innovations. Many banks have made substantial investment in digital banking services. For example, Danske Bank told us that it was investing to improve customer service through its digital banking offer, including apps, an improved registration process for eBanking, web chat functions and budgeting tools. It also told us that in 2012 it had increased the range of PCA services that customers could undertake in over 400 Post Office outlets across NI.

7.151 We discuss innovation in Section 5 and Appendix 5.6 and recognise that innovation has also come in the form of new banking models, for example retailers entering the provision of PCAs and digital-only banks.

Marketing

7.152 Many of the banks told us that they were advertising through different channels to attract new customers. For example, HSBCG told us that it had invested around £[✂] million on marketing HSBC Advance until the end of February 2014. It had advertised in many formats, including branch posters, cinema, digital content, emails, London Underground, press, social media and on television. Tesco Bank told us it spent heavily promoting its PCA at launch, and television advertising was the most effective and wide-reaching channel. It expected its marketing budget to normalise at around £[✂] million per year.

7.153 We found that PCA advertising spend had increased in recent years, but the increase had been small. However, some banks – particularly Halifax, Lloyds and Santander – are spending considerable sums on advertising their

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[138] Metro Bank, using your card abroad, consulted 18 August 2015.
[139] See also Appendix 5.6 and Appendix 7.6 for further details.

PCAs in an attempt to attract customers. Branches still appear to play a role in attracting customers, with PCWs and referral schemes less important.[140]

Summary on competitive strategies

7.154 Overall, the evidence suggests that, in the recent years, there has been some active competition between banks through development of new types of accounts (reward accounts, and accounts offering switching incentives), as well as through marketing spend by some banks. As discussed in Section 5, we also have seen evidence of banks innovating, in particular through digital bank offerings. The evidence indicates that banks are targeting the primary banking relationships, with the focus on attracting more affluent customers and new-to-banking customers, including students, rather than retaining existing customers.

7.155 Banks target these customer groups through offering different types of PCA accounts: either by designing accounts and/or benefits that are only available to new or active customers (eg student accounts and financial incentives to switchers), or by offering accounts that are designed to attract more specifically certain types of customer (interest-paying reward accounts with conditions attached to them such as minimum inflows and/or direct debits). For example, the new Club Lloyds account only pays interest if the customer has at least two direct debits per month and charges a monthly fee of £5 if the customer pays in less than £1,500 per month.[141]

7.156 This targeting through the launching of some of these new accounts suggests that banks are able to price discriminate and there is a proportion of customers who are not benefiting from price competition within banks. However, customers who do not switch are likely to benefit from improvements in service and innovation, in so far as these apply to all the banks' offerings rather than being limited to the new accounts.

7.157 The evidence indicates that pricing is an important aspect of competition between banks. However, we note that there has been less active competition on aspects such as arranged and unarranged overdraft fees, with many of the changes being driven by regulation.

7.158 This suggests that banks are incentivised to set high charges on overdrafts, as these charges, compared with other charges such a monthly fee, which are more transparent, are less likely to lead to customers switching away.

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[140] More evidence on this issue is set out in Appendix 7.6.
[141] Club Lloyds account, consulted 8 September 2015.

PCAs as a gateway product

7.159 As part of the PCA market competition analysis, we also considered the ability of banks to use PCAs as a gateway to cross-sell other products to either retain or acquire customers. Such cross-selling may increase customer acquisition costs for new entrants and particularly benefit incumbent banks.

7.160 As discussed in Appendix 5.3, most PCAs are individually profitable and therefore banks do not need to sell additional products to ensure PCAs are profitable, but it may benefit their overall business performance. Marketing additional financial services to existing PCA customers is a strategy adopted by most banks. Below we discuss the banks' strategies and the evidence from the banks and GfK PCA consumer survey on cross-holding rates.[142]

Banks' strategies

7.161 The banks' evidence suggested that they adopted differing cross-selling strategies, although a prevalent theme was a desire to reward customers for taking out multiple products. For example, Lloyds told us that its new Club Lloyds account offered better rates to customers who chose to have their savings or mortgages with LBG. This rewarded customers' loyalty and reflected the lower costs of acquisition and of serving customers with multiple product holdings.

7.162 We investigated whether there was any evidence of banks tying or bundling other products with their PCAs in a way that could lead to AECs in PCAs. We found some examples of tying, for example customers who wish to have a First Direct Regular Saving Account must have a First Direct 1st Account.[143] We found no examples where customers had to purchase an additional product before they could obtain a PCA, ie no examples where the PCA was the tying product.[144]

Cross-holding rates

7.163 We requested information from the banks on their PCA customers' holdings of other products with the same bank in order to understand the extent of

[142] Further evidence on cross-holding rates is given in Appendix 7.7.
[143] First Direct Regular Saver, consulted 4 September 2015.
[144] Tying occurs when the supplier makes the sale of one product (the tying product) conditional upon the purchase of another distinct product (the tied product) from the supplier or a firm designated by that supplier (*CC3*, paragraph 287).

cross-holdings.[145] The evidence showed that [✄]. However, it was difficult to interpret these figures, as different banks adopted different definitions of cross-holdings when responding to this question.

7.164 We also investigated the average number of PCA customers' holdings of other products by analysing the responses to the GfK PCA consumer survey.[146] We found that [✄].

Summary on PCA as a gateway product

7.165 The evidence indicates that selling additional products to PCA customers, while an important source of revenue for banks, is not a fundamental driver of PCA competition. In particular, there was no evidence that PCAs are a loss-leader used to attract customers, who can then be sold other financial products.

Provisional conclusions

7.166 As detailed in our analysis of outcomes in the PCA market in Section 5, there have been some positive developments in recent years such as product innovation, new entry by firms with new business models and innovation in digital banking.

7.167 However, despite these positive developments, we found that PCA markets in GB and NI remain concentrated and market shares have remained relatively stable. We have also found that banks that deliver a higher quality of service, or those that offer the lowest prices on average, have tended to gain market shares, but at a very slow pace. This indicated to us that there is a lack of responsiveness by PCA customers.

7.168 The overall level of PCA customer engagement, while having increased in recent years, remains low, as demonstrated by levels of searching and switching. There are a number of reasons for this weak customer engagement:

(a) A lack of trigger points because PCAs have no contract end date.

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[145] We asked the banks to provide information on their PCA customers' holdings of BCAs, credit cards, insurance, investments, mortgages, personal loans, savings accounts (instant access and other) and other financial products.
[146] GfK PCA consumer survey. I2: 'Which of the following do you have with any provider? 1. Mortgage; 2. Personal loan; 3. Cash ISA/NISA; 4. Other cash savings; 5. Credit card.'

(b) Customers' reported satisfaction with their existing account, although the low levels of searching lead us to believe that customers are not always making an informed decision to remain with their existing PCA provider.

(c) For many customers PCAs are low-cost products and they perceive that there are few gains from switching; however, our analysis of the benefits of switching indicates that, at least some customers would gain financially from switching PCAs.

(d) Barriers to accessing and assessing information on PCA charges and service quality contribute to low customer engagement. In particular, in order to identify the best account for them, customers need to combine the information on the different account charges, including complex overdraft charges, with a detailed knowledge of their own account usage. PCWs play a limited role and while the Midata initiative is a positive development, there are issues around its current implementation.

(e) Barriers to switching accounts still remain. Customers perceive that switching accounts is burdensome and there is still fear that something may go wrong. Awareness of and confidence in CASS is still low.

7.169 We have particular concerns regarding engagement by overdraft users:

(a) Overdraft users, despite being those who would potentially gain most from switching, generally show limited awareness of and engagement with their overdraft usage. Many overdraft users believed they did not use an overdraft when they did and/or underestimated their usage.

(b) Overdraft charges are particularly complex to compare across banks, due to both the complexity and diversity of the charging structures and customers' difficulties in understanding their own usage.

(c) There are additional barriers to switching for overdraft users due to uncertainty surrounding the acceptance and timing of an overdraft approval.

(d) Our quantitative evidence showed they were as likely to search but less likely to switch. The evidence from banks was less representative and had mixed results. Some evidence showed that overdraft users were more likely to switch, while other evidence showed they were less likely to switch. A consistent message was that heavy overdraft users were less likely to switch.

7.170 Overall, the evidence shows that overdraft users are less likely to switch, even though many would benefit from switching.

7.171 We analysed the characteristics of engaged customers. Our quantitative analysis of searching and switching found the following.

(a) Customers who searched had on average higher income, higher balances and higher education levels than those who did not. Customers who used internet banking were more likely to search than those who do not and having confidence in the use of the internet had a positive effect on the probability of searching.

(b) Customers who switched had on average higher income and higher education level than customers who did not. Confidence in the use of the internet was positively correlated with switching but the results were less robust than for searching.

7.172 We also considered two other groups of more engaged customers: internal switchers and multi-bankers:

(a) Internal switching may indicate that banks are encouraged to improve offers to existing customers in order to retain them; however, internal switching has limitations as a competitive constraint as the propensity to search by this group of customers is lower and the primary bank still maintains the relationship.

(b) Multi-banking may contribute to increased customer engagement, as it reduces barriers to searching and switching because it increases the transparency of price and service attributes across different banks. Customers will be more familiar with the products and services offered by other banks, particularly where these cannot be experienced without being a customer. Customers can also more easily move between different banks when they already have a relationship with more than one provider. This is because identification verification and credit references may be reduced. However, multi-banking that results in people switching their main account is very low, and the main reason for holding multiple accounts is to manage finances rather than to arbitrage between banks.

7.173 We recognise that there are a number of factors that are reducing barriers to engagement. As discussed in Appendix 5.6 we consider that the increasing digitalisation of banking, through internet and mobile banking, has facilitated customer engagement with their own account. We also consider that this development reduces customers' searching and switching costs as it eases customers' ability to access and assess their expected account usage, and therefore facilitates choosing the best-value PCA.

7.174 The general lack of customer engagement in the market may affect banks' incentives to compete and how they compete. The evidence indicates that banks are competing to obtain the primary banking relationship and specifically targeting more affluent customers. Consistent with this, LBG with Halifax and Lloyds brands, and Santander are the largest spenders on advertising and Lloyds and Santander have launched new accounts with conditions that encourage affluent customers to move their primary banking relationship to these brands.

7.175 Pricing is an important aspect of competition between banks, particularly switching incentives and interest rates on balances. We note that there has been less active competition on aspects such as arranged and unarranged overdraft fees, with many of the changes being driven by regulation. This less active competition on arranged and unarranged overdraft fees is consistent with our analysis of the levels of engagements, searching and switching by overdraft users as described above in paragraph 7.169.

7.176 We have specifically considered whether the FIIC pricing model contributes to low customer engagement and low switching levels. While FIIC reduces to some extent awareness of the costs (direct and indirect) that customers are incurring, we have not found that the FIIC model, in itself, is contributing significantly to low switching rates. The UK is almost unique in having this pricing structure, but switching rates are also low in countries where customers pay for their PCAs. Rather than the FIIC model itself, the lack of triggers and customers' perception of the low cost of PCAs and of lack of benefits in searching and switching are the important factors explaining weak customer engagement.

7.177 We found that the FIIC model works well for many customers, as it means that many customers are not charged for basic banking services, and it is associated with relatively high satisfaction rates with PCAs. Nevertheless, with the FIIC pricing model, customers who are in credit pay for banking services indirectly through interest foregone on credit balances, while those who are in debit pay directly through overdraft charges.

7.178 Banking can be expensive, particularly for those who are not in credit: banks have an incentive to set high overdraft charges due to the low customer engagement by overdraft users, as described above. This, we considered, would be the case whether or not banks operated a FIIC model. Our proposed remedies[147] therefore seek to address the source of this low pressure on charges directly, by encouraging more searching and switching, and enabling customers to better compare the terms, such as overdraft charges, that they can get from different banks.

7.179 The low customer engagement means that the discipline imposed by customers on banks through switching and the threat of switching is not as strong as it would be if more customers were engaged, and this in turn weakens banks' incentives to compete to gain new customers and retain existing customers.

7.180 It also makes it difficult for new entrants and smaller providers to expand organically. This weakens the constraints that new entrants and smaller banks impose on incumbent banks and as a result market shares of the larger incumbent banks remain high and stable.

7.181 We therefore provisionally found that there is weak customer response. In Section 12, we set out how this weak customer response gives rise to an AEC in the provision of PCAs in each of GB and NI respectively.

[147] Remedies Notice.

8. SME banking: demand for SME retail banking services

Introduction

8.1 In this section we examine the issues affecting the demand for SME banking services. In Section 9 we look at the supply of SME retail banking services and bring together at the end of that section our overall provisional conclusions on competition in SME retail banking services.

8.2 SMEs are extremely important to the UK economy. They employ around two-thirds of the private sector workforce and produce just under half of all UK private sector turnover. In the last few years, there has been a large expansion in the number of people starting up and growing a business, and there are now just under 5.2 million SMEs in the UK.[148] This growth has come from the self-employed but also among employing SMEs and from all sectors of the economy from highly innovative, high-tech start-ups to more traditional businesses in the construction industry and in manufacturing and retailing.

8.3 BCAs are an indispensable service for the vast majority of SMEs and perform broadly the same functions as a PCA. SMEs require a reliable banking service as the potential impact on an SME's business of payments to and/or from customers, suppliers and employees can be significant. In addition, for many SMEs, banks are an important source of finance both during critical periods of growth when businesses are seeking to expand, as well as during difficult periods when a business may need short-term financial assistance (for example to manage cash flow).

8.4 SMEs are highly diverse and what they look for and demand from their bank will vary depending on factors such as the stage and life cycle of the business, the sector they operate in, the complexity of the business, whether they employ staff or are self-employed the growth ambition of the business's owners and whether they trade internationally.

8.5 There are several key stages in the life of an SME that will impact on an SME's demand for banking products and the nature of their engagement:

(a) The start-up phase: when first opening a BCA and establishing a business banking relationship for the first time.

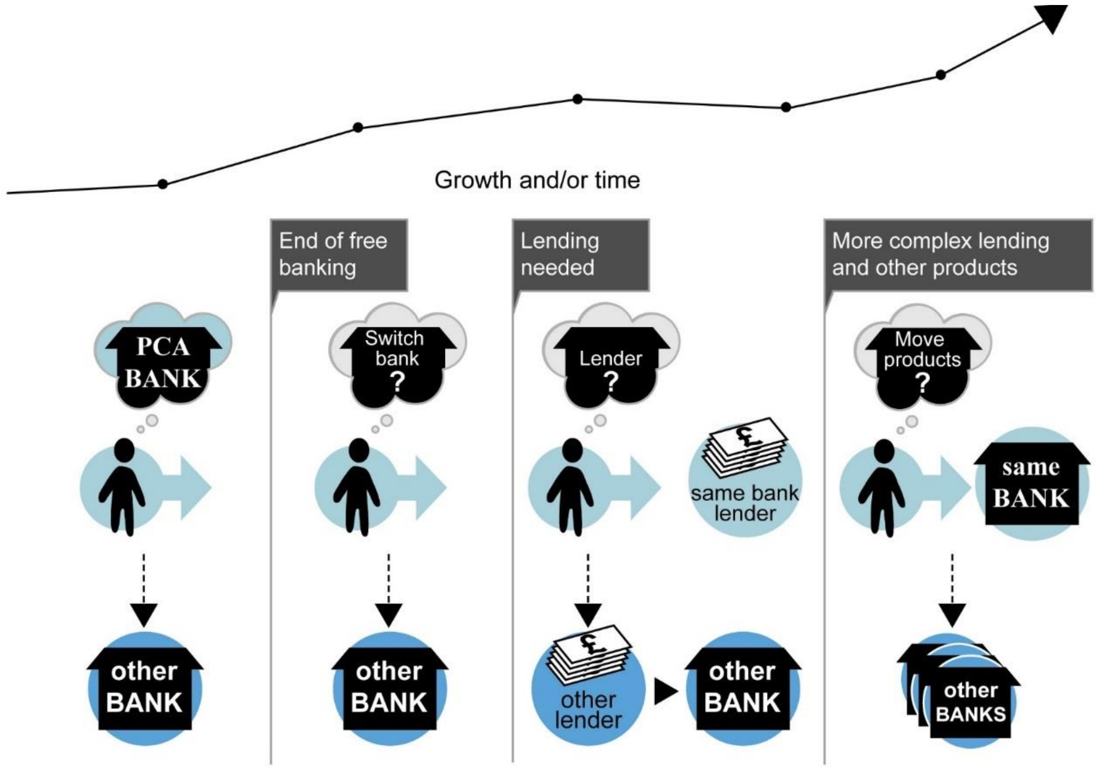
[148] See Appendix 8.1, Table 1 and Figure 1.

(b) The end of the free banking period: usually after 12 to 24 months when an SME will have a more established relationship with their business banking provider and they start paying for transactions.

(c) More established SMEs: as an SME grows and becomes more established, the need for other business products and services, including in particular lending, may increase and, as a result, the relationship aspects of banking become potentially stronger.

8.6 Figure 8.1 below displays a stylised journey of an SME through the key stages in its life that impact on its banking decisions. At start-up an SME chooses whether to open a BCA with its current PCA bank, or go elsewhere. Then, once free banking has finished, it may consider switching to a different bank. At some stage, should the SME require lending, it may go directly to the bank it holds its BCA with, or try a different lender. If it takes out lending at a different bank it may consider whether to move its BCA as well. As the lending needs get more complex or the SME requires other products, the SME may consider moving at least some products to another bank or alternative lender.

Figure 8.1: SME journey in relation to banking



8.7 Each year a large number of new SMEs will be established or will cease to trade. The level of churn in SMEs and how SMEs engage in the market at each stage will affect how banks compete for SMEs. For example, at start-up SMEs may be more focused on other priorities than their banking relationship.

8.8 In addition, having chosen a banking provider, an SME's needs may change over time and/or it may then find it more difficult to switch provider. Or, having established a relationship with one provider, an SME's ability or incentive to change bank may be constrained. This in turn may incentivise banks to focus on competing for SMEs at start-up.

8.9 Much of our assessment has therefore been to analyse, for each of these stages, the extent to which SMEs can and do drive competition between banks, whether there are impediments to them doing so, and how in turn this affects banks' incentives to compete for SMEs.

8.10 We have provisionally defined, in Section 4, the following separate product markets in relation to SME banking services: BCAs (with or without overdraft facilities), business loans and deposit accounts.[149] We also identified GB and NI as separate geographic markets for each of these products.

8.11 The SME market study did not identify any concerns in relation to SME deposit accounts and we have similarly not received evidence to suggest that further analysis should be undertaken of competition in relation to business deposit accounts.

8.12 Access to finance for SMEs has been the subject of much government focus throughout the UK, in particular since the financial crisis. Whilst there is clearly a link between competition and access to finance, the focus of our investigation has been on assessing the nature of competition between banks in the provision of retail banking services to SMEs, including lending. Where relevant we have considered the impact of schemes such as the British Business Bank and the FLS on our assessment but we have not considered wider access to finance issues as part of the investigation.

8.13 This section is structured as follows:

- First, we provide background information on SMEs and the way in which banks segment SMEs. We also summarise our analysis contained in Section 6 on market structure and outcomes.
- Second, we look at SMEs' attitudes to banking.

[149] While we consider overdrafts as part of the BCA market for the purpose of market definition (see Section 4), for most of this section overdrafts are analysed and reported alongside other lending products, as they share a number of similarities. We recognise, however, that an overdraft cannot be obtained without a BCA and make reference to overdrafts where relevant to SMEs' decisions and behaviours regarding BCAs.

- Third, we analyse the nature of engagement when an SME first considers a BCA and thereafter.
- Fourth, we examine whether there are barriers to searching and switching BCAs and whether these might explain the observed outcomes in the market.
- Fifth, we examine whether there are barriers for SMEs to search and purchase business loans from a different provider than their main BCA bank.
- Sixth, we summarise our findings on SME engagement.

8.14 In addition Appendix 8.1 on BCAs and Appendix 8.2 on SME lending support the analysis in this section.

Background information and outcomes

8.15 Demand for SME banking services is affected by the demographics of the SME population. For example, microbusinesses tend to have simpler banking requirements than larger SMEs which may trade over more than one site and internationally. Appendix 8.1 contains further background information on SMEs including recent trends in the SME population in the UK, and their characteristics. It also provides a brief description of SME usage of banking products and how banks segment the SME population.

SME characteristics

8.16 In 2014 there were just over 5 million SMEs in the UK (Appendix 8.1, Table 1) accounting for 99.9% of all businesses. Since the recession there has been a sustained rise in the number of SMEs in the economy, up by 760,000 since 2010 and 330,000 since 2013. This has been among both sole-trader SMEs with no employees as well as those with employees. However, despite the rise in the number of SMEs, the total number using a BCA in GB has remained broadly stable over time at around 4.8 million since 2012 (see Table 6.1).[150,151]

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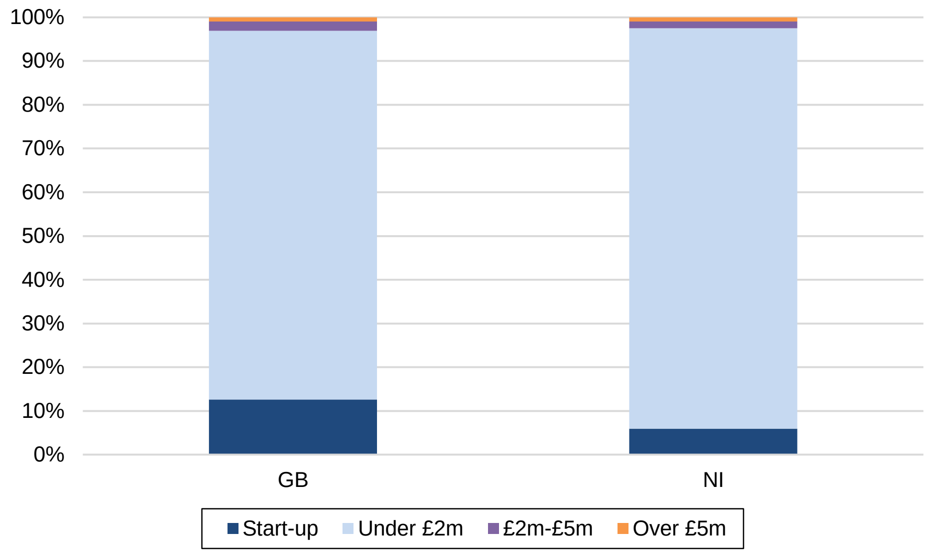
[150] This figure refers to active accounts.
[151] The difference in the total number of SMEs and the total number of active BCA accounts can partially be explained by some SMEs using a PCA for business purposes. The SME Finance Monitor estimates the proportion of SMEs using PCAs to be approximately 14%. SMEs that are most likely to use a PCA for business purposes include low turnover SMEs and sole traders as PCAs tend to lack the functionality needed for the majority of larger SMEs. For instance, paying wages and authorising multiple payments from one account.

8.17 The vast majority of SMEs are small. Data from Charterhouse BBS shows that 97% of SMEs with BCAs in GB have a turnover less than £2 million, including 13% that are start-ups.[152,153] Less than 1% have a turnover above £5 million. In NI just over 90% of the SME population with a BCA have a turnover below £2 million and 6% are start-ups (see Figure 8.2). The proportion of SMEs with a BCA and a turnover above £5 million is broadly similar to GB at 1%. We observe similar patterns on employee numbers: approximately 75% of the SME population have no employees and 20% employ one to nine employees. Less than 1% have more than 50 employees.[154]

Figure 8.2: Turnover profile of SMEs in GB and NI using BCAs



Source: Charterhouse BBS 2014 and Charterhouse NI BBS.
Base: All SMEs 2014 (14,239).
Notes: Some SMEs use a PCA rather than a BCA so the number of businesses may be higher. However, the Charterhouse survey only asks about the SME with a BCA account.

8.18 Each year a number of new businesses will start trading and a number of businesses will cease to trade.[155] In 2013, approximately 14% of the total business population in the UK were new businesses and 10% exited (see Figure 4 in Appendix 8.1).[156] This natural business turnover is partially reflected in the level of churn in BCAs. As set out in Section 6, approximately 12% of BCAs were opened and closed in 2014.

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[152] Start-ups in Charterhouse BBS are defined as businesses that began trading within the 12 months prior to the questionnaire.
[153] We provide details of the Charterhouse BBS in Appendix 8.1. In general results from the Charterhouse BBS are for GB only, unless NI is specifically noted.
[154] See Appendix 8.1.
[155] In addition, businesses can expand beyond the size of an SME.
[156] This includes all businesses not just SMEs, however, large SMEs account for a relatively small proportion of the overall SME population.

8.19 Start-ups have the highest failure rates. After the first year of trading approximately 90% of SMEs are still in business. However, by year 3 this has dropped to 60% and by year 5 less than half (around 40%) are still operating.[157] Whilst there is a great deal of churn at the start-up phase, at the other end of the spectrum just under half of SMEs (46%) are over ten years old and just over a quarter (26%) are over 20 years old (Appendix 8.1, Figure 6,). As will be discussed in more detail in Section 9, the natural level of entry and exit or 'churn' has implications on how banks compete for SME customers and which segments of the SME market banks seek to attract.

SMEs usage of BCAs and other banking products

8.20 As we set out in Section 4, BCAs are core payment accounts, generally used to make and receive payments and to manage cash flow. As such, they are a must-have product for most SMEs seeking to do business.

8.21 However, the types of transactions that SMEs make via their BCA and the services and products they use from their bank will vary significantly depending (among others) on the size of the SME, the type of business and the sector they operate in. For example, a retail cash handling business that primarily makes and takes cash payments is likely to require access to branch services, whereas an online business will need access to online banking services rather than branch-based services. Similarly, a larger business that employs multiple staff and has numerous suppliers and customers is likely to need a wider range of services and products from its bank and will use its BCA for multiple types of transactions, including to pay staff.

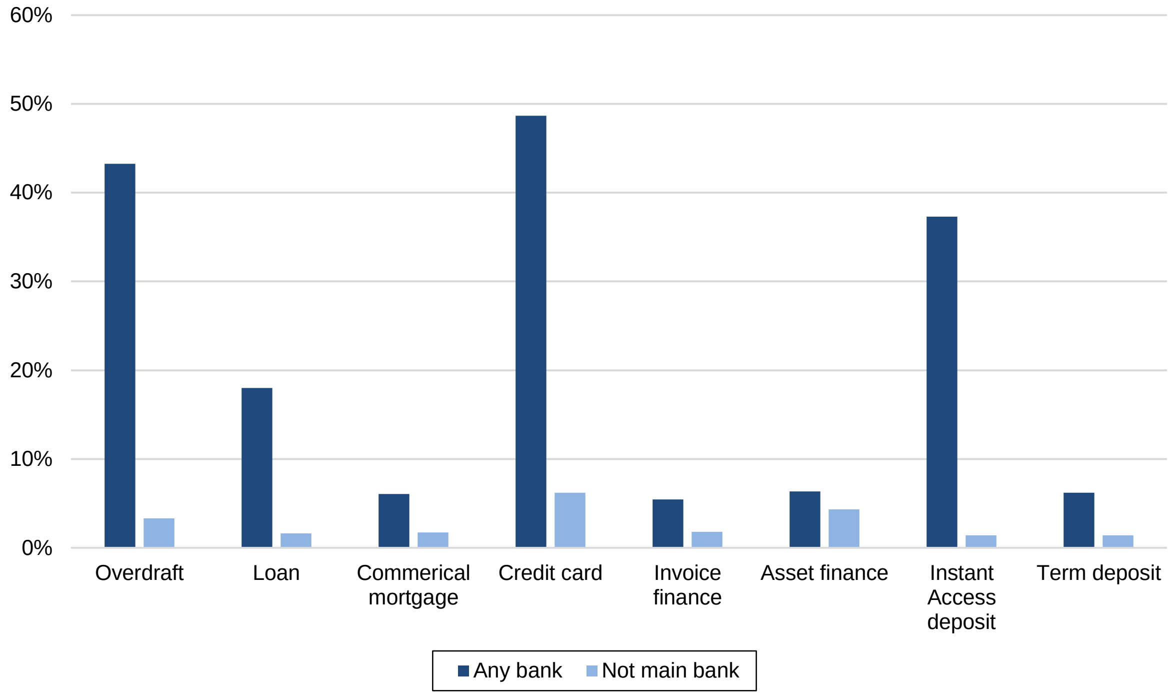
8.22 This wide diversity of usage means that BCAs are inherently complex products that need to support a variety of different transactions and requirements. In relation to SMEs, banks will typically charge per transaction or more recently charge a monthly fee which will include a specific volume of transactions within the monthly fee or at a reduced fee. Anything not covered by this monthly fee is paid per transaction at the banks' standard rates. Examples of transaction charges for SMEs include direct debits, standing orders, depositing cash and taking cash out at ATMs.

8.23 Alongside this many banks may also provide additional services with a BCA. This include overdrafts, access to a relationship manager to provide advice and support to SMEs. Many banks also provide additional products and services beyond their specific BCA such as other forms of lending, deposits,

[157] See Appendix 8.1.

and mortgages. As shown in Figure 8.3 SMEs will generally hold more than one product with their main bank. Larger, more complex businesses will hold more products than their smaller counterparts.

Figure 8.3: Proportion of SMEs holding banking products (GB)

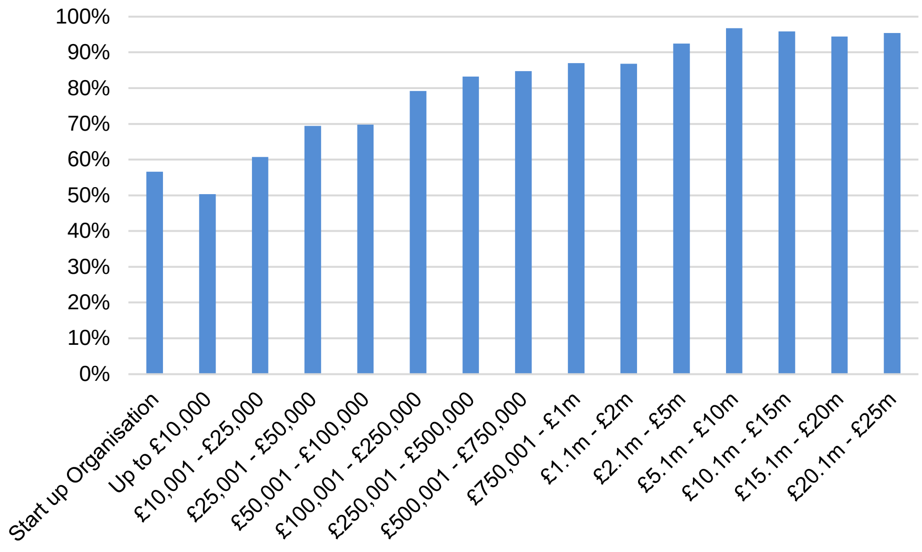


Source: Charterhouse BBS 2014.
Base: All SMEs asked about other products (4,993).

8.24 Lending facilities are not used by all SMEs. Some SMEs do not require finance, and others are more suitable for or may prefer other types of finance such as personal equity.[158] The Charterhouse BBS shows that larger SMEs are more likely to take out lending.

[158] See Section 4 and Appendix 8.2 on types and suitability of types of finance.

Figure 8.4: Proportion of SMEs who held finance in last 12 months by SME turnover (GB)



Source: Charterhouse BBS 2014.
Base: All SMEs asked about banking products other than their BCA.

8.25 Credit cards account for the greatest proportion of lending including overdrafts (48% of SMEs have credit cards and 43% held overdrafts) while only 18% held a loan in the last 12 months. Few SMEs use invoice or asset finance and those that do are predominantly larger SMEs.[159]

Banks segmentation of SMEs

8.26 Reflecting the diversity in the SME population, banks will typically segment customers based on the turnover or the value of the business.[160] The segmentation by banks influences the products available and the degree of negotiation on tariffs and terms as well as the level of support and quality of relationship management SMEs receive. The largest five banks generally serve SMEs across two business units: business banking and commercial banking.

(a) Business banking is where the majority (around 95%) of SMEs lie and is generally for smaller businesses with turnover up to around £2 million.[161] These SMEs, particularly those at lower turnovers in this band, will tend to have simple banking needs, often requiring only a transactional relationship with their bank (eg making payments, cash handling). Some of these SMEs will get access to relationship managers, albeit as part of

[159] Charterhouse BBS 2014.
[160] This is a proxy for the complexity of the business and the types of services it is likely to require.
[161] Names and exact turnover splits vary by bank (See Appendix 8.1).

a large portfolio. Negotiation of prices and terms is limited. Start-ups and to a lesser extent switchers will tend to get a period of free banking.

(b) Commercial banking serves the remaining SMEs (around 5%). It generally includes SMEs with a turnover of over £2 million. These SMEs will often have a greater degree of financial sophistication (including employing specialist financial management staff) and are more likely to require a wider range of products and services than those required by smaller SMEs. SMEs with turnover greater than £2 million will generally also be provided with an individual relationship manager by their bank. Such SMEs will tend to generate more revenue for banks and are more likely to be able to negotiate on price and other terms (see Appendix 6.2, Table 5).

Outcomes

8.27 In a well-functioning market with active and engaged customers we would expect to see those banks offering lower prices and/or higher quality gaining market share as customers switch to take advantage of these better rates and/or quality of service. However, our analysis in Section 6 shows that there has been very little variation in market shares despite wide variability in price and quality across banks. In fact, there is some evidence of banks gaining market share despite appearing to offer above-average pricing and below-average quality. Conversely, there is evidence of banks appearing to offer below-average prices and above-average quality either losing market share or gaining market share at a very slow pace.

8.28 More specifically our analysis found that:

(a) There was significant variation in monthly BCA charges between banks. The difference between the highest and lowest monthly cost was over 100% for 15 of the 17 customer profiles that we examined. For five of the customer profiles the highest monthly cost was over three times as large as the lowest. The bespoke nature of SME loan pricing reflecting the specific risks associated with a given SME customer means that it is difficult to carry out an equivalent analysis for SME lending products.

(b) On quality our analysis found that the most recent entrants to the GB BCA market (Handelsbanken[162], Co-op and Santander) had higher satisfaction scores when compared with the largest banks, which all had

[162] We note that Handelsbanken has a targeted offering, which may not be replicable for mass market.

similar satisfaction ratings. Similar results were observed using NPS.[163] For NI the results were more mixed.

(c) Market shares for both GB and NI in relation to both BCAs and general-purpose loans have remained relatively stable since 2005 and concentration levels are similar. For example, the combined market share of the four largest banking groups had reduced by only one percentage point since 2012 in GB to 83% in 2014 in relation to BCAs. In NI this had reduced by two percentage points since 2012 to 86% in 2014.

8.29 We also found additional indicators of competition not being fully effective: we found that the extent of innovation in the SME markets had lagged behind the levels observed in the PCA markets (see Section 6). We also found that although there had been some entry into the provision of banking services to SMEs, in particular in relation to some lending products such as asset and invoice finance, it has been more limited than in the PCA markets. Growth by recent entrants had also been limited. This is considered in more detail in Section 10.

8.30 These indicators suggest that competition is not fully effective in the BCA and SME business lending markets, and that there is weak customer engagement in the market and/or there are barriers to searching and switching, preventing SMEs from identifying better offers in the market and acting on these and/or seeking an alternative lending provider to their BCA provider.

8.31 In the remainder of this section we look at first, in relation to BCAs, how SMEs make their initial choice of bank and what happens once they become a more established business, before examining whether there are barriers to searching and switching. We then consider SME lending, the nature of SME engagement in the market and barriers to searching and applying for credit.

SMEs' initial choice of BCA provider

8.32 One of the first opportunities for SMEs to actively engage with business banking products is when they first open a BCA. The Research Works qualitative research shows that SME owners will often start by using their

[163] Other measures of quality were also examined including opening hours and relationship managers. For more details see Section 6. It should also be noted that these measures do not cover all aspects of quality. For NI due to small sample size it is more difficult to interpret the results of the analysis.

PCA account but when they consider themselves more established, they will then open a BCA account.[164]

8.33 The Research Works qualitative research also found that those opening their first BCA were more likely to look around for alternative providers than they had when looking for their original PCA. The Charterhouse follow-up survey with start-ups showed that 54% of SMEs did some searching before opening a BCA, although 36% went straight to their PCA provider.[165,166] When asked whether they compared different providers against each other, 58% said that they did not compare other providers and a further 23% did so in a superficial way.[167]

8.34 We find that, overall, just over half of start-ups open a BCA with their PCA provider, although this varies by bank (see Figure 8.5).

Figure 8.5: Proportion of start-up SMEs in GB opening a BCA with their PCA provider (by brand) (2010 to 2014)

[✂]

8.35 We do not have equivalent data for NI due to the small number of start-up SMEs in Charterhouse's survey sample.

8.36 For start-ups that did not compare banks, the most important reasons given for choosing a BCA provider were the bank being the personal bank (25%), branch location (20%), and free banking (17%). For those that did compare providers, free banking was the most important reason given (39%), followed by attractive charges and fees (12%) and the branch location (12%).[168]

8.37 While the survey suggests free banking was a significant driver for SMEs that were considering different banks, we note that most banks offer initial free banking periods, so it is not a clear differentiating factor beyond the different lengths of free banking offered.[169] However, the follow-up survey also provides evidence that SMEs do not consider the lifetime cost of banking. We found that 28% of start-ups did not consider future fees when choosing their initial BCA, although SMEs that compared banks were more

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[164] See Research Works SME qualitative research, p14. Research Works qualitative research covered the UK.
[165] SME follow-up surveys, p9. Results from the Charterhouse SME follow-up surveys cover the UK.
[166] The remaining 9% were SMEs who did not go to their PCA bank, but did not compare banks either.
[167] SME follow-up surveys, p16.
[168] See Appendix 8.1. The chart displaying the results for all start-ups can be found at p11 of the SME follow-up surveys.
[169] The variation in the length of the free banking offer may explain why 'free banking offer' comes up as a choice factor for those who compared different banks. Further information on length of free banking periods is presented in Appendix 8.1.

likely to consider future fees (41% of start-ups who compared banks considered future fees compared with 15% who did not compare banks). Of the 72% of all start-ups who did say that they considered future fees, 12% then went on to say that they did not look into the fees at all, 24% did not spend much time looking at fees and 14% looked at the fees of the provider they chose without comparing between banks.[170,171]

8.38 Few SMEs compare across banks the fees that they will pay after the end of the free banking period.[172] This means that the ability of SMEs to search and switch after they have chosen a BCA provider is particularly important for the competitive process.

SME behaviour after they have chosen a BCA provider

8.39 Once an SME has made an initial choice of BCA, the suitability of the product may change over time. This will particularly occur at the end of the free banking period, when the charging structure may not suit the SME, but will also arise if its needs change, as its business evolves and/or it requires additional banking products such as access to lending. Equally, an SME may become dissatisfied with their bank if the service does not meet its expectations. These changes could cause an SME to reassess its banking needs and which provider is best suited, and potentially switch BCA provider.

8.40 The annual switching rate for BCAs in GB was around 4% in 2014 (see Figure 8.6).[173] This compares with around 3% for PCAs.[174] In addition, around 4% of SMEs hold more than one BCA.[175] In NI, only 2.6% of SMEs switched BCAs in the last year.[176]

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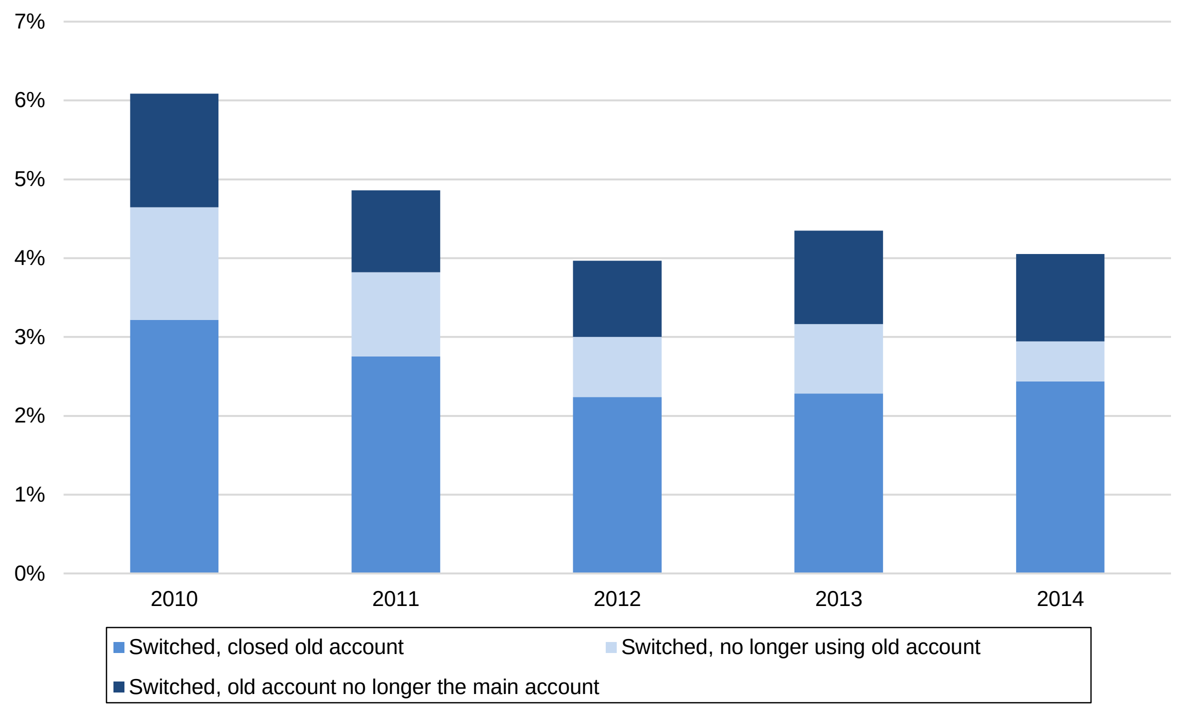
[170] SME follow-up surveys, p18.
[171] Our view is that considering future fees and looking into future fees are slightly different, and that looking into future fees is a better measure of its importance to SMEs.
[172] SME follow-up surveys, p18.
[173] This followed a decline in switching after the recession, when switching rates fell from 6% in 2010 to just under 4% in 2012. These rates include partial switching where the SME retains their old account.
[174] This excludes internal switching. We do not consider that internal switching is a reliable indicator of engagement, especially where SMEs come to the end of their free banking period and are simply moved on to a different tariff at this stage.
[175] This does not suggest there are a significant number of SMEs that are engaging in partial switching between existing BCAs (see Appendix 8.1, Figure 29).
[176] Charterhouse BBS NI. In addition, around 4% of SMEs use more than one BCA in NI.

Figure 8.6: SME BCA switching rates in GB (2010 to 2014)



Source: Charterhouse BBS, 2010–2014.
Base: 2010 (15,866), 2011 (16,188), 2012 (15,746), 2013 (15,838), 2014 (14,239).
Note: The Charterhouse BBS asked respondents 'Have you changed your main bank over the past 12 months?' While the main bank does not necessarily mean the BCA provider, 96% of businesses named their main bank as their BCA provider.

8.41 In 2014, switching rates in GB were higher for SMEs which had been operating for two to five years compared with older SMEs (see Appendix 8.1, Figure 23).[177]

8.42 We found that older SMEs have a particularly low inclination to switch BCA providers. 70% of SMEs in GB that have been in business for over ten years have been with their main bank for at least ten years, and 79% of SMEs who have been in business for at least five years have been with their main bank for at least five years.[178] Similarly in NI, 77% of SMEs who have been in business for over ten years have been with their main bank for at least ten years, and 88% of SMEs who have been in business for at least five years have been with their main bank for at least five years.[179]

8.43 We also found indications of limited searching by SMEs once they have chosen a BCA: the Charterhouse follow-up survey found that 77% of

[177] Due to the sample size of the Charterhouse NI BBS, there are few SMEs who have been in business for less than two years. Therefore all SMEs under five years old are grouped together. Switching rates for this group were higher than for those SMEs over ten years old. (See Appendix 8.1, Figure 24).
[178] Charterhouse BBS 2014.
[179] Charterhouse BBS NI.

businesses between two and five years old said that that they never compared the costs of their BCA with those of other providers.[180]

8.44 When SMEs do switch, the main drivers for switching appeared to be dis-satisfaction with an element of service and the costs of banking.[181] For younger SMEs costs were particularly important. In the Charterhouse follow-up survey of SMEs between two and five years old, the main reasons for considering switching were the current service being too expensive and the offer of free banking from another provider. Service issues appeared to be a much less significant factor.[182]

8.45 Even at a potential trigger point at the end of the free banking period, the majority of SMEs did not consider switching (67%) and only six of the 78 respondents who considered switching actually switched banks.[183] Of those who did not consider switching, the main reason stated by respondents was satisfaction with their main bank (45%).[184] However, over a quarter reported not considering switching because it was 'too much hassle' or thought it would take too long[185] with others citing existing payment arrangements/ continuity of payment arrangements (9%) and products linkages (6%) with their BCA. 12% cited the charges being too small to warrant switching.

8.46 As discussed above, the main reason given by SMEs for not switching at the end of the free banking period was satisfaction with their provider (45%) which might suggest that levels of engagement are higher than switching rates may indicate.[186,187]

8.47 Whilst we would not necessarily expect those customers satisfied with the current service to want to switch, in a competitive market we would still expect a higher proportion of the least satisfied customers to consider switching.

8.48 Evidence from Charterhouse BBS shows that while businesses that were least satisfied with their bank are more likely to switch, around 35% of those who considered their banking service to be poor were still not considering

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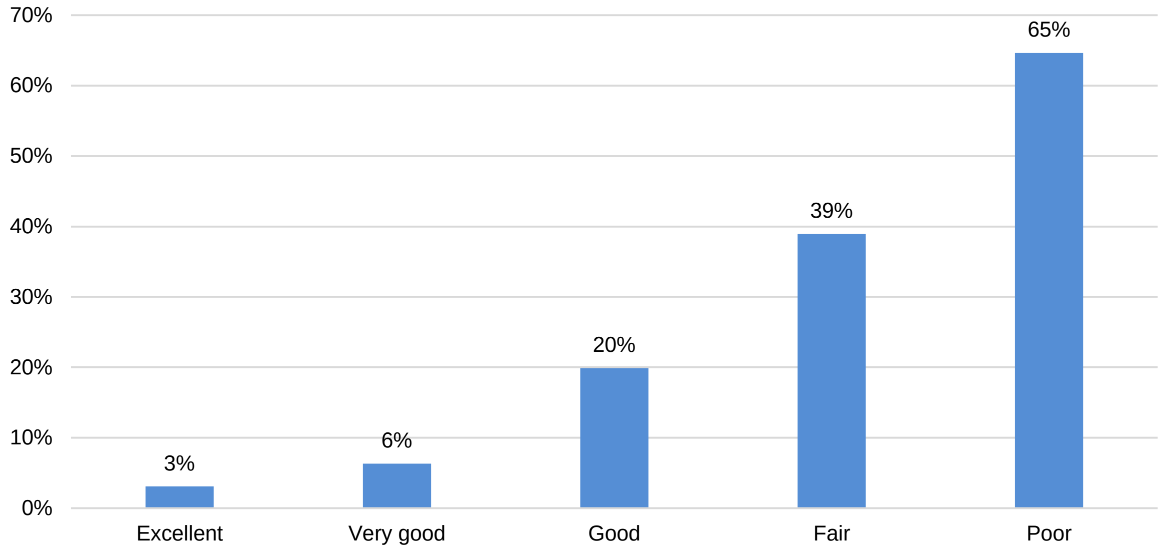
[180] SME follow-up surveys, p32.
[181] The drivers of switching are discussed in Appendix 8.1.
[182] SME follow-up surveys, p30.
[183] SME follow-up surveys, p29.
[184] SME follow-up surveys, p29.
[185] Further results are in the SME follow-up survey results.
[186] Another potential explanation of low switching and long times spent with a bank is negotiation. However, as outlined in Appendix 8.1, banks do not tend to negotiate with SMEs in their retail banking divisions (the parts of the bank that deal with smaller SMEs). Therefore, for at least 95% of SMEs, negotiation is not an option and is not a relevant consideration.
[187] In a market with a high degree of churn, switching may not be a relevant benchmark of customer engagement. However, for reasons outlined in Section 9, we do not consider that churn diminishes switching as a relevant measure of customer engagement.

switching. The pattern in NI was similar, although there were more customers considering switching among those who were least satisfied (see Appendix 8.1, Figure 46).

Figure 8.7: Rates of switching consideration by satisfaction level GB (2014)



Source: Charterhouse BBS, 2014.
Base: All SMEs asked; excellent (2,181), very good (3,481), good (2,507), fair (1,139), poor (801).

8.49 This is broadly consistent with evidence from Research Works' qualitative research[188] and FCA qualitative research,[189] which found examples of SMEs that had been unhappy with their bank, yet remained disinclined to switch. Typically, these respondents were 'tolerating' their situation. Some felt that a change to an 'unknown' provider might lead to a worse outcome.

8.50 In addition, given the difficulties in comparing offers across banks we identify below, and the low levels of search (with 77% of businesses between two and five years old saying that that they never compare the costs of their BCA with other providers), satisfaction levels do not necessarily always reflect an awareness of whether SMEs are indeed best served by their bank.[190]

8.51 Therefore, given the evidence above we do not consider customer satisfaction explains the levels of switching.

Barriers to searching and switching BCAs

8.52 So far we have observed low levels of switching and low levels of searching around by SMEs when coming to the end of their free banking period. We

[188] See Research Works SME qualitative research.
[189] See Optimisa Research for the FCA (March 2015), *Engagement with current accounts and the switching process* ('FCA CASS qualitative research').
[190] Satisfaction levels are examined further in Appendix 8.1.

have also found that, although there are higher rates of searching by SMEs at start-up, few start-ups spend time comparing future fees when considering their choice of bank. In the following section, we consider possible explanations for SMEs' behaviour, looking at various factors that may act as barriers to searching and switching.

8.53 We look at the following possible explanations for the low searching and switching levels:

(a) Whether SMEs' attitudes to banking may reduce their propensity to search and/or switch.

(b) Whether there is a perception of lack of differentiation between banks.

(c) Whether there is a perception that the financial gains from switching are limited.

(d) Whether there are barriers to searching because of a lack of transparency and/or comparability of information on BCA offerings.

(e) Whether there are barriers to switching BCAs.

SMEs' attitudes to banking

8.54 Various research on SME attitudes to banking suggest that SMEs' propensity to search and switch BCAs is low.

8.55 The FCA conducted qualitative research on SMEs' attitudes to banking.[191] Four key themes emerged from this research:

(a) low maintenance, where reliable current accounts are taken for granted with few customers having experienced problems;

(b) low priority, because current accounts are not generally perceived as being costly to customers;

(c) long term, because customers may feel they receive benefits from being loyal; and

(d) convenience, especially for customers who need access to a certain channel such as a branch, and have become used to using that channel.

8.56 The Research Works SME qualitative research found that some SMEs would not consider switching BCA if they felt existing arrangements were

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[191] See FCA CASS qualitative research.

working well. Their attitude tended to be one of 'if it's not broken, don't fix it.' This attitude was particularly prevalent among respondents representing younger businesses, largely because they did not demand much from their banking providers. Among this group, transaction rates were typically low due to smaller client bases, as were charges, and the types of transaction were relatively straightforward. As a result, this group typically had a limited interaction with their banking provider, particularly if all their transactions were carried out online.[192]

8.57 Both the FCA qualitative research and Research Works found that there is a perception amongst some SMEs that staying loyal means 'you get a better deal', which again may reduce SMEs' propensity to search and switch. The FCA's qualitative research found that:

> Some customers feel they may receive beneficial treatment for being a long-term customer, as their existing bank/building society would know their history, e.g. their ability to keep up with payments. This sentiment is particularly pronounced amongst [SMEs], who sometimes have long-standing relationships with Relationship Managers.

8.58 The Research Works SME qualitative research found that some respondents considered that banks would be more inclined to give the SME a better deal if they did not switch, because the bank would know the business better.

8.59 For SMEs to consider searching and/or switching, they will need to expect benefits from searching, either because they expect to receive a better-quality service or a cheaper service (or a combination of both). Their perception that there are differences between providers and between products are therefore likely to be key drivers in their willingness to engage and shop around at the outset and search once they have a BCA.

Perception of limited differentiation between banks

8.60 Our analysis of outcomes found that there was very little difference between the largest four banks on quality[193] although differences between providers were found on both price and free banking periods for start-ups and switchers (see Appendix 8.1, Table 2).

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[192] Research Works SME qualitative research.
[193] See Section 6.

8.61 The FCA's qualitative research also noted that SMEs did not think other providers would be any different to their current provider. This was identified as part of a wider distrust in the banking industry and was more evident among smaller SMEs that felt they were 'just a number' to the larger banks.[194]

8.62 The Research Works SME qualitative research found similar results. In particular, it found that the perception of a lack of differentiation was based on assumptions rather than a factual appraisal or understanding of the range of BCA banking offers. Nonetheless, when prompted during the research interview, no bank was perceived to have a clearly differentiated business offer, ie a business offer distinct from any other provider; and, when prompted during the research interview, there was perceived to be a general lack of specific BCA advertising (particularly in comparison with PCA advertising).

8.63 This perception of a lack of differentiation between banks is in our view likely to be a factor which reduces some SMEs' propensity to search and switch.

Perception that the financial benefits from switching are insufficient

8.64 The annual average cost for a BCA was around £379 in 2014.[195] The relatively low cost of BCAs for many SMEs, compared with other costs they incur (such as supplier bills or energy and telecoms bills), means that SMEs may have low incentives to consider switching BCAs.

8.65 There is evidence from several sources suggesting that the financial benefits from switching may be perceived to be insufficient by some SMEs to switch.

8.66 In the Charterhouse follow-up survey with SMEs between two to five years old, although 'satisfaction' and 'hassle' were the primary reasons given for SMEs not considering switching at the end of the free banking period, 12% said it was because the differences in charges were too small, 5% mentioned banks being the same and 5% said that switching banks was not a priority.[196]

8.67 The HSBCG survey 2014[197] found that 94% of 'considerers' and 75% of 'non-considerers'[198] considered there was a lack of incentive to switch

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[194] FCA CASS qualitative research, p32.
[195] See Appendix 8.1.
[196] SME follow-up surveys, p29.
[197] HSBCG survey 2014. See Appendix 8.1 for a discussion of this survey.
[198] Analysis of the survey was broken down by three groups of SMEs: SMEs that have switched BCA providers in the past five years ('Switchers'); SMEs that have considered switching BCA providers in the past five years, but

provider, with 46% of considers and 41% of non-considerers mentioning other offers being too similar to the existing offer and 43% of considerers and 36% of non-considerers saying there was not enough price benefit.

8.68 The HSBCG survey 2014 also asked customers how much they expected to save if they switched. Among considerers, 22% did not know how much they could save, 15% did not expect that they could save anything while a further 36% expected to save less than £10 per month.[199] 67% of considerers did not think they could save enough to make switching worthwhile. Among non-considerers, 38% did not know how much they could save, 35% did not think they could save anything while a further 24% expected to save less than £10. 88% did not think they could save enough to make switching worthwhile.

8.69 The FCA's qualitative research supported the HSBCG survey 2014 in suggesting that businesses considered that there was very little differentiation between the banks, and there was little being offered by other banks to induce switching.[200] In addition, qualitative research conducted by LBG on customer retention noted that the market was not dynamic and there were few pull factors evident with little evidence of competitors seeking to incentivise switching behaviour.

8.70 This perception that the financial gains from switching are insufficient is likely to be a factor explaining low switching rates for some SMEs.

Barriers to searching

8.71 In order for an SME to understand and compare BCA features, it needs to understand the offers (including charges and levels of service) from the different banks and to understand its own likely transactional behaviour so it can understand how the transaction charges would impact on it. If it is difficult or too time-consuming for SMEs to identify the best offers in the market, then they are unlikely to search in the first place. This is particularly true of smaller SMEs, which tend to be more time-poor and consider banking less important than other more immediate business priorities.

8.72 In this section we consider the degree of transparency for BCAs, first considering transparency of information from providers about both price and

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did not switch ('Considerers'); and SMEs that have not considered switching in the past five years ('Non-Considerers').

[199] The remaining proportion were distributed as follows: £11–£25 (12%), £26–£50 (9%), £51–£100 (6%), >£500 (1%). Please note that weighted base for this question was 135.

[200] FCA CASS qualitative research, pp32 & 33.

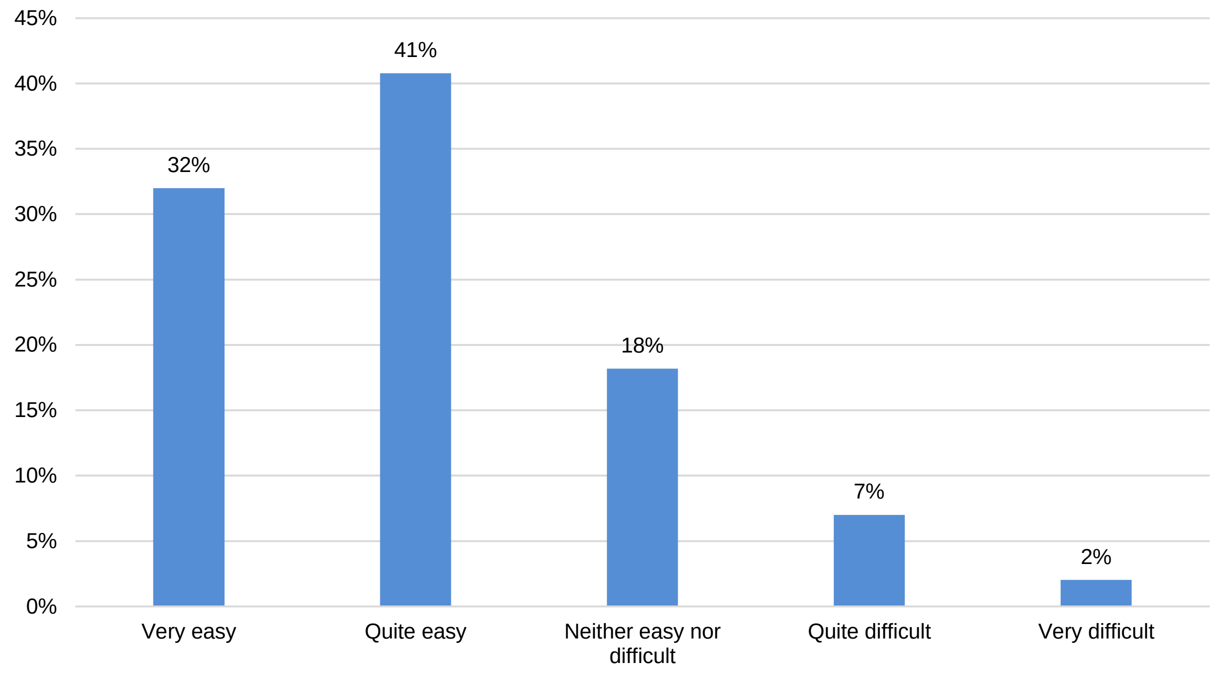
quality before considering the ease with which SMEs can compare different banks' offers.

Transparency of account charges and rewards

8.73 The parties submitted to us that information on account charges are accessible across a number of channels, including the banks' websites. This was the most frequently mentioned source of information in the Charterhouse follow-up survey with start-up SMEs.[201] Our analysis of banks' websites showed that much of the basic information on costs can be found fairly easily.[202] Getting detailed information on the exact charges for each account requires slightly more searching on some banks' websites but is generally visible.[203]

8.74 Information from our start-up survey suggests that the majority (73%) of start-ups that had considered the post free banking fees found it easy to find information on these (see Figure 8.8), although 9% found it quite or very difficult.

Figure 8.8: How easy is it to find information on post free banking prices (UK)



Source: Charterhouse follow-up survey of start-ups, Question C6.
Base: All offered free banking and considered future fees (129).

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[201] SME follow-up surveys, p16.
[202] The type of information that is displayed on each bank's web pages varies from bank to bank, but basic information includes monthly account fees, whether interest is paid, maximum transactions or cash paid in or out, or basic information on overdrafts.
[203] For example HSBC has a publically available Business Banking Price List. Appendix 8.1 contains more information on the sources of information SMEs use and the ways of accessing account charge information.

8.75 The HSBCG survey 2014 asked SMEs how difficult it was to access pricing information, but also the length of time needed to assemble the information to make comparisons. It found that 15% of switchers and 27% of SMEs who considered switching account in the last five years ('considerers') thought it was difficult to access pricing information from other banks. A third (34%) of 'considerers' also thought it took a large amount of time to assemble the relevant information to make a comparison.[204] Moreover, some SMEs felt they lacked information to assess offers, (54% of considerers and 28% of non-considerers). This suggests that, while accessing the information is not generally considered to be difficult, there are more difficulties for SMEs to assemble the information and compare this information across banks.

8.76 Larger SMEs are more likely to receive bespoke pricing through negotiation.[205] Naturally a negotiation process involves speaking with business or relationship managers to come to an agreement on charges (and terms and conditions). This potentially reduces transparency of prices, although this is just a natural part of the process of negotiation.

Transparency of service attributes and quality

8.77 While price is an important factor for SMEs when choosing who to bank with, there is significant evidence to suggest that non-price elements of business banking offers – namely service attributes and service quality – are also very important. While price was mentioned by more start-ups as the most important reason for choosing a BCA, a significant proportion also mentioned branch-related factors and staff or service-related factors as the most important factors.[206]

- *Service attributes*

8.78 The Research Works qualitative research suggested that the following service aspects were important to SMEs:

(a) branch opening times and the availability of a relationship manager;

(b) speed of access/establishment of services; and

[204] HSBCG survey 2014. As discussed in Appendix 8.1 we have some reservations about the robustness of this survey, but find it useful to give an indicative sense of the ease with which SMEs can find information on prices from other banks.
[205] Banks have different turnover criteria necessary for offering bespoke prices. Table 2 in Appendix 8.1 shows at what turnover SMEs are able to start negotiating on BCA pricing at each bank. [✂]
[206] SME follow-up surveys, p11.

(c) characteristics of customer services (eg UK-based call centres, dedicated customer handling staff, no automation).

8.79 Evidence from the Charterhouse follow-up survey of start-ups and the Charterhouse BBS supports the qualitative research. At least 80% of SMEs had visited a branch counter service over the past year and around a quarter of SMEs (23%) reported that this was their most used method of banking.[207] The vast majority (84%) of start-ups mentioned that branches were important in their choice of BCA, with 84% of those SMEs saying this was because they needed to pay in cash or cheques and 19% needing to meet a relationship manager face to face.[208]

8.80 Information on branch locations and opening hours is generally readily accessible. The Business Banking Insight website[209] helps SMEs to collect and compare information on both service attributes and banks' quality of service. It allows SMEs to leave comments as well as rate the quality of service on a number of aspects.[210] However, evidence from the Research Works qualitative research suggests that SMEs are more likely to place weight on experiences from their known SME peers, rather than from comments on a website (if they do not have their own experience of using a BCA with a particular provider).[211]

- *Service quality*

8.81 There is a general lack of comparative information in the public domain on service quality, including the performance of relationship managers, customer service and errors or complaints.[212]

Assessing BCAs

8.82 Assuming that SMEs can access the information on charges, they still need to be able to assess the different product offerings to make an informed decision. This involves understanding and comparing prices, charges and quality. SMEs may be unable to do this because:

(a) their own account usage data is difficult to access;

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207 Charterhouse BBS 2014.
208 SME follow-up surveys.
209 Jointly driven by the FSB and British Chambers of Commerce (BCC), Business Banking Insight was originally initiated by HMT and is supported by an advisory group that includes the British Bankers' Association, RBSG and the Department for Business, Innovation & Skills. It is operated by ICM Unlimited and TMW.
210 Appendix 8.1 covers more information on the use and functionality of Business Banking Insight.
211 Research Works SME qualitative research, p31.
212 However, RBSG submitted to us that on its website it presented its service level agreements (SLAs) and the performance against those for particular products.

(b) they lack information or awareness on the costs of their BCA;

(c) charges are complex;

(d) they lack financial sophistication;

(e) comparisons tool are insufficient; and/or

(f) there is a lack of other support, such as advisers.

8.83 We consider these issues in turn below.

- *Access to account usage data*

8.84 For SMEs to compare the costs of using different BCAs they need to have some understanding as to their likely future usage. In many cases their previous transaction history may be a good proxy for future usage and hence a good basis from which to calculate the likely cost of using a particular BCA.

8.85 Established SMEs have some experience and track record of using a BCA and therefore will typically have a much better idea of their own transaction history. However, there is no equivalent to Midata[213] for SMEs at present that could be used in conjunction with a price comparison tool.

8.86 We note that BCA transaction history may be less useful or non-existent for start-up SMEs. Start-ups will either have been using a PCA for their business up to the point of opening the BCA (and as such may have some transaction history from their PCA to assess the likely costs of their BCA) or may not have any transaction history.

- *Awareness of costs of existing BCA*

8.87 To compare the costs of different BCAs, SMEs that are considering switching will need to have information on the costs of their existing BCA against which to compare an alternative provider. The Charterhouse follow-up survey results suggest that SMEs have relatively high awareness of the costs of their BCA: 66% of start-ups and 77% of two to five year old businesses monitor the cost of using their BCA.[214] The follow-up surveys also found that charges on own BCA accounts were transparent. For instance 83% of two to five year old SMEs that had compared the cost of

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[213] See Sections 3 and 7 for more information on Midata.
[214] SME follow-up surveys.

using their BCA with other banks said the charges on their own account were either very or quite transparent.[215]

8.88 At least one bank told us that it provided new start-up or switcher SMEs with summaries of BCA charges and interest in the form of a pre-notification advice statement every month during their free banking period.[216] This gives SMEs on free banking an idea of the likely costs of their BCA once they start paying charges.

- *Complexity of charges*

8.89 There is a wide variety of transactions that are made through BCAs. By way of illustration, NatWest has a summary document which lists 19 different charges for each standard tariff and business plus tariff.

8.90 Due to the complex nature of BCAs and the number of different charges and transactions that can arise, it can take some time to compare costs. While an SME will wish to keep its costs down, the relative size of the charges of running a BCA compared with other costs the business faces (particularly for established SMEs) may mean that an SME would rather spend time on other tasks than calculating the best BCA for its needs. For example, the main reason given by both start-ups and two to five year old SMEs for not comparing costs was that they did not have the time to compare the current level of charges (see Appendix 8.1, Figure 11).

8.91 Furthermore, the Research Works SME qualitative research suggested that comparing information was far more difficult than obtaining it in the first place. Salient issues were the high number of different charges making calculations difficult (particularly when calculated mentally), and trying to understand the different charges and how they correlate across banks.[217] For instance one SME said: ‘It’s difficult to hold everything in your head as you go through them.’

8.92 Some parties also submitted to us that comparing accounts could be challenging for some SMEs. This view was also held among some SME advisers:[218] ‘Charges are visible, but not transparent.’ (Independent Financial Advisor.) ‘I think charges are complex because they can differ so much across different products and you have to know how many transactions you do.’ (Accountant.)

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215 SME follow-up surveys.
216 This letter shows the amount they would have been charged had they not been on free banking.
217 Research Works SME qualitative research, pp30 & 42.
218 Research Works SME qualitative research.

8.93 The HSBCG survey 2014 suggested that some SMEs found calculating and assessing which product was best for them a difficult task. 14% of switchers and 34% of considerers found calculating the costs difficult or very difficult, and 16% of switchers and 28% of considerers found assessing the best pricing option difficult.[219]

- *Financial sophistication*

8.94 Where charges are complex, understanding them may be difficult. SMEs with lower levels of financial sophistication may struggle to compare products or fully understand the different charges and when they might occur. This in turn may either lead to SMEs making poor decisions, or being entirely put off searching and comparing.

8.95 Evidence suggests that few SMEs have staff solely responsible for financial decisions. However, this appears related to the turnover of the business: 88% of respondents to the Charterhouse BBS GB survey[220] working in start-ups and 82% working in SMEs with turnover less than £2 million were owners, managing (or other) directors, chairmen, or partners. In contrast, 53% of respondents working in SMEs with turnover between £2 million and £10 million and 83% with turnover over £10 million were financial directors/managers/controllers or accountants.[221]

- *Comparison tools*

8.96 Considering the complexity of comparing BCAs and the limited time that SMEs have to make these comparisons, tools that help simplify and shorten the process may encourage comparisons and improve decision-making, particularly if they include service quality elements and the ability to take into account past usage.

8.97 In this section we assess PCWs, calculators and Business Banking Insight.

  - *Price comparison websites*

8.98 Business Finance Taskforce and the British Bankers' Association have created a comparison tool that allows SMEs to compare accounts on a

[219] HSBCG survey 2014. As discussed in Appendix 8.1 we have some reservations about the robustness of this survey, but find it useful to give an indicative sense that at least a significant minority found assessing the best price option difficult.
[220] And hence the person best placed to talk about banking matters at the SME.
[221] See Appendix 8.1.

range of factors.[222] The Business Account Finder has the most comprehensive information on BCAs in terms of the number of different charges and costs it covers,[223] as well as the range of providers covered.

8.99 We are also aware of four commercial PCWs that offer some ability to compare BCAs. There is some variation in the level of detail and coverage they provide, but none is as comprehensive as the Business Account Finder. Additionally, none of these sites has a facility for selecting transaction usage (including the Business Account Finder),[224] as there is no equivalent to Midata for business accounts.

8.100 Many parties have also acknowledged that PCWs are not comprehensive enough. HSBC noted that there were limited tools available to SMEs to compare the prices and services offered by different providers, and in particular that PCWs for SME customers lagged behind those available for personal customers in terms of coverage and detail.[225]

8.101 Other major PCWs active in other sectors told us that they had no plans to enter the SME banking comparison market, with either BCAs, loans or other SME products in the foreseeable future.[226]

8.102 The lack of PCWs offering SME product comparisons may be explained by the lack of commercial viability. Revenues in this SME banking price comparison market are low. Business Moneyfacts told us that it only offered best buy tables and not a full search function of all accounts because it did not believe it was commercially viable to build a full search facility for the revenues available in this market.[227,228] Further information on revenues for PCWs can be found in Appendix 8.1.

8.103 Few SMEs use PCWs. According to the Charterhouse follow-up survey of start-ups only 9% of SMEs used PCWs when first considering which BCA to use.[229] There may be low awareness of the PCWs that do offer SME product comparisons. For instance, many SMEs in our qualitative research had used

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222 SMEs can specify certain criteria such as whether they need an overdraft, want interest paid, or a branch-based account.
223 This includes transaction charges such as paying in and taking out cheques and cash, direct debits, standing orders, the amount of interest paid on credit balances, and whether overdraft facilities are available.
224 Which means SMEs would need to be aware of their future transaction usage and calculations need to be done manually.
225 Similarly LBG and RBSG, as well as some other banks either noted that PCW tools were more limited for SMEs or that SMEs were under-served in having a one-stop-shop portal or online comparison.
226 [✂]
227 Moneyfacts noted that it had no immediate plans to enhance its business best buys into a full search in the SME market, but it constantly reviewed plans so this might change in the future.
228 Also, the most comprehensive website, Business Account Finder, is not intended to generate revenue or profit.
229 SME follow-up surveys, B5.

price comparison sites when choosing personal financial products, but few had realised that business banking products could be compared in the same way. The Business Account Finder, for instance, currently only appears on the fourth page on a Google search for 'Business current account comparison'.

8.104 Evidence from the Research Works qualitative research and the HSBCG survey 2014 suggested that there was some interest in PCWs for BCA comparisons. The HSBCG survey 2014 found that 51% of those that had considered switching in the last five years were more likely to switch if they could use a PCW to compare quotes, reducing to 23% for those that had not considered switching in the last five years.[230] In Research Works qualitative research some SMEs thought that PCWs were a good 'starting point'.[231]

BCA tariff calculators

8.105 Several banks have price comparator tools such as BCA tariff calculators.[232] These allow SMEs to compare a range of accounts at an individual bank assuming they have some idea of their future usage or transactional behaviour (usually by using past statements as an indication of future use).

8.106 These tools can be helpful, but they do not allow for an easy comparison across providers as separate calculators would need to be used on each banks' website. An exception is Santander's calculator which compares the cost of its own tariff (that best meets the SMEs' usage criteria) against that of tariffs at the largest four banks and TSB, by showing how much could be saved over a year. It does not, however, show where this money is saved (ie on which specific transactions).

8.107 During the Research Works qualitative research SMEs were shown some of these calculators. In general they were perceived as a useful 'starting point' for comparisons, however some expressed a degree of scepticism about the results, especially as the provider brand used for calculating always appeared most cost-effective.[233]

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[230] HSBCG survey 2014. As discussed in Appendix 8.1 we have some reservations about the robustness of this survey, but find it useful to give an indicative sense that some SMEs would find a price comparison tool useful.
[231] Research Works SME qualitative research, p30.
[232] For instance Lloyds Tariff Calculator, Santander Business Current Account Calculator, HSBC Banking Cost Calculator and Barclays Price Plan Selector.
[233] Research Works SME qualitative research, p30.

- *Business Banking Insight*

8.108 The only quality comparison tool that we are aware of is the Business Banking Insight website.[234] The website allows SMEs to rank providers on their overall service rating as well as their performance under a number of different service attributes. The website also shows feedback in the form of quotes from the SMEs interviewed in the survey. Users can then view results by SME size (both number of employees and turnover), location and industry sector among other attributes.[235]

8.109 Both awareness and use of the website is low. Less than 2% of SMEs spontaneously mentioned the Business Banking Insight website as an information source when considering which bank to choose.[236]

8.110 SMEs were also shown the Business Banking Insight website as part of the Research Works SME qualitative research. No SMEs was aware of the website before being shown it during the interview. SMEs that were concerned about service quality perceived the website as a potential 'final layer' of assessment. However, for most, the website was seen as akin to Trip Advisor, and as such, while such a tool would be fine for getting information on PCAs, for example, it was not a credible enough measure of service quality for business purposes.[237] Instead factual information such as branch opening hours, UK-based call centres and the availability of a relationship manager were seen as more helpful.

8.111 Despite these concerns, considering the importance of service quality to SMEs, the Business Banking Insight website could be a helpful tool. The HSBCG survey 2014 for found that 47% of those that had considered switching BCA in the last five years and 25% of those that had not, were more likely to switch if there was an independent website that rated the quality of service of each bank.[238]

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[234] The website allows SMEs to rank providers on their performance under five attributes (fairness and clarity, value, tailoring, availability, and being informative) as well as on their overall service rating, based upon a weighted average of all five attributes, with scores out of five also given for a range of other products. SMEs are also able to view feedback from the SMEs interviewed in the survey.
[235] Although sample sizes for some providers are low, scores are still presented along with information on how many ratings were used to calculate these scores, leaving it to the SME to decide on how much weight to place on the information presented.
[236] SME follow-up surveys, question B5.
[237] Some SMEs did not trust the reviews from other SMEs as they did not know who they were. Many would place far more weight on peer SMEs than ones they did not know.
[238] HSBCG survey 2014. As discussed in Appendix 8.1 we have some reservations about the robustness of this survey, but find it useful to give an indicative sense that some SMEs would find an independent website that rated quality useful.

- *Role of third parties*

8.112 Given the complexity of BCA charging and the lack of tools to help compare charges, we considered whether SMEs are turning to advisers such as accountants to assist and advise them on their choice of bank.

8.113 Research Works qualitative research indicated that advisers tended to simply suggest different banks, or banking strategies to SMEs, rather than helping with calculating comparisons. In general accountants were more influential than independent financial advisers, but views varied. Some were more conservative and traditional, suggesting that SMEs should stay with the banks they knew, while others suggested a more active approach of shopping around for the best deals.

Summary on barriers to searching

8.114 For smaller SMEs, information on price is generally available. Information on quality is less readily available, partly due to some aspects of SME banking being an experience good.[239]

8.115 There are a number of factors which make comparisons difficult:

(a) Information about usage is not really available for start-ups, and whilst bank statements and online transactions are available, there is no equivalent of Midata. This is likely to impact on how easy it is compare banks.

(b) Due to the extensive charging structure of BCAs, pricing is complex, making it more difficult to compare providers.

(c) Many SMEs lack the financial sophistication to compare providers in a comprehensive fashion.

8.116 Whilst these issues are not problems per se, the lack of effective price comparison tools and assistance from advisers on the best options means that, overall, it is likely that many SMEs would find it difficult to compare BCA offers effectively.

[239] An experience good is a product or service where product characteristics, such as quality or price, are difficult to observe in advance, but these become evident as the good is consumed/used.

Barriers to switching BCAs

8.117 Even if SMEs are engaged in the market and have the information and tools to compare different products and providers, there may still be barriers to them acting on this information. In this section we consider the various potential barriers to switching BCAs.

Account opening process

8.118 When seeking to move BCA, an SME has two separate processes to engage in, namely the account opening process and the account switching process. Although these can sometimes be conflated and confused in customers' minds, they are separate and distinct processes.

8.119 For SMEs, the account opening process can be lengthy and onerous depending on the complexity of the businesses. This reflects in part banks' processes in implementing of AML and counter financing of terrorism regulations.[240]

8.120 Some banks provided an indication of how long it takes to open a BCA. In particular two banks noted it took around 48 hours for smaller businesses (which are more likely to involve simpler AML checks).[241] For larger SMEs the time to open an account was at least two weeks.

8.121 The Research Works SME qualitative research noted that some SMEs considered that the account application and administrative process dissuaded them from switching banks.[242] It also found that for some customers there were perceived barriers in both the application and switching process. It was noted that 'those who saw the application process as a barrier to switching also tended to see themselves as time poor. Typically, this group had little appetite for the assumed complexity of the application process which, for some, was a barrier to switching in its own right'.

8.122 The FCA's CASS qualitative research found that:

> The effort involved in opening a new account was identified as a major barrier for considerers[243] across all audiences. It was recognised that there would be some hassle involved in

[240] For further details see Section 10.
[241] And in some circumstances this could be completed more quickly. [✄]
[242] Research Works SME qualitative research, pp17 & 18.
[243] Optimisa defined 'considerers' as those who had actively considered switching and either decided not to do it or not got round to it.

> organising a change-over of accounts, and finding the time to do this was felt to be challenging. This was particularly true for SMEs and charity organisations that may have more complex banking arrangements or multiple stakeholders involved.[244]

8.123 In addition it noted that:

> The experiences of some business considerers also suggested this could be a difficult process. Where lending was involved, some reported feeling like they were pitching for the new bank's business (rather than the other way around) and had found that the process was sometimes held up as they awaited approval. In a couple of instances this had led to considerers dropping out of the process.[245]

Account switching process (including CASS)

8.124 Like PCA customers, account switching for almost all (99%) of BCA customers[246] can be done through CASS. However, many of those who are eligible for CASS are not aware of CASS and/or the service it provides. Evidence from the Payments Council suggested that only half of SMEs that had not switched knew assistance was available (and the majority of these knew little or nothing about what the assistance consisted of), while the FCA's CASS research noted that CASS had been more visible to consumers than SMEs (see further detail in Appendix 8.1).

8.125 The levels of account switching through CASS by SMEs also suggest a lack of awareness and understanding of CASS. Only approximately 10% of BCAs are switched through CASS.[247] If CASS is not used, an SME needs to manually transfer all payments in and out of its old account to its new account and inform all suppliers and customers of its new account. For some SMEs this will involve significant time and resource with the risk that some payments in and out are at best delayed.

8.126 As identified by the FCA's review of CASS,[248] whilst CASS guarantees redirection of payments in and out of the account for 36 months, there are a

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[244] FCA CASS qualitative research, p35.
[245] FCA CASS qualitative research, p35.
[246] Since April 2015 an SME with an annual turnover that does not exceed £6.5 million and employs fewer than 50 people can use the CASS. Before the change, use of CASS was limited to SMEs with turnover or assets up to €2 million (this is in accordance with the EU definition of a microbusiness.) This covered about 95% of SMEs.
[247] In total 22,452 SMEs switched their BCA through CASS in 2014, around 0.4 % of the total number of active BCAs. Given that switching rates are around 4%, 90% of SME switchers are not using CASS to switch.
[248] FCA CASS report.

number of aspects of the CASS service which are potentially of concern to SMEs:

(a) Loss of historical account data: the CMA's qualitative research found that one potential barrier to switching is that SMEs will lose access to their previous transaction history following a switch through CASS. This could potentially affect businesses' ability to apply for financial products in the future as they would not have proof of their transaction history.

(b) Period of redirection: whereas PCA customers tend to have one main payment coming in, SMEs will tend to have multiple payments coming in from more than one source. Although, as of March 2015, payments are redirected for 36 months by CASS, SMEs still need to contact their customers to ensure they update their payment details so that at the end of the automatic redirection period payments are made to the new account.[249]

8.127 Research Works SME qualitative research found that

> Those who saw the switching process itself as a barrier typically valued their familiarity with existing arrangements, and were apprehensive about having to learn a new set of procedures and passwords. More importantly, they also anticipated difficulties with customers and disruption to processing payments. A fear of jeopardising current payment systems was a key barrier to switching.[250]

8.128 The FCA's review of CASS also noted that risks and effort were felt to be heightened among business and charity audiences, where mistakes were felt to potentially have an even greater impact than among PCA customers, and the changeover was felt to involve more administration.[251]

Access to lending and multi-product holdings

8.129 Research Works SME qualitative research found that customers perceived that staying with their current bank meant they were more likely to get access to lending. This was because they believed that having an estab-lished relationship with a bank gave the business credibility. There was an

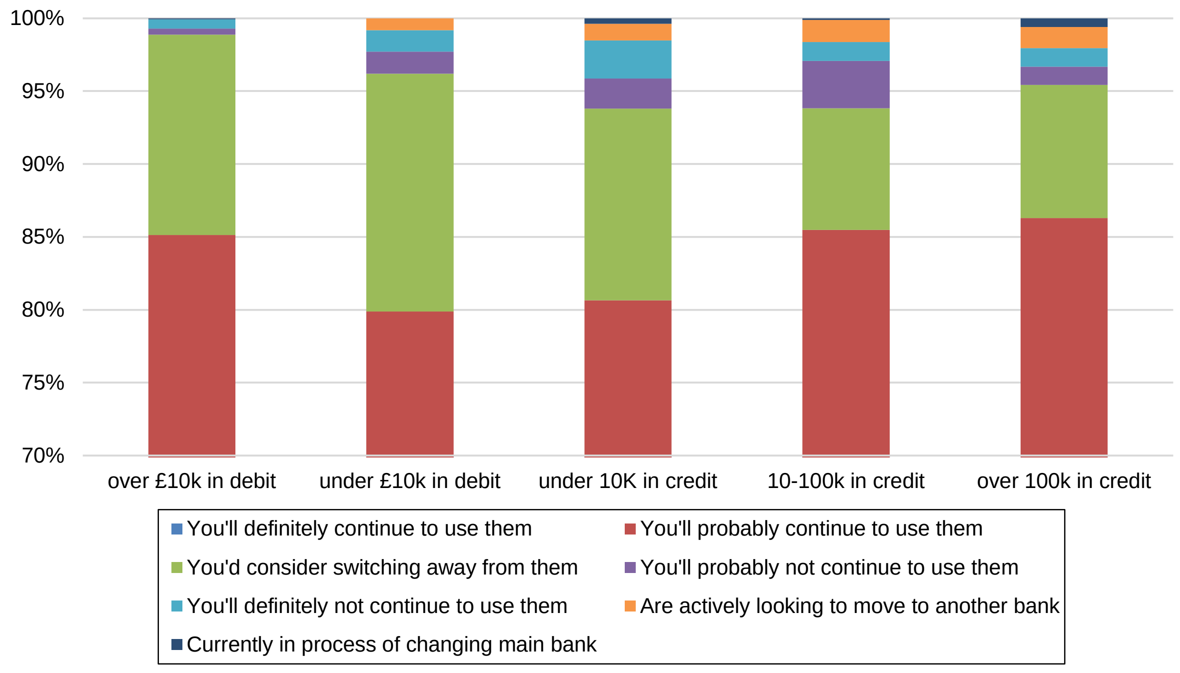
[249] This was noted by some SMEs in Research Works SME qualitative research (see pp17 & 18).
[250] Research Works SME qualitative research , p17.
[251] FCA CASS qualitative research, pp36 & 37.

underlying assumption that banks would look more favourably on businesses which had had multiple interactions with that bank in the past.[252]

8.130 Similar to PCAs, another concern expressed in the FCA's qualitative research was whether customers could move their overdraft facilities. SMEs mentioned that they would want to negotiate with their new provider if they were to move.[253] Given that banks can charge arrangement fees for overdrafts as well as holding collateral, this could slow down the switching process. However, this did not emerge as a primary concern.

8.131 Data from the Charterhouse BBS suggests that the customers most likely to consider switching are those with low credit or debit balances (see Figure 8.9). While we would expect SMEs to be less likely to consider switching if they have a high debit balance, the research does not show significant differences between the groups.

Figure 8.9: Proportion of SMEs in GB considering switching by credit/debit balances



Source: Charterhouse BBS.
Base: All SMEs asked about account balances 2014: over £10,000 in debit (337), under £10,000 in debit (330), under £10,000 in credit (1,836), £10,000–£100,000 in credit (1,168), over £100,000 in credit (662).
Notes: Balances are for BCAs only (including overdrafts) but do not include loans.

8.132 The FCA's qualitative research also found that 'having multiple products linked to the account was a potential barrier to switching. Amongst businesses this was occasionally referenced by those who had overdrafts

[252] Research Works SME qualitative research , p16.
[253] FCA CASS qualitative research, p36.

and/or lending linked to their account or international banking arrangements.'[254] The Charterhouse BBS showed that switching consideration fell as the number of products rose (see Appendix 8.1, Figure 18). This supports the views that were expressed in the FCA's qualitative research.

Summary on barriers to switching

8.133 In this section we have identified a number of potential barriers to switching. In respect of account opening, the process can be difficult, in particular due to banks' differing requirements for complying with AML regulations. SMEs considered this to be a potential barrier. In addition, the switching process itself is considered to be time-consuming, difficult and potentially risky. We noted that awareness of CASS was low among SMEs, despite most being eligible. In addition, CASS does not cover all the issues of concern for BCA customers. These processes can be considered a "hassle" and this provided a deterrent to switching.

8.134 In addition, for some SMEs access to finance played a key role in deterring them from switching with fears that moving would make it less likely that they would be able to access finance in the future.

SME lending

8.135 As SMEs grow they are more likely to seek additional products from their bank (or other financial institution). An SME may have a wider portfolio of products to consider than simply their BCA. Some SMEs may require credit, others may require a deposit account.[255]

8.136 In particular there are a number of reasons why an SME may require credit. The business may be seeking to grow, but require some funding to do so, whether for immediate expansion of the business or an investment in future expansion. Alternatively it could be to deal with a shortfall in cash flow, late payments from customers, or an unexpected cost. The Charterhouse follow-up survey of start-up SMEs showed that the most common reasons for seeking finance were for investment to expand the business (30%), purchasing new equipment (22%) or shortfalls in cash flow (28%).[256] SMEs may then turn to their bank for lending products.

[254] See FCA CASS qualitative research, p32.
[255] SMEs may also require other products such as insurance, merchant acquiring, hedging and foreign exchange. However, these products are not part of our ToR and therefore not considered in this section.
[256] See Appendix 8.1.

8.137 As described in Sections 2 and 4 banks provide a range of debt finance products. Different types of finance aim to address the differing needs of SMEs for finance. As outlined in in Appendix 8.2, SMEs may consider a number of different types of products, but equally only certain products may be suitable for a particular need. The product suitability may depend on:

- whether short-term capital is needed or longer-term finance;
- whether security is available and/or the finance is to purchase an asset; and
- the urgency of the need for finance.

8.138 In particular, overdrafts and credit cards may be suitable for cash flow issues while loans and asset finance may be more suitable for investments and business expansion.

8.139 As noted in paragraph 8.25, credit cards and overdrafts are the most common forms of lending for SMEs. As shown in Appendix 8.2, Figure 3 larger SMEs are more likely to take out finance than smaller SMEs. In GB 94% of SMEs with turnover above £2 million took out finance compared with 72% of SMEs with turnover less than £2 million and 57% of start-ups. Very few SMEs with annual turnover under £2 million take out commercial mortgages, invoice finance or asset finance.

8.140 This section examines SMEs' behaviour when obtaining credit and barriers to searching and applying for credit.

Indicators of SME behaviour

8.141 We first consider some indicators of SME behaviour in relation to loans: the amount they search and the extent to which SMEs take out loans with providers other than their main BCA provider.

Search levels: consideration of providers

8.142 The Charterhouse follow-up survey of SMEs applying for finance suggests that 60% of SMEs only considered one provider when seeking finance.[257] HSBCG survey 2015 suggested that the proportion that did not search was

[257] Of those that only considered one provider, only 5% did not consider their main bank.

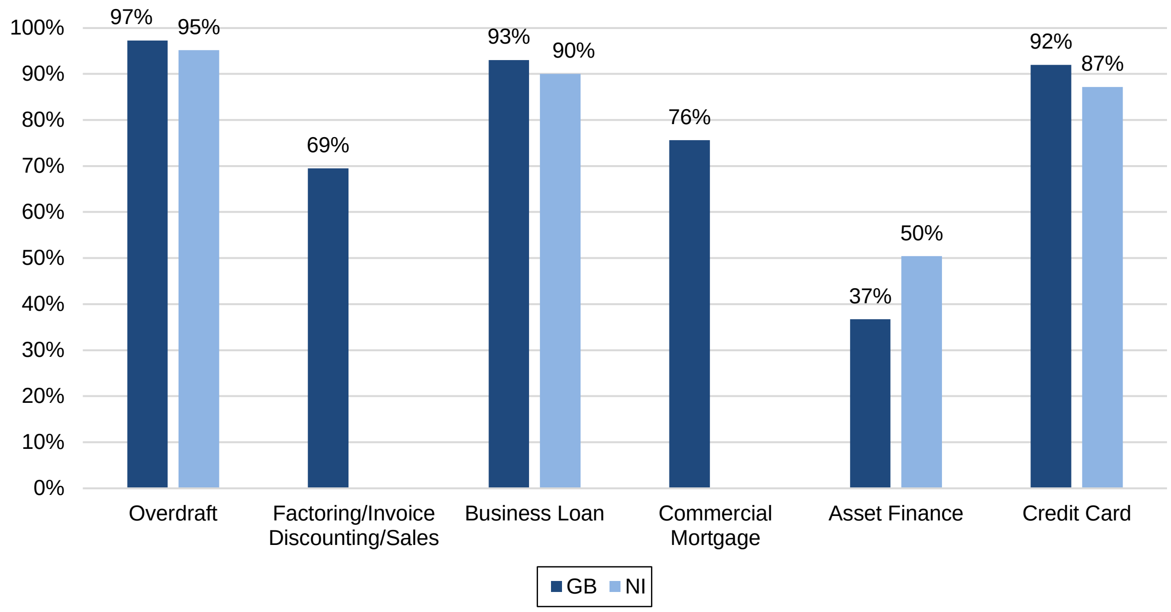
lower: 45% of SMEs that considered taking out a new loan in the last five years spoke only to their main bank.[258,259]

8.143 Of those in the Charterhouse follow-up survey of SMEs applying for finance that did consider more than one organisation (40%), nearly two-thirds (64%) made some comparison between providers to help them make a decision, although the majority of these were done superficially without comparing each factor one at a time.[260]

Choice of provider

8.144 The vast majority of SMEs seeking finance go to their BCA bank, despite 40% considering other lenders. This is consistent across all types of core bank finance except asset finance. Figure 8.10 shows that over 90% of SMEs went to their main bank for overdrafts, loans, and credit cards, while 69% went to their main bank for invoice discounting and factoring and 76% for commercial mortgages.

Figure 8.10: Proportion of respondents saying they used their main bank for each product



Source: Charterhouse BBS 2014 and Charterhouse BBS NI.
Base: All SMEs who held product in last 12 months; GB: asset finance (633), company credit/charge card (2,802), business loan (1,062), overdraft (2,219), factoring/invoice discounting (469), commercial mortgage (461); NI: asset finance (52), company credit/charge card (161), business loan (92), overdraft (182).
Note: The base for asset finance in NI is relatively low at 52. As such the confidence interval around the figure of 50% will be quite wide. Invoice finance and commercial mortgages in NI have not been reported as the base sizes for both were very small.

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[258] HSBCG survey 2015
[259] As noted in Appendix 8.1 we have concerns about the representativeness of the HSBCG survey 2015, and consider while these two survey questions measure different things, a minority of SMEs consider using any other provider than their main bank.
[260] SME follow-up surveys, p43 & p49.

8.145 In NI the picture is very similar with around 90% of SMEs going to their main bank for loans, credit cards and overdrafts.

8.146 The Charterhouse follow-up survey with SMEs applying for finance suggests that there are two primary reasons why SMEs go to their main bank for finance: the relationship the SME has with its main bank; and the time, effort and convenience associated with going to their main bank rather than elsewhere. We now look at each of these in turn.

Relationship with their main bank

8.147 A considerable amount of evidence pointed to the importance of the SME's relationship with its main bank when choosing a finance provider. Research Works SME qualitative research, British Business Bank/BMG's Journey Towards Raising Finance survey,[261] and the Charterhouse follow-up survey of SMEs applying for finance suggested that the relationship with their bank was a primary reason for going to their main bank for finance.[262]

8.148 Some SMEs in the Research Works SME qualitative research noted the importance of a trusted relationship with their bank and their loyalty to their bank might help them get finance should they suffer some financial distress (ie the bank would still lend to them despite their current financial situation).[263]

8.149 In the Research Works SME qualitative research SMEs also noted that the bank where they held their BCA had knowledge of their financial and transaction history.[264] When a bank decided whether to lend, and at what price, the bank needed to assess the risk of the SME defaulting on its repayments. This required assessing certain credit information.

8.150 To assess risk banks look at:

- Application data:
  - Financial data (including balance sheet, accounts, other debt, profitability).

[261] Please see British Business Bank/BMG, 2014 'SME Journey Towards Raising Finance' Survey, where information about this survey can be found. This survey only covers GB.
[262] See Appendix 8.2, Figure 10 and SME follow-up surveys, p50.
[263] Research Works SME qualitative research, p37.
[264] Research Works SME qualitative research, p37.

- Non-financial data (purpose of the loan, how long the business has been trading, plans for growth and business plans, expertise and strength of management).

- Behavioural data:
  - This is held automatically for existing customers (those with a BCA); for those without a BCA at the bank this will be part of the application data (often bank statements).
- External credit checks:
  - For smaller SMEs more emphasis on individuals (owners and directors); for larger SMEs on the SME itself.
- Other information:
  - Valuation of collateral (if secured loan).
  - The local area and industry sector as well as the banks' appetite for lending in these sectors.

8.151 Considering that an SME's BCA bank holds more information on its financial performance, the BCA bank is in a position to better assess the risk, more accurately price credit, and potentially make a lending decision more quickly than other finance providers. While of benefit to the SME, this would also suggest that the informational advantages that the BCA bank holds over other potential lenders is a real barrier to searching for credit, rather than simply a perception of SMEs.[265]

8.152 This was mentioned by a number of parties. Santander noted that 'Incumbent banks have an advantage as they are likely to have had an existing relationship with the SME, and will therefore have more data and a richer understanding of that business'. During the 'challenger banks' roundtable Secure Trust Bank noted that a bank holding the BCA or PCA had an advantage when it came to credit decisions, but also that many SMEs would simply go to their main bank as the first thing any other lenders would ask for was details of their accounts.

Time, effort and convenience

8.153 The entire process of applying for finance can take some time. Beyond the search process, SMEs need to gather material for their application and fill in

[265] We note this is an adverse selection problem for banks who do not provide the SMEs BCA.

forms, then wait for the bank(s) to make a decision and submit an offer(s). Finally, the SME needs to review all offers.

8.154 As noted in in Appendix 8.2 debt finance may be required for a number of different reasons and quite often may be required at short notice. Where finance is required to help with cash flow timing may be particularly important (for example, if a customer pays late). The Charterhouse follow-up survey of SMEs applying for finance shows that 24% of SMEs applied for finance at the time it was needed, and a further 12% within two weeks of needing the finance.[266]

8.155 The time spent filling in an application and gathering documents can vary greatly, and the British Business Bank/BMG Journey Towards Raising Finance suggests that of all applications (the majority of which are to the SME's BCA bank), around 46% took less than 1 hour to complete but 9% took over 20 hours.[267]

8.156 When considering how long it takes for banks to make a decision on lending, the banks told us that smaller loan decisions were generally made within a few days, while for larger loans the decision could take a couple of weeks (particularly if security was required). It usually took a few days to get a decision on asset finance and decisions on invoice discounting or factoring could take quite some time (potentially months). A number of banks noted that it could take longer to reach a decision for a new customer to the bank.

8.157 When SMEs were asked why they went to their main bank or why they did not consider other organisations, ease of application, hassle and time constraints were all some of the reasons mentioned most often. Ease of application was the second most common reason given for going to the SME's main bank in the British Business Bank/BMG's Journey Towards Raising Finance survey[268] and over a quarter of SMEs who applied for finance at their main bank in the Charterhouse follow-up survey of SMEs applying for finance did not consider other organisations because of the hassle or time associated.[269]

8.158 Similarly, the Research Works SME qualitative research found that faster and easier access and less initial paperwork were some of the main reasons for SMEs going to their main bank for finance.[270]

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[266] SME follow-up surveys, p52.
[267] British Business Bank/BMG, 2014 'SME Journey Towards Raising Finance' Survey, A20b. This survey only covers GB.
[268] See Appendix 8.2, Figure 10.
[269] SME follow-up surveys, B10b, p44.
[270] Research Works SME qualitative research, p37.

8.159 Overall, the amount of time and effort needed to apply to banks other than the SME's BCA/main bank lead SMEs simply to choose their main bank, which already holds information about them (including credit information for assessing risk), if they believe this will be a quicker, simpler process.

Summary on customer behaviour

8.160 Overall, we find low levels of searching and a high proportion of SMEs that take out a loan with their BCA provider. The main reasons for choosing their main bank appear to be the relationship SMEs have with their bank (in particular the information asymmetry between the knowledge of the SME's main bank and other providers), and the time and effort involved in applying and awaiting responses from providers other than their main bank. We now consider whether there are barriers to searching for lending products.

Barriers to searching

8.161 Typically the information required to make a decision as to which lending product to purchase is different from that needed to make an assessment for choosing a BCA.

8.162 For an SME to understand how good a deal it can get with a particular lender it needs to understand all the costs and terms and conditions of the finance product.

Interest rates and arrangement fees

8.163 There are two main prices that make up a lending product. The interest rate and any arrangement fees.[271] To be able to understand and compare lending products an SME needs to be able to collect information on these costs for each product.

8.164 Lending prices are generally bespoke. For a lender to set a price for finance it will use a matrix of variables, and any combination of these variables could result in a different price offered to an SME. When setting prices lenders will consider:

- the size of the loan;

[271] Arrangement fees are not the only fees for some products. In some cases where security is needed there will be a fee for valuing the security, but also potentially for the administration costs of taking legal charges over assets or securing via debentures. In all these cases, however, the fee is fixed upfront, which may either be added to the loan or paid upfront as a lump sum.

- whether (and how much) security is held against the loan;
- the term (length) of the loan;
- the SME's business sector; and
- the risk band of the SME.

8.165 The combination of all these factors results in a large range of potential prices.[272] As such, some banks have told us that they do not publish exact prices externally.[273] For instance lenders do not publish tables (either in leaflets, branches or online) of interest rates and arrangement fees, as may be found when searching for residential mortgages (with different rates depending on all possible circumstances/variables).

8.166 Therefore to find out rates an SME will need to have a discussion with a relationship manager or other member of staff either in branches or over the telephone, or go through an online application process. Collecting this information can take some time as the process needs to be repeated with every provider.

8.167 For larger SMEs rates are more bespoke as they are more likely to negotiate either the prices (interest rate and arrangement fees) or terms of the loan, and more likely to be successful. The Charterhouse follow-up survey on SMEs applying for finance suggested that 38% of SMEs with turnover over £250,000 a year tried to negotiate compared with 9% of those with turnover under £250,000.[274] Typically negotiation is only possible where the SME has a relationship manager (see Appendix 8.1, Table 1), as relationship managers are often able to flex the price of a lending product beyond the bespoke target price.

8.168 Depending on the size of the loan, the risk band of the SME, and the particular bank, a relationship manager may reduce the interest rate by a certain amount of basis points, (or to a minimum level) and/or reduce the arrangement fee. With the exception of senior relationship managers, Barclays noted that relationship managers could reduce the interest rate by between [✂] and [✂] basis points depending on the risk rating of the

[272] Internally the lender may also be considering capital costs and funding costs, service, sales and distribution costs as well as its appetite for lending.
[273] Some lenders provide typical percentages or ranges, others provide a minimum ('from') rate. However, the exact price will still depend on the various circumstances of the SME (including its risk band).
[274] SME follow-up surveys.

SME,[275] while RBSG told us that.[276] LBG told us that relationship managers could not price below their matrix of prices, although they could [✂].

8.169 In many cases the relationship manager may not have the authority to reduce the price of the loan and require further approval from more senior staff (for instance due to the size of the discount, or size of the loan). For instance, of the four largest banks, [✂],[277] [✂], [✂], and [✂]).

8.170 Negotiation therefore, naturally adds a further layer of opacity and has implications on the ability of SMEs to obtain clear pricing information.[278]

8.171 A number of banks have told us that they can make lending decisions very quickly for smaller loans and overdrafts. For instance Lloyds can issue an offer (or rejection) for most loans and overdrafts up to £[✂] through their online system giving an instant decision and personalised lending quote.[279] However to receive a fast (or instantaneous) lending quote the SME needs to already hold a BCA with the bank.[280] This is clearly helpful for SMEs who need a quote from their own bank at short notice. But difficulties with finding out information from other providers, or for larger loans, still remain.

8.172 In the Charterhouse follow-up survey on applying for finance SMEs were asked how easy it was to find out information about different aspects of finance. Around 15% of SMEs found it difficult to find out information on interest rates and around 10% found it difficult to find out information on arrangement fees (and a further 9% did not look into this).[281,282]

- *Terms and conditions*

8.173 Lending products may stipulate certain terms and conditions of the lending contract. For instance paying off a loan early may result in early repayment charges and penalty clauses, or there may be charges for making late repayments, or terms may stipulate the security required for the loan.

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275 This is in relation to its SME customers with turnover of up to £5 million.
276 [✂]
277 [✂]
278 Although we note that in markets with negotiation we will not typically expect customers to negotiate with more than a few providers.
279 LBG also note this will be raised to £[✂] in the near future.
280 And this seems consistent across the banks that offer fast quotes for smaller loans.
281 However, we note that this is across all SMEs and therefore contains both those that sought information from their own bank (the vast majority) as well from other banks. As such it is not very informative when considering how easy it is to find information on finance from providers other than the SME's own bank.
282 SME follow-up surveys, p46.

8.174 LBG submitted to us that certain fees such as early repayment charges and unplanned borrowing charges are made available to customers through various channels.[283]

8.175 The Charterhouse follow-up survey on applying for finance also asked SMEs how easy it was to find information on penalty charges and early repayment charges. 19% of SMEs found it difficult to find out information on penalty charges and early repayment charges (and a further 17% did not look into this).[284]

8.176 The Treasury Select Committee report on Conduct and Competition in SME Lending noted that the presence of multiple credit searches in an SME's credit history could damage the SME's credit score and that this may deter SMEs from comparing providers in the first place.[285] During our SME round table the FSB and BCC also raised this as a potential concern. However, we did not find any evidence from SMEs that this prevents searching or that it is a consideration when searching.[286]

Comparability

8.177 Understanding interest rates can be complex. To compare lending products SMEs need to have a certain level of financial capability and understanding (or pay for the services of someone who does).This becomes more important when comparing across different types of lending products. As noted in paragraphs 8.94 and 8.95 many SMEs do not have a dedicated person responsible for financial decisions.

8.178 The British Business Bank/BMG Customer Journey survey suggests that larger SMEs are more likely to think the information they are provided with allows them to judge whether a product is suitable for their needs (Figure 8.11).

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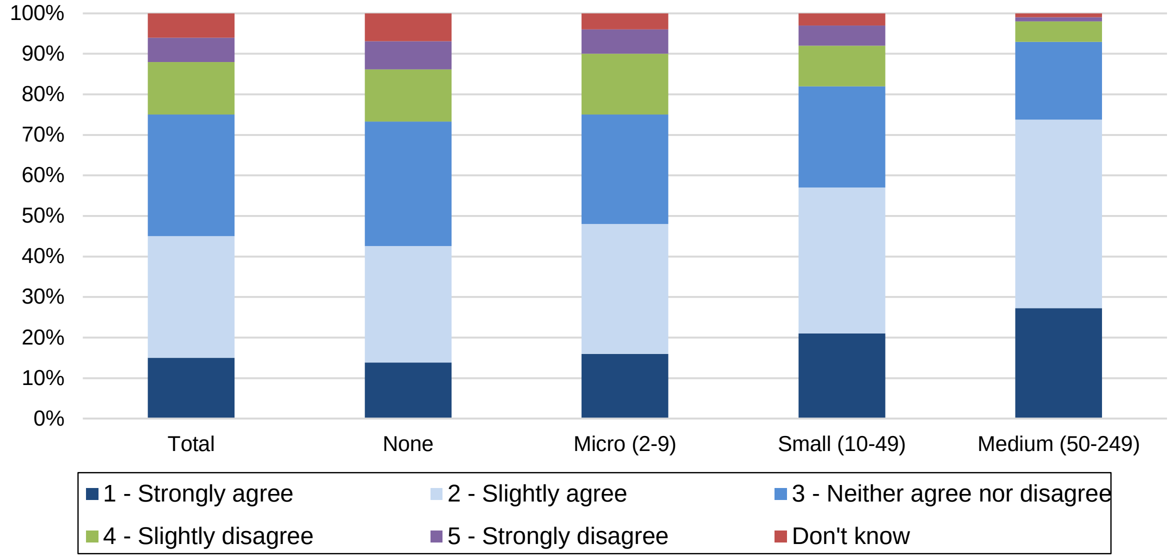
[283] LBG noted that its website set out which loans had early repayment fees, and during quotation LBG provided customers with an indicative breakage cost if they repaid their loan early at various stages of the repayment schedule.
[284] SME follow-up surveys, p46.
[285] House of Commons Treasury Committee (2015), *Conduct and competition in SME lending*, p84.
[286] For instance this was not mentioned as an issue by SMEs when asked why they did not consider other organisations in the Charterhouse follow-up survey of SMEs applying for finance or as part of the Research Works qualitative research.

Figure 8.1: Finance providers give sufficient information about their products for the SME to judge whether they are suitable for their needs



Source: British Business Bank/BMG, 2014 'SME Journey Towards Raising Finance' Survey, A4e.
Base: Total (1,000), none (377), micro (334), small (195), medium (94).

8.179 The Charterhouse follow-up survey on applying for finance found that only 2% of SMEs that were applying for finance had used a PCW. While there are a small number of PCWs that compare business loans and credit cards,[287] they do not provide interest rates, and generally only give ranges for the term length and loan sizes. As such, PCWs offer limited help in making comparisons across providers.

Summary on barriers to searching

8.180 Overall, this leads to a market where prices are opaque and which involves significant search costs. While it may be simple for an SME to get a quote from its own BCA bank, it is a lot harder to quickly find and compare quotes from other lenders. The general opacity around how banks price and approve lending also means that the factors underlying lending decisions will often be unclear to SMEs before they make an application.

Barriers to switching

8.181 For lending, we may not expect to see SMEs switching providers during the term of a particular loan. Changing loan provider would involve paying off the existing loan and taking out a new loan. As such this is not always possible, and where it is the SME may be subjected to significant costs. For instance

[287] Comparisons of invoice finance products, asset finance products and commercial mortgages are very limited.

certain loans have early repayment charges or other clauses which result in a payment to their existing provider for paying off the loan early.[288] Typically new loans also have arrangement fees which can be significant and thus represent a considerable switching cost.[289]

8.182 We do not consider barriers to switching to be a concern for lending products due to the short-term nature of the majority of loans, and therefore the ability of SMEs to consider the cost of the loan over its full duration.[290] For longer-term loans such as commercial mortgages we have not received any submissions that barriers to switching would be a competition concern.

Summary of our analysis of SME demand for banking products

8.183 In this section, we have looked at SME demand for banking services. We find low levels of switching and relatively low levels of searching by SMEs when coming to the end of their free banking period. We also find that, although there are higher rates of searching by SMEs at start-up, half of start-ups open their BCA with their existing PCA provider, and few start-ups take future fees fully into consideration in their choice of bank. In relation to business lending, we find that the vast majority (around 90%) of SMEs take out loans, credit cards and overdrafts with their existing BCA provider,[291] and there are low levels of search.

8.184 We have analysed the reasons for these low switching and search rates, and found that there are barriers to SMEs accessing and assessing information on BCAs and business loans, as well as barriers to switching BCAs. In addition, many SMEs do not consider providers other than their main BCA provider for business loans because of the time and effort in applying to other providers and the importance of the relationship with their main bank.

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[288] LBG told us that it did not have exit fees on any of its lending products (including early repayment charges). However, there are break costs/gains for certain fixed rate products.
[289] Arrangement fees are typically between 1% and 2% of the value of the loan. SME Finance Monitor reports that the average (mean) arrangement fees paid were £969 on a loan and £363 for an overdraft (year to Q2 2015).
[290] Santander was the only party to mention that exit fees on loans created difficulties for SMEs to switch products. Furthermore this was not raised by any SMEs during the Research Works qualitative research.
[291] The proportions for other lending products in GB are 76% for commercial mortgages, 69% for invoice discounting and 37% for asset finance.

9. SME banking: competition between banks

Introduction

9.1 In this section we present evidence on the way in which banks compete in the supply of banking services to SMEs, focusing on BCAs and lending products. Evidence presented in Section 6 and Appendix 6.3 suggests that, through the economic cycle, BCAs and SME banking are profitable. As summarised above, however, we also found in Section 8 that there are low levels of customer engagement and barriers to switching and searching BCAs, and in comparing lending products. These factors, together with the levels of churn in the market,[292] will affect banks' incentives to compete.

9.2 This section is structured as follows:

(a) First, we examine BCA competition, looking at start-ups, established SMEs and the impact of customer churn.

(b) Second, we examine competition in SME lending, looking at some key characteristics of the supply of lending by banks, and competitive developments including competition from alternative finance providers.

9.3 At the end of this section, we bring together our overall analysis on the demand and supply of SME retail banking services and whether our analysis leads us to provisionally conclude that there are one or more features which, alone or in combination, give rise to one or more AECs in the provision of retail banking services.

Business current accounts

Start-up SMEs

9.4 A key point when competition for SMEs takes place is when SMEs are starting up (or being established). The SME follow-up survey with start-ups showed that free banking was one of the most important reasons given for their initial choice of bank.[293] The free banking period enables start-up SMEs to use 'core' transactions free of charge for a set period of time. Most banks offer start-ups a period of free banking of between 12 and 24 months (see Table 9.1).

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[292] Churn refers to the rate of entry and exit by SME.
[293] This is particularly true of SMEs who compared different banks against one another. However, we note that most banks offer initial free banking periods, so it is not a clear differentiating factor beyond the different lengths of free banking offered. See Section 8.

Table 9.1: BCA incentives offered by banks to start-ups and switchers, as at January 2015

Bank	*BCA incentives*	
	Start-ups (period with no monthly/ standard transaction charges)*	*Switchers (period with no monthly/ standard transaction charges or cash payment)*
Barclays	12 months	†
HSBC	18 months‡	6 months§
Lloyds	18 months¶	6 months¶
BoS	18 months	6 months
RBS, NatWest	24 months#	£150–£250~
Santander	12 months★	None
Clydesdale	24 months♦	18 months♦
Yorkshire Bank	24 months♦	18 months♦
TSB	18 months	6 months▲
Metro	None	None
Handelsbanken	None	None
Co-op	Special offer to members of Federation of Small Businesses✷	
BoI	No transaction charges for 12 months and a 50% discount for a further 12 months⅄	■
Danske Bank	12 months◇	6 months□
First Trust	For those with certain loan types, 12 months' free banking	
Ulster Bank	24 months	None

Source: Banks' responses to Question 11 in SME MQ (January 2015), supplemented by bank websites.
*Typically businesses in first year of business, setting up their first BCA.
† Possible [✂].
‡ £2 million turnover or below (start-ups with annual turnover above £2 million are offered bespoke terms that are negotiated with their relationship manager and may include a period of free banking).
§ Turnover up to £0.5 million (increased to 12 months). Switchers with turnover of £0.5 million to £2 million may be offered a period of free banking following a discussion with their relationship manager and those with annual turnover above £2 million are offered bespoke terms that are negotiated with their relationship manager and may include a period of free banking.
¶ Also offers fee-free overdrafts.
# Up to £1 million turnover. Also offers a fee free overdraft facility of £500 for the first 12 months.
~ For customers with turnover of up to £2 million, accounts are credited £150 (or £250 if the customer also switches an overdraft) by the end of the fourth full month after account opening.
★ Additional six months if customer has PCA with Santander, or switches to it.
♦ Increase to 25 months for start-ups and switchers with effect from 4 May 2015.
▲ Changed from 6 to 18 months effective from 15 June 2015.
✷ Co-op offers FSB Business Banking Account customers free banking, £25 annual loyalty reward and a fee free overdraft.
⅄ Except for cash deposits greater than £10,000 per quarter.
■ No free banking offer for switchers, but a three year package for growing businesses.
◇ Extended to 24 months if the business owners/directors have/switch to a PCA with Danske.
□ Extended to 12 months if the business owners/directors have/switch to a PCA with Danske. Also offers 12 months' free Business e-Banking (payments module) and no arrangement fees on certain products during the first 12 months.

9.5 Introductory offers in the form of free banking for start-ups (and indeed switchers) have been a common feature since at least the 1990s. Prior to this, most banks charged start-ups for their banking services. HSBC was the first bank to introduce free banking for start-ups and for switchers in 1986 and 1998 respectively with other banks soon following.

9.6 The banks told us that the rationale for offering free banking to start-up SMEs was:[294]

(a) to minimise the cost of banking during the start-up phase;

[294] See Appendix 9.1 for further details.

(b) a profitable strategy in the long run as a means of acquiring and establishing a relationship generating greater revenue as the SME grew; and/or

(c) as a response to competitive pressures, in order to improve customer acquisition.

9.7 We asked banks whether there had been changes to their free banking offers to start-ups. Responses show that there have been few changes in the length of the free banking period offered to start-ups since 2011:[295]

(a) Barclays' free banking policy has not materially changed since 2002, although it informed us that during this time there had been introductions and withdrawals of 'free banking' extensions linked to other products (ie alongside a customer's 12 months' free banking they would be entitled to an additional six months if they signed up to certain services). For example, in November 2013 it withdrew its offer to extend the period of free banking for start-ups if they signed up to specified business packaged accounts or a business protection plan for late payments or bad debt on opening their initial BCA with Barclays.[296]

(b) RBSG told us that its offer of free banking for start-ups remained unchanged at 24 months since 2007 for its NatWest brand and since 2010 for its RBS brand, the longest free period of any of the banks.

(c) Santander told us it had not changed its free banking policy for start-ups since 2011, when it removed its monthly fee free banking product from sale and replaced it with the Fixed Fee Business Bank Account.[297]

(d) Similarly, LBG has not changed its free banking policy for start-ups since at least 2011.

(e) HSBCG has not changed its free banking offer to start-ups since 2012.[298]

(f) Handelsbanken does not have a standard policy of offering free banking for start-ups or switchers.[299] It told us that it did not provide free banking

[295] See Appendix 9.1 for further details.
[296] Until November 2013, Barclays extended the period of free banking to 18 months if the start-up SME signed up to its monthly packaged account (which included business software applications and support services alongside the BCA); or it took out a business protection plan for late payments or bad debt.
[297] This account offers start-ups a 12-month fee waiver period for all standard transactions (or 18 months for existing Santander customers with a 123 Current Account or 123 credit card).
[298] [✂]
[299] Handelsbanken noted that decisions on whether a charge was levied, for any type of customer, was determined locally ([✂]).

for start-ups because it had a conservative risk appetite and therefore few of its customers were start-ups, and furthermore that it did not segment customers.

9.8 With the exception of Metro and Handelsbanken who focus on the quality aspects of their service offering rather than price, free-banking periods continue to be an important focus for most banks in attracting start up SMEs. There is variation between banks in the free-banking period although in more recent years there is little evidence of dynamic competition between banks on free banking periods for start-ups or on service/quality. We have not been presented with evidence from banks of targeted advertising and marketing to start-up SMEs.[300] We note that Barclays' market share of new BCAs in GB increased from [✂] between 2012 and 2014 notwithstanding its shorter periods of free banking relative to its competitors.[301]

Established SMEs

9.9 We set out below our analysis of how banks compete for established SMEs, both in terms of attracting new established SMEs and retaining existing SMEs.

Switching incentives

9.10 Some banks offer free banking periods as an inducement to switch. As shown in Table 9.1, the majority of larger established bank brands – HSBC, Lloyds, BoS and Barclays – offer free banking to switchers for six months.[302,303] Many of the newer and smaller banks do not offer free banking to switchers, for example, Handelsbanken, Metro and Santander. The exceptions are Clydesdale and Yorkshire Banks which offer 25 months' (recently increased from 18 months) free banking to switchers[304] and TSB, which increased its free banking period from six months to 18 months for switchers in June 2015.

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[300] See Appendix 9.1.
[301] See Table 6.4 for further details.
[302] For Barclays, this is subject to the discretion of the business manager.
[303] RBSG withdrew its offer of free banking for switchers in 2014 as part of RBS's and NatWest's strategy to end teaser rates across all brands for personal and business customers. It replaced the offer with a flat rate cash contribution of between £150 and £250 to cover SME switching costs for customers with a turnover less than £2 million.
[304] Some banks also link their free banking periods to other products. For example [✂] and LBG offers to waive lending arrangement fees and security fees for switchers taking out a new term loan or overdraft.

9.11 Banks told us that the rationale for offering free banking to switchers was to compensate SMEs for the cost of switching banks, and in particular the costs attributed to the transfer of lending facilities.

9.12 We have observed some changes by banks in the free banking periods for switchers. Some banks (LBG[305] and HSBCG[306]) have recently increased the length of the period of free banking to switchers, while RBSG have removed the free banking periods to switchers.[307] Both HSBCG and LBG submitted information on the impact of free banking offers to switchers on their customer acquisition rates.

(a) HSBCG told us that following a promotion in January 2011, which extended the free banking period for switchers from 18 months to 24 months, [✂]. In February 2012, it reduced the free banking period from 18 months to six months. [✂] from switchers. This is shown in the figure below.[308]

Figure 9.1: HSBC switcher account opening volume

[✂]

Source: HSBCG.

(b) In mid-2013 LBG stopped offering six months' free transactional banking for switchers replacing it with individually negotiated arrangements. The number of switchers LBG acquired reduced significantly. This prompted LBG to review its policy and at the end of 2014 it reintroduced a six month free banking offer for switchers.

BCA tariffs after free banking periods

9.13 Most banks have at least two tariffs for smaller SME customers: one tariff for customers who use branches and a lower tariff for customers who use online channels.

9.14 In the last few years, there have been a number of adjustments made to these tariffs, but there have not been significant changes in tariffs or other

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305 LBG has reintroduced six months' free transactional banking for all SME switchers in December 2014 following its withdrawal in 2013.
306 HSBCG recently (February 2015) revised its policy for switchers, increasing the length of free banking from six months to 12 months.
307 RBSG withdrew its offer of free banking for switchers in 2014 as part of RBS's and NatWest's strategy to end teaser rates across all brands for personal and business customers. It replaced the offer with a flat rate cash contribution of between £150 and £250 to cover SME switching costs for customers with a turnover less than £2 million.
308 We note that HSBCG provided other example of changes in free banking period, but these were some of the most substantial changes made by HSBCG.

aspects of pricing of BCAs, such as credit interest. The key driver for tariff changes according to several banks has been simplification of tariffs and the introduction of lower tariffs for electronic bank usage to encourage non-branch channel usage by SMEs (which is also less costly to the banks). For example, in 2011 LBG introduced a monthly price plan which, for a fixed fee, included a certain number of transactions per month, with extra charges for off plan transactions. Similarly in October 2011 Santander introduced a fixed fee BCA allowing unlimited transactions included within a monthly account maintenance fee.

Quality/relationship management

9.15 Evidence set out in Appendix 8.1 shows that one of the principal factors motivating SMEs to switch away from their bank is poor quality of service. The proportion of SMEs reporting that they switched away from their bank due to poor quality of service was broadly similar to the proportion switching away due to price.[309] This would suggest that quality of service is as important as price for established SMEs.

9.16 A distinctive feature of SME banking compared with the PCA markets is that SMEs are typically provided with access to advice and sometimes a relationship management services. For smaller SMEs with turnover below £250,000, this will typically be provided through a call centre and/or business centre; whereas small to medium and larger SMEs (above £500,000) will generally be provided with a relationship manager. However, even SMEs that have access to a relationship manager, the level of service and support of their relationship manager will typically vary depending on size of SME.[310] SMEs with turnover between £500,000 and £2 million receive a relationship manager, but their relationship manager is likely to manage a large portfolio of customers, between 200 and 300 SMEs. As the turnover size of the SME increases, the more likely the SME will receive more personalised support from its relationship manager (see Table 2 in Appendix 8.1).

9.17 In recent years there have been changes by some banks to their offering of relationship management services. [✄]

9.18 As shown in Table 2 in Appendix 8.1, relationship managers are primarily offered to larger SMEs. Given that only 5% of SMEs have a turnover above £2 million, few SMEs benefit from more dedicated and personalised relationship management services.

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[309] See Appendix 8.1.
[310] See Appendix 8.1, Tables and 3.

9.19 Banks have used a variety of sources to measure customer satisfaction and quality of service, ranging from surveys and benchmarking reports to internal metrics and complaints data. As shown in Section 6, customer satisfaction in GB (as measured by the Charterhouse BBS) has remained broadly constant between 2010 and 2014 (just above 50% when looking at the number of 'excellent' or 'very good' ratings).

9.20 The parties, provided some examples of improvements they have made to services based on results from these quality and service measures (see Appendix 9.1) However, attempted improvements in customer service generally appear to be aimed at retaining existing customers, although we do note some instances of trying to acquire new customers.

Customer targeting

9.21 Banks can target customers either through the use of advertising and marketing or through relationship managers. Compared with personal banking and PCAs in particular, we found little evidence of banks engaging in mass media advertising for SME products. Most banks confirmed that their focus for mass media advertising was on brand awareness rather than for specific products. In relation to SME banking, this is likely to be a consequence of the disparate nature of SMEs and the number of potential new customers being much smaller than for PCAs. Evidence from Mintel shows that advertising expenditure in UK by the largest five banking groups on SMEs was £24.7 million in 2013. This compares with £160 million for PCAs.[311]

9.22 Relationship managers can have a significant role in attracting new SMEs. Some banks have told us that as part of their role, relationship managers will have shadow portfolios of SME customers who currently bank elsewhere and will have targets to attract a certain number of SMEs to switch banks.[312]

9.23 We note, however, that these policies are mainly targeted towards larger SMEs (turnover above £2 million), as relationship managers are typically seeking to attract SMEs of commensurate size to their current portfolio. Therefore, it does not appear that relationship managers are being used to attract and retain the vast majority of SMEs. Relationship managers are typically offered to larger SMEs and these currently represent only 5% of the SME population.

[311] Mintel (October 2013), *Consumers and retail banking (UK)*, Figure 35, p47.
[312] For instance, this was noted by LBG, [✂],[✂], [✂] and RBS. [✂]

Churn

9.24 Some banks have indicated that, because of the high churn in BCAs, they continually need to compete for new business in order to maintain their market share, and therefore switching rates are not the relevant indicator of customer engagement.[313]

9.25 As set out in Tables 6.1 and 6.2 in Section 6, approximately 12% of BCAs were opened and closed in GB and 9% in NI in 2014. The death and attrition rates of start-ups is likely a major contributor to the closure rates of BCAs.[314] However, we also found that, despite the large level of business closures in the first few years of a business's life, once a business is more established and survived this initial period, many businesses continue to operate for long periods of time.

9.26 As noted earlier banks compete for start-ups, in particular through offers of free banking periods. There is variation between banks in the nature of their offers and several smaller banks and new entrants do not offer any free banking periods to start-ups. However, we found little dynamism in competition for start-up SMEs with few changes to free banking periods since 2011.

9.27 In addition, while banks may compete for start-ups, this does not necessarily guarantee that all customers will benefit from this competition. For competition for start-up SMEs to benefit the whole market we would need to find that either:

(a) there was no price discrimination between start-ups and established businesses; or

(b) SMEs considered the entire cost of their banking relationship over the lifetime of the product holding.

9.28 If there is no price discrimination, then intense competition for new business could mean that lower prices to attract start-ups may benefit all SMEs. If there was price discrimination but SMEs considered the entire cost of banking over the lifetime of their relationship with the bank, then banks would be competing over the whole life cost of their products (including the costs of BCAs after the free banking period) rather than just for the start-up period.

[313] See Appendix 8.1.
[314] See Appendix 8.1.

9.29 Most banks offer periods of free banking to start-ups, and many also offer albeit shorter free banking periods to switchers and therefore banks can and do price discriminate between start-ups and established SMEs.

9.30 As outlined in section 8, we find evidence that 58% of SMEs do not compare different providers against one another at start-up and while 72% said they considered banking costs beyond the free banking period, 12% then went on to say that they did not look into the fees at all, 24% did not spend much time looking at fees and 14% looked at fees of the provider they chose without comparing between banks.[315]

9.31 Therefore, because, at start-up stage, SMEs are not fully engaged, with many SMEs either not searching, or not comparing fees across banks, we do not consider that competition for start-up SMEs is likely to be particularly intense. All SMEs will benefit to an extent from the initial free banking periods they are offered. However for those SMEs that stay in business for a long time, the benefits of that initial competition will be limited, especially considering the low switching rates. This means that any churn will drive limited incentives to compete.

SME lending

9.32 Business lending is an important component of SME banking. SMEs will often have to draw on external funds to help cover shortfalls in cash flow, invest in new equipment and/or to fund expansion.

9.33 In Section 8 we found:

- *(a)* For overdrafts, loans and credit cards, at least 90% of SMEs in GB use their main bank.[316] These are also the three most common forms of finance taken out by SMEs.
- *(b)* The follow-up survey on SME lending found that for 26% of SMEs, the interest rate was the most important feature when deciding where to go for finance, followed by the relationship with the bank (18%), availability of finance (17%) and ease and speed of application (10%).[317] However, when asked about why they applied to their main bank, the reasons given were relationship (26%), convenience (26%) and satisfaction with previous service (23%).[318]

[315] SME follow-up surveys, p18.
[316] Findings are similar in NI. See Section 8.
[317] See SME follow-up surveys, p48.
[318] See SME follow-up surveys, p50.

9.34 Lending markets are characterised by information asymmetry, both between the customer and the potential lender as well as between the main bank and other lenders. The asymmetry of information between customers and lenders arises because lenders cannot easily distinguish between high-risk and low-risk customers when assessing SME lending applications. This is particularly true for smaller and younger SMEs where there is a lack of available information on the past performance of these businesses.

9.35 Information asymmetries between SMEs and lenders may be reduced when the SME takes out a loan with its main bank. This is because the main bank will typically have information on the transaction history of the SME sourced from its BCA and, in some cases, the PCA of the business owner.[319] This enables the main bank to make a more accurate and quicker assessment about the creditworthiness of an SME as well as being able to better price loans.

9.36 This is likely to impact on competition in the market. Santander, for example, told us that, 'as a challenger trying to attract new business loan customers, a key challenge is to be able to gather the transaction data required in order to make a lending decision within the timeframe for providing the funding. Many SMEs apply for funding at short notice; this leaves very limited time for a bank new to the customer to respond'. Santander told us that, 'as a result, Incumbent banks had an advantage as they are likely to have had an existing relationship with the SME, and will therefore have more data and a richer understanding of that business'. It further told us that: 'Transaction data is one of several factors taken into account when making lending decisions. Challenger banks starting from scratch to collect basic information are up against the clock in order to meet the deadline. This difficulty is amplified by the effort made by banks to retain customers.' Similarly, Secure Trust Bank noted that banks holding a BCA had significant advantages when making credit decisions. Section 10 considers in more detail whether information asymmetries between an SME's main bank and other lenders is a barrier to entry and/or expansion.

9.37 Debt finance may be required for a number of different reasons and quite often may be required at short notice, for example, where debt finance is needed to help with cash flow, timing may be particularly important (for example, to cover short-term shortfall in funding because a customer has paid late). This could potentially lead to a competitive advantage for the bank where the SME holds its BCA.

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[319] In addition, having access to a pool of data about SMEs will help a bank make better assessments on the reliability of estimates in a business plan. This issue is discussed further in Section 11.

9.38 In the remainder of this section we discuss competitive developments, responses to competitor behaviour and the response to alternative finance such as crowd-funding and peer-to-peer lending.

Competitive developments and response to competitor behaviour

9.39 There have been some developments in the process for applying for loan offers for SMEs. In July 2014, Barclays launched a facility to enable SMEs to get instant lending decisions online for unsecured borrowing below £25,000. Barclays told us that while this new service was principally driven through customer feedback, they submitted that it was also the result of competitive pressure both from new alternative lending platforms and from competitor banks.

9.40 Similarly, LBG told us that it had recently streamlined its lending applications and affordability assessment for new lending applications up to £[✂] to provide a quicker assessment.

9.41 Other recent developments, namely the offer of discounts and incentives, appear to have principally stemmed from government initiatives. The FLS[320] prompted different responses from banks. For example, Barclays provided 2% cashback on loans to boost the amount of resource made available, while LBG initially reduced the interest rates on all new term lending to SMEs written from October 2012 by 1% for the full life of the loan. There is also some limited evidence of banks responding to the price offers of competitors at a local level. For example, [✂].

9.42 Meanwhile, despite not participating in FLS, [✂].

9.43 On asset finance and invoice discounting we have found limited evidence of banks responding to competitors' behaviour. As noted in paragraph 25, Appendix 8.2, a number of smaller banks indicated that the larger established banks had withdrawn from such finance, which had provided opportunities for new banks such as Aldermore and Shawbrook to enter.

Competition from alternative finance providers

9.44 In recent years there has been a growth in alternative finance for SMEs, including peer-to-peer lending and crowdfunding. While all of the large banks told us that these new providers were significant competitors, they only provided limited examples of changes they had implemented in response to these competitors. The most significant examples were on peer-to-peer

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[320] For further details please see Section 3.

lending, where banks mentioned that they had made significant investments improving their digital capabilities and offering more timely lending decisions in response to alternative finance providers such as Funding Circle, Zopa and PayPal.

Summary of Competition for Lending

9.45 We find evidence of banks seeking to increase their lending volumes by improving the availability of finance and the speed with which an SME can obtain a decision on lending applications, but these appear mainly focused at existing BCA customers. We also find some limited evidence of banks responding to the price offers of competitors at a local level. However, this seems to be mostly targeted at larger SMEs and focused largely on retaining their existing customers. Evidence of pricing initiatives and discounts aimed at attracting new customers are much more limited and mainly prompted by government initiatives.

Overall conclusion on competition in SME retail banking

9.46 SMEs are a diverse population, both in size, in the types of sectors they operate in and the length of time they have been in business and their aspirations. However, the vast majority of them (approximately 95%) are small with a turnover below £2 million.

9.47 There is evidence that suggests that competition in the SME banking market is not fully effective in both GB and NI:

(a) The markets for both BCAs and SME lending are concentrated and market shares have been stable since 2005 notwithstanding wide variations in price and quality between banks.

(b) There has been limited new entry, in particular for BCAs, and their growth has been limited. Most new entry has been among specialist lenders, such as asset and invoice finance.

(c) We found evidence of some banks gaining market share despite appearing to offer a combination of below-average quality and above-average prices. Conversely, there are providers appearing to offer below-average prices and above-average quality that are either losing market share or gaining market share at a very slow pace.

(d) We also found that the extent of innovation has lagged behind the levels observed in the PCA market.

9.48 We examined SME demand for banking products at different stages in the life cycle of an SME:

(a) the start-up phase, when first opening a BCA;

(b) once an SME has chosen a BCA, in particular at the end of the initial free banking period (after 12 to 24 months); and

(c) as the SME grows and becomes more established, the need for other services from the bank (in particular lending).

9.49 When choosing a first BCA, approximately 50% of start-up SMEs go to their PCA provider, and many do so without comparing different providers. For those who do some searching, the Charterhouse follow-up survey suggests free banking was a significant driver for SMEs, although we note that most banks offer initial free banking periods, so it is not a clear differentiating factor beyond the different lengths of free banking offered. However, few SMEs fully compare the fees that they will pay after the end of the free banking period across banks. This means that the ability of SMEs to search and switch after they have chosen an initial BCA provider is particularly important for the competitive process.

9.50 After SMEs have set up a BCA, the annual switching rate is low (4% in GB and 2.6% in NI) and older SMEs tend to remain with their banks for many years. We also find indications of limited searching by SMEs once they have chosen a BCA: we found that over two-thirds of SMEs between two to five years old have never compared the cost of their BCAs with other providers. Even at the end of the free banking period (a natural trigger point for switching) two-thirds of SMEs did not consider switching at all, and, of those that did consider switching, very few actually do switch banks. The primary reason given for not considering switching was satisfaction with their bank, although a significant number of SMEs also considered that it would be time-consuming or difficult.

9.51 Although banks have submitted that switching rates may be low because SMEs are satisfied with their bank, a significant number of SMEs dissatisfied with their bank did not consider switching. In addition, the low levels of searching and the differences in price and quality between banks suggest that SMEs may not be making an informed decision to remain with their BCA provider. We therefore investigated whether there are other factors which act as barriers to searching and switching.

9.52 We first examined SMEs' attitudes to banking, and found that there are a number of factors that may reduce SMEs' propensity to shop around for BCAs. There are a lack of triggers and BCAs are a low cost compared with other costs of business. SMEs perceive that remaining loyal to a bank will be beneficial, in particular in relation to future lending decisions. There is also a perception that potential gains from switching are not high and that there is limited differentiation between banks.

9.53 We then examined the barriers to searching: we found that while price information is available, it is difficult for SMEs to compare fees across banks because of the complex tariff structures and multiplicity of charges for BCAs; the importance of usage in comparing BCAs, including accessing information on quality; and the lack of effective price comparison tools, including ones that are able to use SME usage data to calculate which BCA offered the best prices. This is likely to particularly affect smaller SMEs without specialist financial capability.

9.54 We also identified some barriers to switching. The account opening process can be lengthy and onerous, particularly because of many banks' processes for undertaking AML and Know Your Customer (KYC) checks. We also noted that awareness, use and understanding of CASS was particularly low among SMEs, despite most SMEs being eligible. In addition, CASS does not cover all the issues of concern for BCA customers when switching BCA. In addition, for some SMEs, access to finance may deter them from switching BCA with fears that doing so would reduce their ability to continue to access finance and/or access finance in the future.

9.55 For SME business lending, we find there is little shopping around, with the vast majority of SMEs going to their main bank for finance. We have found that there are barriers to shopping around. It is difficult to compare prices and other terms as prices are opaque and lending products are complex. In addition, there are a lack of tools to help SMEs make comparisons which may particularly affect smaller SMEs without specialist financial capability.

9.56 In addition, an SME may not even consider providers other than their main bank because of:

(a) the time and effort involved in applying for finance from other providers (particularly when finance is needed at short notice); and

(b) the importance of the relationship with their main bank and in particular the information asymmetry between the SME's main bank and other providers affecting the ability of other providers to accurately price credit and make a lending decision.

9.57 We looked at how banks compete for start-up SMEs. We found the following:

(a) Competition is mainly focused on providing free banking periods of between 12 and 24 months for BCAs. There is variation between banks in the length of free banking periods offered, although in more recent years there is little evidence of dynamic competition between banks on free banking periods or on service/quality.

(b) There are incumbency advantages for PCA providers to acquire start-ups, with just over half of SMEs opening a BCA with their PCA provider, and limited evidence of entry from BCA providers that do not provide a PCA. After free banking, the most important factors driving SME choice of BCA provider at start-up were branch location and the bank being the SME's personal bank.[321]

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

9.58 We looked at competition for established SMEs in GB and NI and found the following:

(a) While many banks offer free banking periods as inducements to BCA switchers, some banks such as Santander and RBS have moved away from offering free banking as an inducement to switchers and newer entrants such as Metro are focusing on quality and convenience to attract new SMEs. However several banks including LBG, HSBC, TSB, Clydesdale, and Yorkshire Bank have extended free banking periods for switchers. Offers by banks in NI have remained more constant.

(b) Banks' acquisition and retention strategies tend to focus on larger SMEs. In particular, larger SMEs have access to more personalised relationship managers, partly to provide these customers with a better quality of service. This supports banks' ability to retain these customers. Where relationship managers have acquisition targets, again these tend to be geared towards the larger SMEs (SMEs with turnover above £2 million). In addition, banks are willing to negotiate with larger SMEs. However this group, while likely to be important for banks in terms of revenues, represents just 5% of all SMEs.

(c) There has been some innovation on tariffs, particularly with the introduction of electronic banking tariffs, but little evidence of price competition on other price aspects.

[321] See SME follow-up surveys, p11.

(d) We generally observe less innovation for SMEs compared with personal banking. Most innovations have had their roots in personal banking and there has been a lower uptake of digital channels in SME banking, most notably in mobile banking

9.59 These findings reflect our findings in Section 8, where we found that there are difficulties for SMEs to switch, and that the drivers of SMEs' choices at start-up are free banking, branch location and their personal banking provider. Given these characteristics of SME demand, competition for start-ups is primarily focused on price/free banking.

9.60 There are fewer incentives on banks to compete for established SMEs beyond their free banking period, given the difficulties in switching we identified. In particular, given the barriers to searching and switching, banks have limited incentives to invest in activities to increase switching (such as eg marketing and advertising, innovations in pricing structures etc.). This is likely to further exacerbate the lack of dynamism in the market and the perception by SMEs that there is little to be gained from switching.

9.61 While it has been submitted that the degree of churn impacts the way banks compete for customers, it appears unlikely that competition for start-ups benefits the whole market. This is because:

(a) there is price discrimination between start-ups and established SMEs, as demonstrated by free banking periods; and

(b) at start-up, SMEs do not appear to consider the whole life cost of banking and tend to make short-term optimal choices, focusing more on free banking and not considering future fees. This means that competition between banks for start-ups is unlikely to discipline banking fees beyond the free banking period.

9.62 With respect to lending to SMEs, we have found very strong incumbency advantages for the BCA provider. This is driven by a combination of factors including the following:

(a) Information asymmetry between the BCA bank and other banks means that the BCA provider can generally make quicker and more accurate assessments for providing credit.

(b) The desire for finance at short notice by SMEs means that the BCA provider is often best placed to provide finance to SMEs. Convenience and relationship with their existing BCA provider were cited as the most significant reasons for SMEs applying to their main bank for finance.

(c) There have been changes in response to FLS schemes, which are designed to increase access to finance, although this has been as a result of government intervention rather than banks initiatives per-se. While some banks have followed innovations from peer-to-peer lenders, to improve speed of lending decisions, this is available only to existing BCA customers rather than being a service available to all SMEs.

9.63 We therefore provisionally found that there is weak customer response in BCAs and SME lending. In Section 12, we set out how this weak customer response gives rise to an AEC in the provision of BCAs and in the provision of SME lending, in each of GB and NI respectively.

10. Barriers to entry and expansion

Introduction

10.1 In this section we set out the CMA's analysis of potential barriers which might act to constrain the ability of firms to enter or expand in the provision of retail banking services. As stated in our Guidelines,[322] entry or expansion by firms, or the prospect of entry or expansion by firms within a short time, will often stimulate competition and can sometimes countervail against features which might otherwise give rise to an adverse effect on competition. A significant source of competitive discipline may therefore be eliminated or reduced if there is any barrier to market entry and/or expansion, whether an absolute barrier or some other form of restriction.

10.2 This section is structured as follows. We first outline the framework within which we consider barriers to entry and expansion. We then summarise recent entry and expansion in the retail banking market, describing some of the trends and market developments that have facilitated and continue to facilitate entry into the market. Next we summarise the evidence on each of the potential barriers identified as part of this investigation before drawing our conclusions.

Our framework

10.3 Our Guidelines group barriers to entry and expansion into four broad categories: regulatory barriers to entry, natural or intrinsic barriers to entry, strategic advantages, and 'first-mover' advantages of incumbent firms. We have examined barriers within this framework, although we consider strategic advantages and 'first-mover' advantages in combination given the natural overlap between them.

(a) **Regulatory barriers to entry** – To enter and operate in the retail banking market, providers must meet a number of regulatory requirements or conditions set by UK authorities.[323] These conditions include obtaining a banking licence, meeting capital requirements and satisfying AML regulations.

(b) **Natural or intrinsic barriers** – To enter the retail banking market entrants require access to inputs such as payment systems, IT, funding and distribution channels (including branches and online). The cost of

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[322] *CC3*, paragraphs 205–236.

[323] UK authorities responsible for setting and monitoring adherence to bank regulation include HMT, the BoE, the PRA and the FCA. See Section 3 of this report.

accessing these facilities may be significant, affording advantages to scale providers. Another important consideration in evaluating the impact of these costs on providers' ability to enter and/or expand is the extent to which they are 'sunk' – ie cannot be recovered upon exit. Economies of scale in combination with sunk investment costs increase the risk of entering the market and can create a barrier to entering the market. Economies of scale can also be reinforced by other barriers, such as customer inertia and high customer acquisition costs. For example, economies of scale and sunk costs may not represent a barrier to entry and expansion if banks are able to acquire sufficient numbers of customers within an appropriate timeframe to recover their costs.

(c) **Strategic and 'first-mover' advantages** – Barriers to entry and/or expansion may be exacerbated by the actions of incumbent banks (supply-side factors), or they may result simply from the established position of existing banks (supply-side and demand-side factors). Regardless of origin, these barriers can raise entry costs and create an un-level playing field for entrants relative to established market participants. Such barriers include access to customer data (allowing incumbents to better target and price products). They also include the cost of customer acquisition arising either from first-mover advantages and/or weak customer response.

10.4 We consider the potential barriers to entry and expansion identified within the broader context of recent market developments and ongoing trends both on the supply side and demand side of the market.

Market developments and recent trends

10.5 Entry into the UK PCA market has occurred in recent years. Four of the seven providers that have entered the PCA market since 2004 were providers of ancillary financial services products that expanded their product offering to include PCAs.[324] Entry into PCAs has also occurred organically (Metro, 2010), and through divestment (TSB, which was divested from LBG in 2013). Further, Atom is due to launch as a full-service retail bank imminently, having obtained authorisation from the PRA in June 2015.

10.6 Although we recognise that the acquisition of existing businesses is not entry as such, Santander's entry in the UK through the acquisitions of Abbey National plc, Bradford & Bingley Building Society and Alliance & Leicester

[324] These are Virgin Money, the Post Office, Tesco Bank and M&S Bank. The Post Office offers retail banking services under BoI's banking licence. M&S Bank is a wholly owned subsidiary of HSBCG but it has its own banking licence and a profit-sharing agreement with Marks and Spencer plc.

Building Society has created a stronger competitive constraint in the market than the three acquired entities were able to achieve by acting independently, and so we consider Santander alongside recent entrants.

10.7 In addition to entry into the provision of PCAs, there has been some entry into the provision of banking services to SMEs, albeit to a more limited degree than in the PCA market. Unlike the entry that has occurred in the PCA market, no bank has entered with a stand-alone BCA proposition. Further, of the four that have entered since 2004, TSB acquired most of its BCA customers through divestment and has yet to put the same strategic focus on its BCA business as on its PCA business. Further, Handelsbanken (which entered the UK in 1982, initially serving Nordic customers only) expanded to offer domestic banking services, including current accounts, to personal customers and businesses in the UK in 2002.

10.8 In the SME lending market,[325] most of the entry that has occurred has been among specialist lenders and deposit-takers. For example, Aldermore, which entered the market in 2009, offers a range of business finance including invoice finance, asset finance and bridging finance. Shawbrook and Paragon Bank entered in 2011 and 2014 respectively and offer a range of savings and specialist SME lending products (including mortgages). Most recently, OakNorth entered the market for SME lending in March 2015.[326] None of these new entrants offer general-purpose business loans to SMEs. Instead, they all focus on alternative finance products.

10.9 There are further positive developments on the supply side: one retail provider that will offer PCAs is currently in the application stage of the authorisation process, and a further 20 retail firms are active in the pre-application stage of the authorisation process. Half of those firms in the pre-application phase plan to enter with current accounts for personal or SME customers (or both).[327]

10.10 However, while entry has occurred in the PCA and BCA markets and SME lending market, the growth of market share by recent entrants has been limited. For example, Metro, M&S Bank, Tesco Bank and Virgin Money each had less than [0–5]% share of the PCA market in 2014. This may reflect the more targeted approach being pursued by these recent entrants. The growth

[325] In this context, SME lending refers to alternative leading facilities such as asset finance, invoice discounting and commercial mortgages, but excludes general-purpose business loans.
[326] OakNorth became authorised with restriction in March 2015 and had its restriction removed in August 2015.
[327] Information provided by the PRA.

expectations of recent and prospective entrants have also been very modest, averaging [0–5]% over the five years to 2020.[328]

10.11 It appears that recent entrants (and pipeline firms – those either in the application or pre-application stages of authorisation) are tending to focus their approach according to:

(a) product (eg entering niche product areas such as invoice discounting – this is particularly evident for SMEs);

(b) customer type (eg Tesco and M&S have targeted mainly their existing customer bases and their supermarket shoppers through a range of in-store advertising while Atom is focusing on those who are routine users of mobile apps, in particular 18- to 34-year-olds[329]); and/or

(c) service and use of technology (eg a number of pipeline firms intend to offer digital-only propositions. New technology has enabled firms to offer such services at relatively low cost and increased efficiency).

10.12 This has meant that entrant banks are not necessarily trying to compete with incumbents across all product and service lines, but are seeking to target particular (niche) products or customers and/or to offer a differentiated service model (eg delivering through online channels). Some features of the demand side, in particular customers' willingness to engage through online channels, have facilitated this new type of entry and service innovation.

10.13 Recent developments on the demand side must be taken into account when assessing the extent to which barriers to entry and expansion exist in retail banking. For example, banking is increasingly becoming a self-serve activity and consumers, according to a report by Deloitte, expect greater convenience and 'seamless integration of remote and in-person channels'.[330] 85% of personal banking customers and 64% of SME customers now use online banking.[331] Customer interactions with their bank have also become much more frequent with the majority of online and mobile banking users logging on at least once a week.[332]

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[328] Based on data from Atom, Virgin Money, Tesco Bank, Starling, Metro, TSB and Fidor (estimates from Fidor of their growth is based on Fidor's German rates of expansion). Data harmonised to 2020 equivalent using linear interpolation/extrapolation from stated targets and years.
[329] Reuters (August 2015), Atom Bank taps video game technology to win mobile customers.
[330] Deloitte report, *UK bricks and clicks.*
[331] 85% of personal banking customers: from GfK's PCA consumer survey. 64% of SME customers used online banking as their main channel in 2014: from Charterhouse BBS.
[332] 66% and 74% of PCA customers that use online and mobile banking respectively, log on to online (mobile) banking at least once a week.: from GfK's PCA consumer survey.

10.14 This change in customer behaviour has enabled new business models to be brought to the market. For example, digital-only propositions supported by arrangements such as inter-bank branch sharing, become a feasible alternative. It has also led to other service innovations in the PCA and SME banking market including PayM, cheque imaging, video banking and online account opening.

10.15 Despite these developments we have found, as set out in Sections 7 and 8, weak customer response, and this is important to our assessment of the potential barriers to entry and expansion in retail banking.

Regulatory barriers to entry

10.16 Banks have to meet a number of regulatory requirements to enter the banking market and, once there, must meet a number of ongoing requirements to demonstrate that they are financially sound and have high standards of conduct. While regulation has an essential role to play in ensuring a well-functioning banking market and in protecting customers, if regulatory requirements are set too high or applied disproportionately they may hinder competition. Regulation has the potential to delay and even prevent new banks from entering the UK market. It can also hinder their expansion by systematically favouring incumbents. Incumbent banks will typically have more resources to bear the fixed costs associated with regulation, and the experience to meet regulation at a lower cost than new banks seeking to enter the market. This section considers the authorisation process, capital requirements and AML requirements and evidence relating to how these affect entry and expansion.[333]

Bank authorisation

Overview

10.17 To operate in the retail banking market, PCA and SME banking providers must apply for permission from the PRA.[334,335] Deposit-taking entities are dual-regulated by the PRA and FCA and a single authorisation application must be made to the PRA. An entity seeking to carry on regulated consumer

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[333] The analysis included in this section is applicable to banks in NI. NI has to meet and comply with the same banking regulations (AML, capital adequacy rules) as the rest of the UK.
[334] Some types of provider do not need to be authorised. These are appointed representatives, professional firms that run regulated activities alongside their main business, and local authorities and some housing groups. See *FCA firm authorisation.*
[335] See FCA regulated activities for a list of regulated UK financial activities.

credit activities (which includes asset finance and overdrafts) must also apply for authorisation/the relevant permissions from the FCA.

10.18 The OFT's 2010 review of barriers to entry, expansion and exit in retail banking found that firms faced difficulties and uncertainties arising from the authorisation process which had the effect of delaying entry and making it harder to raise capital.[336] Since this review, a number of changes have been made to the authorisation process which have received broad support from recent and prospective entrants to the banking sector.

10.19 This section sets out the changes to the authorisation process that took effect from 1 April 2013 following a joint review by the FSA and the BoE.[337] More detail about these reforms to the authorisation process can be found in Appendix 10.1.

The authorisation process

10.20 Prior to the most recent reforms to the authorisation process in April 2013, applicants were required to be fully operational before authorisation could be granted. 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 operational and business continuity arrangements were in place.[338]

10.21 The changes to the authorisation process were designed to make it more flexible and better reflect the wide variation in applications received by regulators and in the needs of firms.[339] Two options are now available to prospective entrants: Option A is designed for firms that have the development backing, capital and infrastructure to allow them to set up a bank relatively quickly, while Option B is designed for firms that cannot immediately fund the upfront investment required to set up a bank or have longer lead times for raising capital and setting up infrastructure.[340]

10.22 In addition to the process changes, the FCA and PRA also committed to:

(a) providing greater pre-application support to prospective entrants;

(b) requesting less information from firms overall than under the previous authorisation regime; and

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[336] OFT review of barriers to entry, expansion and exit in retail banking.
[337] *A review of the requirements for firms entering into or expanding in the banking sector.*
[338] ibid.
[339] ibid.
[340] ibid.

(c) working with the applicant to determine the application within six months (as per statutory deadline).

Mobilisation of firms under Option B

10.23 Option B offers a different approach whereby the firm can submit a shorter application. Providing a firm meets the threshold conditions,[341] a firm applying under Option B will be authorised with a restriction.[342] Firms that have authorisation with restrictions are said to be in 'mobilisation'.[343] During the mobilisation phase the bank will complete all the outstanding arrangements required for it to become fully operational, including raising capital and putting in place and testing appropriate IT systems.[344]

10.24 Once the firm has completed all of these activities during mobilisation (which is capped at 12 months), 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.[345]

Changes to capital and liquidity requirements

10.25 As part of the reforms to the authorisation process that came into force on 1 April 2013, changes were made to the capital and liquidity requirements imposed on banks.[346] These include the following:

(a) Reduced capital requirements at authorisation – this offers capital concessions at authorisation for entrants. The PRA also has discretion to extend this for a period of time (up to five years) subsequent to a firm

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341 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 *The Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013*.

342 A restriction is a standard regulatory tool that allows the bank to accept deposits but will limit the scale of 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.

343 For example, Atom is in mobilisation having obtained authorisation with restriction in June 2015.

344 A list of activities that can be deferred to the mobilisation stage and those that must be completed prior to application are listed at: PRA/FCA (July 2014), *A review of the requirements for firms entering into or expanding in the banking sector*, paragraph 28.

345 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.

346 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 PRA/FCA (March 2013), *A review of the requirements for firms entering into or expanding in the banking sector*, section 6.

being authorised if the PRA judges that the firm can be resolved in an orderly fashion with no systemic impact.[347]

(b) Reduced liquidity requirements for all banks – all banks, including entrants, face lower liquidity requirements, and there is no longer a differential in liquidity requirements for entrant and incumbent banks.[348]

Observations since the implementation of reforms to the authorisation process

10.26 The PRA and FCA, in a review one year after implementation of the reforms,[349] found a number of positive developments, including:

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

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

10.27 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 including Paragon Bank, Atom and OakNorth. In addition, one retail provider is currently in the application stage of the authorisation process and a further 20 retail firms are active in the pre-application stage.[350]

10.28 While the number of banking licences granted by the PRA in each of its first two years of operation was close to the average number of licences granted yearly by the FSA, a greater proportion of these licences has been granted to new entrants under the PRA as opposed to variations to existing licences (one-third under the PRA compared to one-tenth under the FSA).[351]

Experience of recent entrants

10.29 There has been broad support for the changes to the authorisation process both from recent and prospective entrants. Our case studies on Metro, Virgin

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[347] PRA/FCA (March 2013), *A review of the requirements for firms entering into or expanding in the banking sector*, p9. More detail can also be found in Appendix 10.1.
[348] PRA/FCA (March 2013), *A review of the requirements for firms entering into or expanding in the banking sector*, p47, box 5.
[349] PRA/FCA (April 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*.
[350] Based on information from the PRA. One half of the firms in the pre-application stage plan to enter with current account propositions for personal and/or SME customers.
[351] BoE (11 March 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.

Money and prospective entrants provide more detail on some of these firms' experiences.[352]

10.30 Metro's founder and former chairman Anthony Thomson, now chairman of Atom, told us that the authorisation process has significantly improved since his experience with Metro in 2010. In particular, Mr Thomson stated that the clearer structure of the process provides more clarity to firms. Starling and CivilisedBank have had similarly positive experiences and commented that the reforms have improved the authorisation process for entrants. Atom also told us that the capital requirements on entrants are much more realistic and proportionate today than they were in the past. Atom, Paragon Bank and OakNorth also suggested, however, that the authorisation process remains a substantial exercise for firms seeking to enter retail banking.

Summary

10.31 In summary, the recent reforms to the authorisation process introduced by the BoE and the FSA (and subsequently implemented by the PRA and FCA) appear to have improved the situation for providers seeking to enter the retail banking market.

10.32 Nevertheless, Paragon Bank and OakNorth told us that obtaining authorisation remains a substantial exercise, while Atom told us that the long lead times involved (eg for obtaining access to payment systems) means that banks cannot in practice wait until they are authorised to begin mobilising. However, the reforms to the authorisation process have been broadly welcomed and endorsed by recent and prospective entrants and appear to be proportionate. Evidence from the PRA and FCA also points to an improved process: there has been a substantial increase in the number of firms discussing the possibility of becoming a bank with the regulators and an increase in the proportion of licences being granted to new entrants.

Capital regulatory regime

Overview

10.33 The capital regulatory regime exists to protect customer deposits, banks' trading counterparties and the economy from banks becoming insolvent. It does this by requiring banks to hold sufficient levels of capital to absorb losses in the event of failure or near failure.

[352] See Appendix 10.2.

10.34 A number of new entrants and smaller banks have raised concerns that the current capital regulatory regime places them at a disadvantage when competing with incumbent banks. This is because, they submit, they have to hold larger amounts of expensive equity capital compared with incumbent banks when providing the same type of lending to similar individuals and firms. This means that, all other things being equal, the cost of facilitating a new loan by new entrants and smaller banks will be higher than that of an incumbent bank. This in turn means that they will either have to charge higher prices for their loans making them less competitive, or take a lower return on equity limiting their ability to attract new investment and expand.

10.35 This subsection examines capital regulation as a barrier to entry and/or expansion. It begins by providing a brief overview of the existing capital regulations and their implications for competition. It then goes on to outline the main competition concerns that have been raised with respect to these rules by some parties and the evidence on capital regulation as a barrier to entry and expansion. Finally we briefly examine proposed changes to the current regulatory regime, before summarising our findings.

The Capital Regulatory Framework

10.36 The overarching framework that sets banks' capital standards is agreed internationally by the Basel Committee on Banking Supervision (BCBS)[353] and outlined in the Basel Accords, currently Basel III.[354] This framework is placed into legislation by the EU through the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) and transposed into UK law by the Prudential Regulatory Authority (PRA), which is also responsible for ensuring compliance with these regulations. CRD IV is a maximum harmonising regulation, which means that national authorities in each of the member states have little discretion to apply capital standards other than those set out in CRD IV.

10.37 The current regulatory framework for capital is based on three pillars:

(a) **Pillar I: Minimum Capital Requirements** – this is the minimum amount of capital banks must hold to protect against credit, market and operational risk and is specified under the Basel Accords. Under existing

[353] This is a committee made up of representatives of banking supervisory authorities from major economies and banking hubs, providing a regular forum for cooperation on banking supervisory matters and to encourage convergence toward common standards. The Bank for International Settlements (BIS) provides the secretariat for BCBS.
[354] The Basel Accords – Basel I,II,III – is a set of standards for regulations in the banking industry. They are issued by the BCBS.

minimum capital requirements all banks have to maintain a minimum ratio of 8% capital to their risk weighted assets.[355]

(b) **Pillar II: Supervisory Review** – this requires banks to hold an additional amount of capital to cover risks that are either not covered or inadequately covered under Pillar I. The aim is to ensure that banks have adequate capital to support other business risks such as pension, legal, credit concentration, and interest rate risks. It also seeks to ensure that banks are able to meet their minimum capital requirements even during periods of severe stress, for example during an economic downturn. Unlike Pillar I where capital ratios are agreed internationally by the BCBS and placed into EU legislation through the CRD IV, Pillar II is firm specific and set by the national regulator, in the UK the PRA.

(c) **Pillar III: Disclosure** – this aims to complement Pillars I and II by seeking to foster greater market discipline through improved disclosure by all banks of their capital holdings and risk management practices.

10.38 In addition, all banks are required to hold a number of additional capital buffers, such as the capital conservation buffer and the counter-cyclical buffer.[356] For globally systemically important banks,[357] an additional buffer is applied to reflect the added risks they pose to the financial system and the wider economy.

10.39 As a complement to the risk-based capital framework described above, the leverage ratio requires all banks to hold a minimum amount of capital to their total assets (regardless of the riskiness of those assets). The leverage ratio is intended to guard against banks becoming over-leveraged (ie holding too little capital relative to the liabilities they hold) and to protect against under-estimation of risk by banks and regulators. The leverage ratio effectively acts as a floor on the level of capital that banks have to hold and primarily affects banks with large concentration of assets with low risk weights such as

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[355] The ratio of a banks' capital to their risk weighted assets is known as the Capital Adequacy Ratio (CAR). Risk weighted assets are the total assets held by banks, each weighted for their risk. Risk weights can take a value of 0% to more than100%.

[356] The capital conservation buffer is designed to ensure that banks accumulate sufficient capital in periods of credit growth which can then be drawn down when losses are incurred without requiring banks to draw form their minimum capital requirements. It is set by Basel and transposed into EU regulation through the CRR. The capital conservation buffer is currently set at 2.5% of a bank's risk weighted assets. The countercyclical buffer aims to ensure that levels of capital take account of the stage of the economic cycle. The countercyclical buffer can range from 0% to 2.5% and is set by the Financial Policy Committee (FPC) of the BoE. This is currently set at 0%.

[357] Banks classified as globally systemic are HSBCG, Barclays, RBSG, and Standard Chartered Bank. The globally systemic buffer will be phased in over three years starting in 2016. Systemic buffers for other major systemic banks in the UK will be set by the FPC, following a consultation issued in Q4 2015 and will be implemented in 2019.

residential mortgages (see below for further discussion on the leverage ratio).

Minimum Capital Requirements: Standardised versus IRB

10.40 As set out above, to meet minimum capital requirements banks have to maintain a minimum ratio of 8% capital to their risk weighted assets. Assets are weighted according to their risk to ensure that banks with riskier lending portfolios hold more capital against their assets compared with banks that hold less risky assets.[358]

10.41 The regulations permit banks to use one of two approaches when calculating risk weights for credit risk:

(a) **the standardised approach** – where risk weights are set internationally by the BCBS, and placed into law through the CRD IV[359] and are based on the data supplied from credit rating agencies; or

(b) **the internal ratings-based approach (IRB)[360]** – where banks can calculate their own risk weights based on their own internal risk models and data. The standards required to be met to adopt the IRB approach are set internationally by the BCBS and transposed into law via the CRD IV.[361] In the UK, banks wishing to use their own risk models need to seek approval from the PRA.

10.42 The main benefit of the standardised approach is its simplicity as it applies one risk weight to each assets class based on the broad type and credit quality of the counterparty (eg sovereign, commercial bank, corporate, retail). However, it is viewed by many as being less risk sensitive compared with the IRB approach and can potentially disadvantage banks that have a lower than average risk as risk weights under the standardised approach for some assets classes will be higher than the IRB approach (and vice versa). Risk weights under the standardised approach are also not country specific and based on default data across multiple countries. This means that they may not accurately reflect the risk of certain asset classes in the UK, for

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[358] It is also designed to incentivise banks to hold low risk assets. If banks were required to hold capital against all of their assets regardless of their risk, there would be incentives on banks just to hold more risky assets in order to maximise their returns. This is the rationale for using a combination of the risk weighted framework and the leverage ratio.
[359] Risk weights for the standardised approach are agreed internationally by the BCBS and set into legislation in EU via the CRR. The EBA issues further technical guidance on standardised risk weights.
[360] The IRB approach is also sometimes referred to as the model-based approach.
[361] The standards that need to be met by banks to use the IRB approach are agreed internationally by the BCBS and set into legislation in the EU via the CRR. The EBA issues further technical guidance on to national regulators to further specify the conditions that need to be met by banks to be authorised to use the model approach.

example, they may overestimate the risk associated with residential mortgage lending. The standardised approach is mainly used by smaller and newer banks that do not have the data and/or do not wish to incur the costs to develop sophisticated risk models.

10.43 The IRB approach is mostly used by larger banks. This approach is more complex and relies on the banks having sophisticated risk models and good quality historical data on their past lending. This allows them to estimate key parameters such as the probability of default, loss given default and exposure at default[362] to calculate an expected loss against any given loan. Banks are then able to determine the levels of capital that need to be held against a loan to protect against (unexpected) losses. The IRB approach is much more granular and is intended to better reflect the actual risks held by the bank.

10.44 To use the IRB approach UK banks must meet rigorous minimum standards, set by the EU, and gain approval from the PRA.[363] Once approved they must comply with stringent ongoing operational requirements, including meeting the 'use test'[364] and the stress testing of their models.[365] These requirements mean that gaining approval and maintaining compliance with the IRB regime can be resource intensive.[366]

10.45 Once approved, banks using the IRB approach are required under the CRR to use this across all their assets (the so-called 'full use'). This is to avoid 'cherry picking' where banks use different approaches depending on whether they gain an advantage. It is only in defined circumstances that a bank may continue to use the standardised approach once they are IRB-approved for particular asset classes:

(a) Permanent partial use, where the standardised approach can be applied to certain assets classes indefinitely. Permanent partial use only relates to non-significant business units as well as exposure classes or types of exposure that are immaterial in terms of size and perceived risk profile. The PRA has set an expectation that exposures exempt under this

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[362] The probability of default measures the likelihood that the borrower will default, the loss given default is the share of assets that is lost when a borrower defaults and the exposure at default is the balance of the loan at the time of the default.
[363] The standards for becoming IRB-approved are agreed by the BCBS and set into legislation via the CRR. The EBA issues further technical guidance to national regulators on the requirements on bank to be IRB-approved.
[364] The 'use test' requires banks to demonstrate that the parameters used to estimate risk weights for the purpose of meeting regulatory capital are also employed for internal risk management purposes. Regulators can therefore take comfort in the IRB component as they play an essential role in the decision making of the bank.
[365] Banks are also required to evaluate the adequacy of their capital against severe adverse scenarios. Banks must be adequately capitalised even in these extreme scenarios of stress and may be required to hold additional capital.
[366] See further paragraphs 10.10.51 to 10.10.55.

process should not exceed more than 15% of a bank's total credit risk exposure on a risk weighted asset basis.

(b) Roll-out, where the standardised approach can be applied to certain exposures on a temporary basis. Under the CRD IV, national regulators are required to specify the time period for implementing the IRB approach for all their assets to avoid banks selectively using this to reduce capital.

Comparison of risk weights under the IRB approach and the standardised approach

10.46 Analysis conducted by the PRA[367] shows that, for certain asset types, there are significant differences in the risk weights under the standardised approach and the IRB approach – in particular for safer assets such as mortgage lending. For example, risk weights for residential mortgages with a loan-to-value of 60 to 70%, are broadly 8.9%[368] for banks using the IRB approach compared with 35% for banks using the standardised approach. For an SME loan, risk weights are 77.7% for an IRB-approved bank compared with 100% for a bank on the standardised approach. Table 2 in Appendix 10.1 provides a full list of the risk weights for banks under the IRB and standardised approaches, and Table 3 in Appendix 10.1 contains the list of banks that are IRB-approved for the different types of assets such as residential mortgages and lending to SMEs.

10.47 To illustrate the impact of the different risk weight on banks' capital holdings, a bank on the standardised approach seeking to provide a retail customer with a £100,000 residential mortgage with a loan-to-value of 60 to 70% would have to hold approximately £2,800 worth of capital compared with £712 for a bank on the IRB approach. This is illustrated in Figure 10.1.

[367] For further information please refer to Table A included in the Statement of Policy 'The PRA's methodology for setting Pillar 2 capital' July 2015.
[368] The risk weights for the IRB approach have been calculated using information from Q3 2013 supplied by all IRB-approved banks (including building societies) who have permission to use the approach. The average risk weights presented for each portfolio have been weighted by exposure amount to give importance to larger portfolios reflecting that these models are likely to have been given more scrutiny by the PRA. The mortgage risk weight benchmarks are based on UK data only.

Figure 10.1: Stylised example of capital requirements under the standardised approach and IRB approach for £100,000 residential mortgage

Source: CMA calculation.

10.48 However, for other assets the reverse is true. Risk weights are much lower under the standardised approach than the IRB approach. For example, risk weights for credit card lending are 107% for a bank under the IRB approach and 75% for a bank on the standardised approach.

10.49 The results above are broadly consistent with information we received from Principality Building Society, which was granted IRB approval in 2013. Principality Building Society, which had total assets of £7.3 billion in 2014, of which mortgage lending (including buy-to-let) made up around two-thirds (£4.8 billion), calculated that its minimum capital requirements in 2013 under the standardised approach were just under one-third lower under the IRB approach than the standardised approach, at £216.3 million compared with £154.1 million.[369]

The cost of adopting and using the IRB approach

10.50 There are significant requirements to becoming IRB approved. This is because regulators need to have sufficient confidence that banks have the capability to appropriately model their risk weights for determining capital ratios and that the models used are suitably robust.

10.51 Banks wishing to adopt and use the IRB approach have to make large upfront investments, such as developing an advanced risk model, investing

[369] It should be noted that the figure on the benefits of moving to IRB only relates to Principality Building Society's retail mortgages (including buy-to-let) and commercial business. Principality Building Society's second charge portfolio had not yet migrated onto the IRB approach at the time of the calculations. This means the figure (£154.1 million) included some assets on the standardised approach.

in IT infrastructure to support data collection, and hiring more experienced staff such as risk specialists and consultants to provide modelling expertise. There are also ongoing costs associated with maintaining risk models and complying with relevant regulations.

10.52 Participants that have recently undergone the IRB approval process or are in the process of becoming IRB approved, estimate the total cost of the IRB approval process at £[✂] million. For example, Principality Building Society commenced development of an IRB framework in 2006, submitting a formal IRB Waiver Application in July 2012 which was approved in August 2013. It estimated the total costs to be £[✂] million. But Principality Building Society also noted that it is extremely difficult to quantify direct costs, as these were included within a broader, budgeted, investment programme which reflected the firm's desire to ensure the continuous development and improvement of its risk management capabilities. Yorkshire Building Society, on the other hand, estimated the cost to be [✂]. This includes the cost of hiring external contractors, IT, model development and testing. Both Principality Building Society and Yorkshire Building Society reported that it can take a significant amount of time to develop the required infrastructure and risk capabilities needed for IRB approval and subsequently apply to be authorised to use their own internal risk-based system.

10.53 However, one of the biggest impediments to being able to adopt advanced modelling approaches is data. Banks need to hold significant data on their lending in order to be able to internally model credit risk. Specifically, banks have to hold a minimum of between three to five years' worth of detailed lending data on the relevant asset class to be IRB approved. In practice, more data may be required to ensure that estimates are sufficiently robust and take account of different points of the economic cycle. For example, data from an economic downturn is required to estimate loss given default and exposure at default, and sufficient data is required to estimate a long-run average for probability of default. It is also expected that, following the implementation of technical standards set by the EBA,[370] this data requirement will increase to a minimum of five years. While there is an option to use pooled data from external sources, it would be necessary to demonstrate that such data is representative of the bank's asset portfolio and risk. The PRA and several banks have indicated that this is not a straightforward exercise. Santander has explained that having to acquire

[370] The European Banking Authority (EBA) is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking. The EBA is consulting on the regulatory technical standards on assessment methodology for IRB approaches. For further information please refer to the EBA website: Regulatory Technical Standards on assessment methodology for IRB approach.

data to supplement its own data would mean that its risk weights would be higher than if it only used its own data.

10.54 In addition, banks have to demonstrate that they have been using their IRB models internally for at least three years before they apply for IRB approval.

Views of parties

10.55 A number of smaller and newer banks[371] have stated that the existing capital requirements place them at a significant disadvantage when competing with larger established banks. This is because established banks are able to use the IRB approach, while smaller and in particular newer banks generally use the standardised approach. They contend that on a like-for-like basis, banks using the IRB approach need to hold significantly less capital than banks using the standardised approach, with the difference being particularly large for safer assets such as lower loan-to-value mortgage lending.

10.56 They also argue that the lack of historical lending data required for IRB approval and the relatively high fixed costs involved in developing and maintaining risk models means it is difficult for new entrants and smaller participants to become IRB approved.

10.57 For example, see the following:

(a) The Challenger Bank Panel of the British Bankers' Association told us that smaller banks in the UK are at a disadvantage vis-a-vis larger banks due to the uniform application of the Basel rules to all banks, and the difficulty involved in moving from the standardised approach onto the IRB approach. Banks using internal ratings are able to apply lower risk weightings to many asset classes, enabling them to make more productive use of their capital. They said that the issue is also faced in other European jurisdictions, and the European Commission had just launched a public consultation on the impact of capital regulation, more specifically CRR and CRDIV,[372] which considers the question of the proportionality of regulation for different types of bank.

(b) Metro told 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. In particular, the advanced modelling approaches used by many existing banks allows for too much variability

[371] [✂].
[372] European Commission public consultation on the possible impact of the CRR and CRDIV on bank financing of the economy.

in capital. In order to promote a truly fair and competitive market, capital requirements for all product sets should be brought more closely in line with each other using industry wide indicators set by the regulator. This will make the market more transparent. Metro also told us that it is 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 is the same customer, with the same deposit, on the same property.

(c) TSB (which uses IRB for mortgage lending) cited capital requirements as an obstacle for a new bank. It said that banks that use the IRB approach have significant capital advantages over those banks that the use the standardised approach, most significantly on residential mortgages. On unsecured lending, it is broadly neutral, although in some instances, the IRB approach gives a higher capital requirement than the standardised approach. TSB said that a new bank with a small number of customers and a small infrastructure does not have the data to do the analysis and so would use the standard approach. TSB said that much of this is caused by a 'scale mismatch' rather than a problem with the IRB system itself. The IRB processes and systems are expensive and there are high maintenance costs as well.[373]

(d) Clydesdale (which uses the standardised approach) said that it has an average risk weighting [✂] that is [✂]. A solution suggested by Clydesdale was for regulators to make accrediting standardised banks with IRB status easier and more proportionate in terms of the cost and the process involved. [✂][374]

(e) [✂] stated that (as a new entrant in SME lending) it is required to hold more capital in relation to SME lending than, for example, RBSG would for the same unit of lending. It said that, when it started its SME operations in [✂], it could have bought data to underpin an IRB model. However, this would have distorted its numbers significantly as it would not have been indicative of its underwriting standards and did not reflect its lower risk. Therefore the IRB requirements and the term required for statistical accuracy do not assist new entrants. Instead they create an advantage for established market participants. An example of the impact of the differential in capital financing regulation is that [✂].

10.58 Some of the smaller banks also argue that the higher capital costs imposed under the standardised approach compared to the IRB approach means that they can compete only in areas where the IRB-approved banks do not

[373] TSB hearing summary.
[374] Clydesdale hearing summary.

compete and/or where they may have a competitive advantage (eg in riskier assets) under the capital requirements. They also argue that one of the main reasons the UK has seen an increase in new entrants and smaller banks since the financial crisis is because incumbent banks experienced a period of retrenchment, in particular on SME lending, which allowed smaller banks to take up the residual demand. For example:

(a) Secure Trust said that recent UK banking consolidation was driven partly by the introduction of the Basel II[375] capital methodology. In practice, only the largest firms could commit the resources necessary to meet the criteria required to qualify to use the IRB approach, which gave them an immediate and substantial capital advantage. Secure Trust referred to an ICB report which noted that Nationwide was able to risk weight its mortgage assets at 5%, while Barclays and LBG had risk weights of 16%. This meant that banks on the standardised risk weight of 35% have between a 218% and 700% capital disadvantage relative to banks on the IRB approach. Secure Trust said that new entrants focus their approaches in particular market segments more through necessity than choice – they must concentrate in areas where they have some ability to compete. This in turn means that it will be very difficult to become IRB-approved, for example in relation to mortgages, as they will not be able to collect the necessary data. Secure Trust said that this could imply the market is not functioning effectively. It said that the creation of more new banks could be suboptimal and counterproductive unless it is also aligned to a broader strategy to address the capital disadvantages of new banks.

(b) Clydesdale gave an example of a differential for a [✂] between a standardised and an IRB-approved bank. It said that [✂].

The impact of capital buffers and other measures

10.59 In considering the impact of capital requirements on competition it is important to examine the whole capital regulatory framework, including the impact of Pillar II requirements, capital buffers and the leverage ratio, since none of the requirements work in isolation, but instead seek to complement one another by addressing different limitations of the other.

10.60 In response to our working paper ‘Barriers to entry and expansion: capital requirements, payment systems and IT’, HSBCG and LBG told us that the additional regulatory measures placed on large banks had levelled the

[375] Basel II introduced the dual system of IRB and standardised approaches for calculating risk weights.

playing field. HSBCG told us that in its view, regulatory reforms have resulted in a levelling of the playing field between larger banks and smaller providers. Where larger banks obtain an advantage due to the differences between the standardised approach and IRB approaches, this is largely, if not completely, offset by additional regulatory burdens placed on systemically important banks.

10.61 Barclays told us that any perceived advantages for established/larger banks are counterbalanced by other policy measures, such as capital buffers, which are only applicable to large, systemically important banks, reduced capital requirements for new entrants, and the leverage ratio, which aims to limit large banks' ability to concentrate all their assets in low risk lending.

10.62 However, Virgin Money told us that there were good reasons for requiring large systemically important banks to have higher total capital ratios, because they have to protect themselves against the systemic risks they pose to financial stability as well as against their own risks. Virgin Money thought that it was not appropriate for the CMA to view systemic risk buffers applied to large banks, but rightly not to smaller banks, as counterbalancing the undoubted advantage gained by large banks from using the IRB model rather than the standardised approach to quantify their own risks. In addition, Secure Trust said that although systemic firms are subject to additional capital buffers relative to the smaller firms, these buffers are applied to overall risk weighted assets and hence have a limited effect. It also notes that neither LBG nor Nationwide are subject to these globally systemic buffers.

10.63 While we understand the rationale for larger banks holding additional capital reflecting their systemic risk, in assessing the impact that capital costs arising from regulation have on the ability of new entrants to compete and expand, we need to examine the differential cost created by the whole of the capital regulatory framework regardless of the different underlying rationales for each aspect of the regime. These need to be considered as they determine the nature of any advantage/disadvantage that the regime confers on particular banks. This includes the leverage ratio considered further below. Moreover, the impact of the capital regime on a bank’s competitive position is affected by its total capital requirements, reflecting the portfolio of its assets and how it decides to allocate capital and price its products accordingly.

10.64 In Appendix 10.1, Tables 5 and 6, we set out our analysis, based on PRA data of Pillar II requirements for individual banks, values of capital buffers for all banks and buffers for globally systemic banks. Under current regulation from the EU, only HSBCG, Barclays and RBSG are classified as globally systemic banks and subject to an additional buffer for globally systemic banks. Santander, Nationwide and LBG are not classified as globally systemic and therefore not subject to an additional buffer. However, it is expected that they will be subject to an additional systemic risk buffer for domestically important banks which will be implemented in 2019.[376]

10.65 The analysis shows that once these additional requirements are factored in, the difference in the amount of capital banks are required to hold under the standardised approach and the IRB approach for SME lending are significantly reduced.

10.66 For residential mortgage lending, significant differences between banks on the standardised approach and the IRB approach still remain. For a £100,000 residential mortgage with a loan-to-value ratio below 70%, a bank on the standardised approach needs to hold between £[✂] and £[✂] additional capital for the same loan than a bank on the IRB approach. Even taking account of Pillar II and the additional buffers, banks on the standardised approach face a significant disadvantage in expanding their residential mortgage lending compared to banks on the IRB approach.

The leverage ratio

10.67 The leverage ratio is the ratio of banks' capital to their total assets. The main intention of this is to act as a backstop to the main risk weighted framework by acting as a constraint on banks that hold too little capital because they have a large concentration of low risk assets on their balance sheet. The leverage ratio is intended to mitigate against the possibility of banks' underestimating the likelihood of suffering credit losses on their assets and therefore posing a systemic risk to the economy. For example, banks' internal models may predict that residential mortgages are low risk (due to historical data or past performance on those assets) and therefore hold low levels of capital against these. In the event that an unforeseen external shock to the housing market caused large losses on residential mortgages, the bank (under the risk weighted asset framework) may have insufficient capital. The leverage ratio aims to mitigate this risk by requiring the bank to hold a proportion of their assets in capital regardless of the riskiness of these assets.

10.68 Currently all UK banks are required to report and disclose their leverage ratios under CRD IV. In addition, there is a supervisory expectation that the

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[376] Systemic buffers for other major systemic banks in the UK will be set by the Financial Policy Committee, following a consultation issued in Q4 2015 and will be implemented in 2019. The systemic risk buffer for domestic banks will take the value of between 0% and 3% of a firm's risk-weighted assets.

eight largest domestic banks (HSBCG, LBG, RBSG, Barclays, Santander UK, Nationwide, Standard Chartered Bank and Co-op) have a minimum leverage ratio requirement of 3%. The FPC has directed the PRA to implement a UK leverage ratio framework which will impose a 3% minimum, with a systemic leverage ratio buffer and a countercyclical leverage ratio buffer applied on top of this minimum. The PRA has consulted on this framework[377] and expects to implement it from 1 January 2016. Initially this requirement will only apply to banks with greater than £50 billion in retail deposits, which is expected to capture HSBCG, LBG, RBSG, Barclays, Santander UK, Nationwide and Standard Chartered. The FPC will review its framework in 2017 with a view to extending it to all PRA-regulated banks, building societies and investment firms from 2018.

10.69 At the current rate, the leverage ratio imposes an effective average risk weight floor of 35% on banks. This is broadly equivalent to the risk weight for residential mortgages under the standardised approach. This means that if an IRB-approved bank sought to hold large concentrations of low risk assets to benefit from the lower capital requirements under the IRB approach for such assets, the leverage ratio would effectively eliminate the advantage. This in turn would provide incentives to an IRB-approved bank to reduce the amount of low risk assets they hold to maintain their margins. In this respect the leverage ratio acts as a floor or a lower bound on the amount of capital banks that have a lower-than-average risk weight are required to hold. [✂] are constrained by the leverage ratio.

10.70 However, a well-diversified bank may still have an advantage in assets where it has a lower risk weight than under the standardised approach. The leverage ratio only requires banks to have an average risk weight of 35% across all its assets. It therefore does not reduce the differential between the standardised approach and the IRB approach; rather, it limits IRB-approved banks' ability to take advantage of this differential.

Views from the PRA[378]

10.71 The PRA has told the CMA that it recognises that the use of different approaches to calculate risk weights treats competing banks differently and that the widest gaps (for example in low loan-to-value residential mortgages), are larger than could be considered appropriate or justified. However, it also maintains that some gaps between banks on the

[377] See PRA website: Implementing a UK leverage ratio framework – CP24/15.
[378] For further information please refer to the PRA hearing summary.

standardised approach and the IRB approach are desirable as they incentivise banks to invest in better risk management.

10.72 From a regulatory perspective, the PRA explained that it is difficult to design a regulatory system that optimally aligns capital requirements with the underlying credit risks held by banks. Asymmetric information between the regulator and banks naturally means that there will be some divergence between the regulatory capital set by regulators and the actual capital that should be held by banks given the risks on their balance sheet. Ultimately, this means that some banks will benefit whereas others will lose out under any regime. The introduction of the IRB approach (as part of Basel II) was aimed at ensuring that levels of capital better reflected the inherent risk held by banks and at incentivising better risk management and decision making within banks. However, as regulators were effectively handing over some of the responsibilities of capital setting to banks, requirements to become IRB-approved were set high. Regulators needed sufficient confidence that the risk models used to calculate risk weights were sufficiently robust, there was sound governance in maintaining and using the models, and that banks were using this for their own internal decision making. Moreover, the PRA also explained that while the IRB approach has its advantages in being more risk reflective, it also has limitations to the extent that not all banks were capable of developing risk models and it could lead to risk gaming. For those banks (without IRB approval) the standardised approach was the fall-back option.

10.73 The PRA also told us that while smaller and newer banks may face disadvantages on individual assets compared with IRB-approved banks due to the differences between the IRB and standardised approaches, a number of recent measures had been introduced since the financial crisis such as capital buffers for large systemically important banks, total loss absorbing capacity, the leverage ratio and stress testing for large banks. The PRA considers that these measures have largely offset the apparent capital advantages of the IRB approach compared to the standardised approach. In order to address the larger disparities between the risk weights under standardised and IRB approaches, the PRA explained that it is necessary to address it from both sides. On the one hand the modelling under IRB should be improved to make it more accurate and reduce gaming, and on the other hand the standardised approach should be more reflective of UK risk, in particular for smaller banks.

10.74 In addition, the PRA told us it had very little discretion to move away from the existing regulatory framework set by Basel and implemented in the UK through EU legislation, in particular to lower risk weights under the standardised or IRB approaches. However, the PRA explained that while it is limited in adopting its own approach in most respects under the existing capital rules, it does have some discretion over how it implements Pillar II regulations. For example, supervisors may exercise judgement for small firms where they identify that the credit concentration risk methodology could overstate risks.

10.75 However, the EU is currently consulting on whether some greater flexibility in the capital regime would be appropriate. The PRA said that it would support work to develop a simpler, more flexible regime for smaller firms, provided that it did not create greater distortions.

Future reforms

10.76 There are currently a number of developments being considered by the BCBS that may change the future approach to calculating risk weights:

(a) **Revisions to the standardised approach for credit risk**[379] – In December 2014, the Basel Committee published a consultation on proposed revisions to calculating risk weights for credit risk. The revisions are intended to address existing 'weaknesses' in the standardised approach to credit risk, including lack of granularity and risk sensitivity, over-reliance on the information provided by credit rating agencies, out-of-date estimates of risk weights, and lack of comparability and misalignment with the risk weights under the IRB approach. The new proposals will seek to move from the current flat risk weights for mortgages to a more granular approach assigned by reference to the exposure's loan-to–value ratio and debt service coverage.

(b) **Review of capital risk floors**[380] – The Basel Committee is also consulting on the design of a standardised floor to be applied to all IRB-approved banks. This consultation forms part of broader work to reduce variation in capital ratios across banks.[381] The objective in introducing capital floors is to ensure that the level of capital across banks does not fall below a certain level. This should further reduce the difference between the standardised approach and the IRB approach. However, the British Bankers' Association, for example, has indicated that this reform could negate the benefits from investing in IRB models

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[379] BCBS (March 2015), *Revisions to the Standardised Approach for credit risk*, consultative document.
[380] BCBS (December 2014), *Capital floors: the design of a framework based on standardised approaches*, consultative document.
[381] For further information, please see BCBS (November 2014), *Reducing excessive variability in banks regulatory capital ratios: A report to the G20.*

sufficiently that some IRB-approved banks revert to the standardised approach.[382]

(c) **Review of the structure of the regulatory capital framework** – This is a strategic review considering the costs and benefits of determining regulatory capital that reduces or removes reliance on internal models, while still being adequately risk sensitive.

10.77 Although these are unlikely to be implemented in the near-term, they demonstrate that there is a recognition by the BCBS that there are imbalances in the existing framework. However, Secure Trust said that the proposed changes in particular to the standardised capital model published by the BCBS would dramatically worsen the competitiveness of banks on the standardised approach.

10.78 In addition, DG FISMA is currently consulting on the proportionality of the CRR and CRDIV.[383] In their consultation they state 'the requirements of the CRR and CRDIV, particularly those relating to credit and other prudential risks, are of general application to all financial institutions, without any distinction being made on the basis of size, business model or business line and are designed to ensure a level playing field.' But it notes that smaller banks may be less able to spread the fixed overheads of these regulations over their activities. Further they note that the standards set by the BCBS, on which the CRR was to a large extent based, were originally designed to apply to internationally active institutions only. But a conscious decision was made to make the requirements of the CRR and CRDIV apply more widely. They are now consulting on whether the CRR should allow for more differentiation on how they are applied to banks of different sizes. The PRA is supportive of this development and agree that a more proportionate approach could be adopted on many aspects of banking regulation.[384]

Summary

10.79 The capital regulatory regime is an essential part of the regulation of banks in the UK and internationally. It is a complex multi-tiered system with the requirements placed on banks reflecting their systemic importance, the nature of the portfolio of products and spread of assets of the bank and their ability and willingness to undertake their own risk weighting. Moreover, the framework of the system and the core determinants of the capital that a UK

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[382] See the British Bankers' Association website.
[383] DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy.
[384] For further information on the BoE's response to the consultation, please refer to https://ec.europa.eu/eusurvey/publication/long-term-finance-2015?language=en.

bank is required to hold are set internationally by BCBS and implemented in the UK through maximum-harmonising EU legislation.

10.80 As part of our investigation, several banks – in particular, smaller banks – raised concerns that the regime did disadvantage newer entrants and smaller banks that were unable, due to data constraints and/or because it is too costly, to be IRB-approved. Such banks were unable to benefit from capital requirements that reflected their own risk, and the standardised approach may therefore require them to hold a higher level of equity capital than would be the case if they were IRB-approved. This issue was raised in particular in relation to residential mortgage lending and also in relation to SME lending.

10.81 Data from the PRA confirms that when looking at individual asset classes, there are significant variations in the amount of capital that banks have to hold depending on whether they are on the IRB or standardised approach. In relation to mortgages, and to a lesser extent SME lending, this differential is significant and favours IRB-approved banks. As it is mainly new entrants and smaller banks who are on the standardised approach, this has the potential to distort competition between banks and act as a barrier to entry and/or expansion.

10.82 However, it is necessary to consider the capital regulatory regime as a whole and how it impacts across each bank's entire business to determine the nature of any distortion of competition. Having identified residential mortgages and SME lending as asset classes where there is a differential which advantages IRB-approved banks, we analysed the capital requirements under both the standardised and IRB approaches for residential mortgages and SME lending, taking into account the different capital requirements including the impact of Pillar II and additional capital buffers. In relation to SME lending, this confirmed that the differential is broadly eliminated. However, in relation to residential mortgage lending the differential remained significant and did not appear to be justified.

10.83 We then considered the impact of the leverage ratio that will apply to all banks from 2018, but which currently applies to many UK banks on the IRB approach for residential mortgages. The leverage ratio requires all banks to have an average risk weight across all their assets of at least 35%, broadly equivalent to the risk weight under the standardised approach for residential mortgages. While the leverage ratio reduces the ability of IRB-approved banks to take advantage and expand their lending of lower risk weighted assets, it does not reduce the differential in risk weightings between the standardised approach and the IRB approach for banks where the leverage ratio is not a binding constraint.

10.84 The capital regulatory requirements are complex and have an impact on banks in different ways depending upon the balance of their asset book, their risk profile, whether they are classified as a systemic bank, and their internal approach to capital and to pricing of their products. We also note that in relation to mortgages where the differential is greatest, several smaller banks – including building societies – are IRB-approved, for example Principality Building Society has recently been approved for IRB on mortgages.

10.85 We conclude that the standardised-IRB approach differential is significant for residential mortgages. On other asset classes the standardised-IRB differential is not so significant. Considering the regime as a whole, the issue is therefore the effect of the residential mortgage differential on overall competition between banks. Given the importance of mortgages to many banks' retail banking businesses, the disparity on mortgage risk weightings has the potential to distort competition and act as a barrier to entry and expansion for smaller banks in retail banking.

10.86 The PRA has indicated that it, and other relevant regulators, recognise the need for greater parity between the standardised and IRB approaches, and this is a focus of current discussions to reform the regime. It also emphasised that the reforms currently planned will increase rather than reduce the capital requirements on bigger banks relative to smaller banks. In addition, the PRA also confirmed that it is at the early stages of exploring the extent to which it could be made more feasible for new entrants to develop IRB models.

Anti-money laundering requirements

10.87 UK banks must comply with AML regulations (enacted in the UK through the Money Laundering Regulations 2007 (MLR)) aimed at preventing money laundering and combating terrorist financing.[385]

10.88 These regulations apply equally across many sectors, and are designed to be risk-sensitive so that the costs of compliance are proportionate. Banks are required by the MLR to put in place policies and procedures, including the carrying out of customer due diligence (CDD), to prevent and detect money laundering. Banks are by their very nature (in particular in relation to the provision of current accounts) relatively high risk for money laundering and the policies and procedures adopted will reflect this.

[385] See Section 3 and Appendix 3.1 for more detail.

10.89 As with other forms of regulation, AML regulations can potentially raise barriers to entry and/or expansion if it is disproportionately difficult or costly to establish and operate the internal processes necessary to comply with the regulatory requirements; or if the demands placed on customers in complying with these regulations when opening a new account are factors in deterring customers from shopping around and switching. The following paragraphs summarise our findings in this regard, with more detail provided in Appendix 10.1.

10.90 We set out in our UIS that we had not seen evidence to suggest that AML regulations are a barrier to entry. We have not received further representations to the contrary. 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 see CDD processes as an area in which they can differentiate themselves. CDD management is part of the services Fidor provides, and both Starling and CivilisedBank felt that there were opportunities to improve on existing banks' processes (for example by leveraging technology advantages).[386]

10.91 However, a number of parties, such as Yorkshire Building Society, considered that the 'hassle' of needing to complete CDD in order to open an account deterred customers from shopping around and switching.[387] Some consumer groups attending a CMA roundtable in June 2015 raised similar views, also noting that customers may not have the necessary ID to meet banks' CDD criteria.[388] Similar concerns regarding the administrative complexity of the application process arose in the research with consumers and SMEs conducted by the FCA as part of its review of CASS,[389] and in the Research Works SME qualitative research. Section 7 and 8 discuss this in more detail.

10.92 We have therefore looked at information provided by banks on their account opening processes, with a focus on PCA and BCA opening.[390]

10.93 A wide range of CDD approaches are seen in the market and account opening processes, at the more efficient end, do not appear to be unduly onerous. Assuming firms are generally compliant, this implies that it is individual firms' policies and processing capabilities (such as IT capabilities

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386 See Appendix 10.2.
387 Yorkshire Building Society UIS response.
388 Consumer roundtable summary.
389 FCA CASS report.
390 Similar issues arise when taking out a loan, and this can lead customers to favour their existing PCA or BCA provider for new products, as discussed in Section 9.

or how approvals are internally organised) rather than the content of the regulation itself, that contributes to additional complexity or time required to complete the account opening process. Furthermore, it is not possible to assess the extent to which process complexity or delays arise solely due to the CDD element of the process (as opposed, for example, to credit risk assessment).

10.94 In particular, firms' ability to support account opening via different channels varies and is a significant factor in customers' account opening experience. In-branch account opening is generally the quickest route so long as all documentation is ready to hand. Online account opening times depend on whether the bank conducts electronic ID verification checks and, if so, whether customers pass these or have to undergo supplementary checks in-branch, or by posting the relevant documentation to the bank. Not all banks are able to offer online account opening, particularly for BCAs.

10.95 We also observe significant differences in the extent to which account opening processes appear to affect PCA and SME customers. While there is, as noted, variation in outcomes by channel:

(a) PCA accounts are generally opened quickly (within one to two days); but

(b) for SME customers, the information required to understand the business is inherently more extensive. Account opening times vary considerably and can be significant, particularly for SMEs with more complex ownership structures or cross-border business. While smaller SMEs are often able to open their accounts within 48 hours, for other SMEs ten days or more from approaching a bank to the opening of an account is not uncommon, and this can extend to months in complicated cases. A number of banks have indicated that there is room for industry improvement in existing BCA opening procedures. For example, Santander suggested there was scope to improve CDD checks for larger SMEs,[391] and RBSG observed that more can be done to simplify AML procedures.[392]

10.96 However, the speed and efficiency of the account opening process can in itself be an aspect of competition. It is one where new entrants and smaller banks, some with more focused business models/product portfolios and/or more agile IT capabilities than incumbent banks, appear well placed to compete. Paragraph 10.90 above summarises the views of some new

[391] Santander hearing summary.
[392] RBSG UIS response.

entrants, and Metro, for example, promotes its ability to swiftly open accounts in-branch.

10.97 Furthermore, banks are increasingly investing in enhancements to their account opening processes, including their handling of CDD checks, with online account opening and electronic verification becoming more widespread. Work by the UK government (for example an ongoing review by the Better Regulation Executive of the impact on business of AML regulation) and upcoming legislative changes (the Fourth Money Laundering Directive)[393] are moving in the same direction, towards streamlining processes in a risk-proportionate manner.

10.98 These developments should improve customers' experiences of account opening and thereby encourage greater switching, although account opening may still remain a concern for SMEs as the time and effort necessary to open a BCA can vary significantly according to the complexity of their ownership structure and business needs, and there appears to be potential to simplify and improve the procedures in place.

Summary

10.99 AML regulations are a necessary part of conducting business as a retail bank and are a critical measure to combat financial crime. We have not seen evidence to suggest that these regulations are a barrier to entry. However, how banks handle the CDD process may be among the factors affecting customers' propensity to shop around and switch, which in turn affects competitors' ability to expand their customer base.[394] This is most relevant to SMEs, for some of whom the time and effort required to open a BCA is substantial.

Natural or intrinsic barriers

10.100 This subsection discusses potential barriers relating to access to essential facilities or inputs such as distribution channels (including branches and online), funding (access and cost), payment systems and IT. Large and/or sunk costs of such access may deter entry; barriers to obtaining such access on competitive terms may also deter both entry and expansion.

[393] See Appendix 3.1.
[394] Also see Sections 7 and 8 for further discussion of this.

Branches

10.101 Traditionally, branches have been the principal distribution channel for banks. Branches serve a number of purposes for banks and their customers. For banks, branches provide a platform for customer acquisition, (to a lesser extent) customer retention, and brand recognition. Customers use branches for a number of activities including checking account balances, handling cash payments/withdrawals and obtaining advice.

10.102 Recent developments have altered the role of branches. Many of the functions previously served solely by branches can now be served digitally: over the telephone, online and on mobile devices.

10.103 Multi-channel banking has become the new norm whereby customers interact with their bank through a combination of 'direct' channels (telephone, online and mobile), and more traditional channels (branches and business centres). As a report by Jones Lang LaSalle notes, a 'bricks and clicks strategy will define the decade ahead [for banks]'.[395]

Role of branches today and in the future

10.104 Although branches at present continue to be the primary source of customer acquisition for banks, the proportion of PCA customers acquired through branches is on a downward trend: on average 78% of PCAs were opened in branch in 2014, down from 81% in 2013.[396] This downward trend is likely to continue (for personal and SME customers) as banks invest in technology which enables straight-through online account opening and customers become increasingly comfortable with using online channels (see Appendix 10.1).

10.105 LBG told us in response to our working paper 'Barriers to entry and expansion: branches' ('branches working paper') that customer acquisition via branch is less profitable than via other channels because the majority of customers opening accounts in branch are: students; not in full-time employment; new to the country; or seeking to open a basic bank account (BBA).[397]

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[395] Jones Lang LaSalle report, *Global retail banking: key trends and implications for retail banking real estate.*
[396] We do not have comparative data on SME customer acquisition by channel, but a survey of start-up SMEs undertaken by Charterhouse shows that, on average, 82% of start-ups open their BCA in branch.
[397] LBG told us that customers that are new to the country or not in full-time employment tend to be lower income and have relatively low balances, a low credit score, use their debit card less, and to not have a packaged account.

10.106 Branches are currently commonly used by customers for transactional purposes: 85% of PCA customers[398] and 80% of SME customers[399] that visit a branch use paying-in facilities (either counter services or machines). In-branch cash deposit and withdrawal facilities appear to be of greater importance to start-up SMEs, of which 84% cited paying in cash or cheques as the main reason for using a branch.[400]

10.107 It is generally accepted that in the future, branches will be used less for transactional purposes as these customer interactions are directed to smart-ATMs and other direct channels (using technology such as cheque imaging that allows remote cheque depositing).[401] Branches are likely to increasingly focus on service, sales and relationship building.[402] This process has already begun as banks replace existing branches with smaller, more digitally-focused outlets. There has been a shift toward 'assisted-digital' and centralised advice centres (which the customer can access via video link or over the phone). These innovations enable banks to reduce staff costs and increase efficiency.

10.108 Barclays told us that it is implementing a number of initiatives that will further reduce the need for SMEs to visit traditional branches and business centres. [✂]. Barclays has also launched pre-assessed lending limits for SMEs and instant online lending decisions for unsecured borrowing for loans up to £25,000, which it says was principally driven by customer feedback, but was also affected by the competitive pressure from innovative new lending platforms and more traditional competitors.

10.109 LBG argues that the role of branches in customer acquisition, servicing, and retention is much more limited than it was five to ten years ago and it expects that as trends toward digital accelerate, branches will play even less of a role in the next five years or sooner.

Branches as a cost of entry

10.110 The building and maintaining of branches (and a branch network) incurs significant fixed costs and ongoing costs: a report by Deutsche Bank

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398 85% of respondents to GfK's PCA consumer survey (undertaken in 2015) that had used a branch in the last year used it for paying in cash or cheques (base: 3,764 customers).
399 This is a minimum estimate of branch counter use due to the methodology used in Charterhouse's BBS questionnaire. Although we know what proportion of respondents used branch counter services for their SME, we do not know the exact proportion of other staff at the SME who use branch counter services for the SME when the respondent does not use branch counter services themselves.
400 84% of SME start-ups in Charterhouse's follow-up survey reported that paying in cash or cheques was the main reason for requiring access to a branch (base: 252 SME start-ups).
401 Indeed, this can be seen in the figures from Charterhouse's BBS survey.
402 Jones Lang LaSalle report, *Global retail banking: key trends and implications for retail banking real estate*.

estimates that branches account for 30 to 40% of a bank's retail costs.[403] This affords scale and scope efficiencies to banks with large customer bases and broad product ranges.

10.111 Atom told us that the acquisition of retail branch space and running costs makes branches prohibitively expensive.[404] However, Atom told us that as a result of not having a branch network, online providers can devote a larger budget to advertising, bolstering customer acquisition.

10.112 In response to our branches working paper, LBG told us that while it recognises that there are likely to be transition costs for the change in use of real estate, the 'sunk' element of costs associated with branches is minimal because branches can be quickly refitted and used for alternative purposes. Further, LBG told us that property costs represent only around [✂]% of branch costs. LBG notes that the remainder of branch costs are predominantly staff costs. Due to the automation of some branch services (through, for example, the introduction of automated deposit machines) and the migrations of sales and services online, staff numbers and branch costs have reduced significantly.

Own-branded branches versus alternatives

10.113 While the cost of building and running an own-branded branch network may deter or prevent entrants from doing so, there are a number of alternatives that may act as a substitute channel of interaction with customers. These include inter-bank agency agreements (IBAAs)[405] and counter services at the Post Office. Though they do not carry the brand advantages of traditional branches, these arrangements can act to reduce barriers to entry or expansion where branches are deemed necessary for customer acquisition and/or account maintenance.

10.114 The Campaign for Community Banking Services (CCBS)[406] noted in its response to our branches working paper that use of improved IBAAs, and post offices if and when improved, would be a big step towards increasing competition in 'no choice' communities.

10.115 Further, Barclays told us that demand for traditional branch-based transactional services is declining and customer needs can be met through

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[403] Deutsche Bank Equity Research (September 2014), *UK Retail Banking 2014: Bank to the Future*.
[404] Published in our branches working paper.
[405] Some agency agreements will be packaged with other benefits such as (indirect) access to payment systems. This is the case for Atom who has an agency agreement in place with a high-street retail bank.
[406] According to its website, 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.

alternative services that are not located in traditional branches, including smart ATMs and assisted service counters.

Summary

10.116 In the light of the evidence we have seen, it is not clear that, in the medium to longer term, the need for a branch network will act as a constraint on entry or expansion in retail banking. New technology is fast being adopted that enables straight-through online account opening for PCAs and BCAs. There is also evidence that the process for granting SME loans is becoming more automated. These supply-side developments, in combination with a greater willingness of consumers to engage with their bank through alternative channels, is likely to reduce the need for branches in a modern retail banking market.

10.117 In the shorter term, the role that branches continue to play in customer acquisition could limit the ability of providers to enter at scale and to expand. However, prospective entrants have told us that the familiarity of mobile technology and the alternative channels available to customers mean that they do not consider that a lack of a branch network will impede their ability to compete in the market.

10.118 Notwithstanding the developments described, branches continue to play an important role for some banks and their customers (see Appendix 10.1):

(a) While there is evidence to suggest that customer acquisition through branches may be falling, branches remain the most important channel for acquiring customers. Against the backdrop of low customer switching and engagement, this is likely to give established banks with large branch networks a first-mover advantage with respect to acquiring and retaining customers.

(b) For both PCA and SME customers, branches are used primarily for paying in cash or cheques, and for checking balances. Face-to-face contact with a (branch-based) relationship manager is also important for SME customers. This could lead to a segmentation of customers and channels by banks. Internationally, there is a higher adoption rate of mobile banking among younger adults and in the UK the distribution usage is significantly more skewed to the younger age groups for mobile banking than it is for other channels.[407] Further, it is likely that low-value transactional activities will continue to be directed outside of the branch,

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[407] Deloitte report, *The impact of innovation in the UK retail banking market*, pp11–13.

allowing banks to focus on value-adding activities such as sales and advice.

Access to funding

10.119 This subsection considers whether firms face barriers in accessing the initial funding they require (which is typically provided by venture capital or private equity) to enter the retail banking market.

10.120 A new entrant needs to secure a substantial amount of initial funding in order to obtain authorisation and become operational as a bank. The main costs relate to IT (for example, CivilisedBank told us that it expects its core IT platform to cost in the region of £5 million),[408] access to payment systems (where the costs of direct access have been estimated at £[✄] million,[409] although this is not fully separable from the preceding IT costs) and the cost of setting up its distribution channels (with a branch network, in particular, representing substantial upfront fixed costs).[410] New entrants must also raise enough capital to tide them through an initial period of operations based on their business plan forecasts. For illustration, Atom, which was authorised in June 2015, estimated a total cost of £[✄] million up to launch – as a digital-only bank, its entry costs are likely to be lower than average.

10.121 We examined evidence on whether firms faced barriers to accessing such initial or start-up funding (referred to simply as access to funding for convenience in the remainder of this subsection) which could prevent their entry to the market.

Evidence on access to funding as a potential barrier to entry

10.122 In discussions with potential and recent entrants[411] access to funding was not generally raised as a particular concern. Anecdotal information from the PRA suggests that new entrants are finding it easier to access funding:

(a) Reforms to the authorisation process have reduced the upfront cost required to obtain authorisation and the risk of failing to obtain authorisation.[412] New entrants therefore have more flexibility to stagger

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408 See paragraph 10.199.10.10.200
409 See PSR hearing summary.
410 The costs of the core banking infrastructure required vary depending on the scope of entry (for example, the IT infrastructure required to provide savings accounts will be less complex than to provide current accounts) and the channel strategy (branches have high setup and operational costs).
411 See Appendix 10.2.
412 See also the discussion of the authorisation process earlier in this section.

their calls for funding over time in a more manageable and cost-effective way.

(b) The business models currently being adopted by potential new entrants (small branch networks or none, the use of bank-in-the-box and software-as-a-service solutions, targeted entry) also tend to be lower cost than existing 'traditional' full service banking models.

10.123 Evidence from Atom's management team, which can draw on first-hand experience of entry at different time periods, supported this view.[413] Atom told us that it considered that the reforms to the authorisation process have created a more attractive environment for potential banking entrepreneurs and the performance of new banks funded by private equity such as Metro, Aldermore and OneSavings Bank has further stimulated investor interest. While there remain challenges in attracting investment and competing against other opportunities that offer better returns more quickly, access to finance was not an insuperable barrier and conditions were improving.

10.124 Actual levels of potential entry are consistent with the above evidence. As described in paragraphs 10.26 to 10.28, there has been a substantial increase in the number of firms discussing the possibility of becoming a bank with the PRA and an increase in the proportion of licences being granted to new entrants. The recent IPOs of OneSavings Bank, TSB and Virgin Money in 2014, followed by Aldermore and Shawbrook in 2015, also attest to continuing investor interest.

Summary

10.125 Access to funding has not been raised as a concern by banks, including new entrants. While firms experience some challenges given the significant amounts concerned, access to funding is becoming easier due to the reforms to the authorisation process and trends towards lower-cost forms of entry. The continuing flow of entry we have observed does not suggest that access to funding is a material issue.

Costs of funding

10.126 This subsection considers whether new entrants and smaller banks are disadvantaged in relation to costs of funding.

[413] Atom's founder, Anthony Thomson, previously launched Metro in 2010.

Introduction

10.127 As set out in Section 2, one of the main functions of a retail bank is to make loans. A lower cost of funds means that a bank can be more competitive when lending and thus generate higher overall profits. Funding can therefore act as a barrier to entry and expansion if incumbents hold an advantage by being able to obtain funds at a significantly lower cost compared to new entrants or smaller banks.

10.128 Banks obtain funding from three sources: capital, retail funding (customer deposits) and wholesale funding[414] (borrowing). Currently, they can also draw on the joint BoE and HMT's FLS as an alternative means of funding.[415]

10.129 Banks' funding costs will vary according to the mix of funding they use, which will in turn depend on the relative cost and availability of each type of funding.

10.130 The cost of retail funding or wholesale funding can be considered as a combination of three elements: the risk-free rate; a credit risk premium (the risk of default within a bank's portfolio); and a liquidity risk premium (the risk that banks are unable to fund withdrawals at short notice or can only do so at excessive cost). Each of these premia has a macro-economic element and a firm-specific element that reflects individual firm risk and is subject to market assessment. Regulatory requirements encouraging stability of funding,[416] and the bank's commercial strategy and asset mix, also affect its funding mix and risk profile, and hence its funding costs.

10.131 The availability of wholesale funding is primarily a function of investors' risk/return appetite (which will in turn affect the cost of such funding). The availability of retail funding is integral to a bank's retail strategy, as banks compete for customers' retail deposits in order to have funds available for lending. As current accounts represent a significant proportion of retail deposits, this creates wider incentives to compete for current accounts

[414] Wholesale funding can be obtained on an unsecured or secured basis. Unsecured funding includes unsecured deposits from other firms, or the issuance of debt of varying maturities such as short-term commercial paper and certificates of deposits or medium term notes and bonds. Secured funding can be obtained via sale and repurchase or 'repo' transactions or the securitisation of illiquid assets. For example, mortgages can be securitised to create residential mortgage-backed securities which are tradable in the highly liquid secondary mortgage market. See *Bank funding costs: what are they, what determines them and why do they matter?*, published in BoE Quarterly Bulletin 2014 Q4 (BoE paper on bank funding costs).
[415] The FLS was launched by the BoE and HMT in July 2012, at a time of significant contraction in lending activity as a result of the financial crisis, and has been extended in modified form with incentives skewed towards lending to SMEs, until January 2016. It is designed to incentivise banks to boost their lending to UK households and private non-financial corporations (PNFCs). It does this by providing funding to banks for an extended period, at below market rates, with both the price and quantity of funding provided linked to their performance in the above forms of lending. See BoE quarterly bulletin Q4 2012.
[416] In particular, liquidity requirements. See Section 3 and Appendix 3.1.

beyond considerations of their profitability on a stand-alone basis; hence banks' funding needs are an important factor in competition for PCAs and BCAs.

Cost of funding as a barrier to entry and expansion

10.132 Some new entrants and smaller banks have argued that they are disadvantaged on costs of funding relative to the larger incumbent banks. At the Challenger Roundtable on 3 July 2015,[417] several participants submitted that larger banks benefit from cheaper funding for the following main reasons:

(a) Larger banks hold higher quality (lower risk) assets that can be used as collateral for cheaper borrowing in the wholesale markets.

(b) Larger banks have cheaper and easier access to retail funding as they have a large number of free-if-in-credit current account balances against which they can lend. It was suggested that this advantage would be greatly extended once the base rate starts to rise again.

(c) Larger banks are in receipt of a significant subsidy for being too-big-to-fail (TBTF).[418]

10.133 We note that in many respects these cost of funding issues are not isolated to banking. All businesses need and compete for wholesale funding, and there will be differentials in the cost of wholesale funding for different firms given differentials in the underlying business that affect the risk/return trade-off that different investors perceive across firms and are prepared to accept. Funding concerns are, however, more stark in retail banking as a bank's business **is** to compete for retail deposits and the price will depend both on its intrinsic risk and levels of competition.

10.134 Given the above, in this subsection we examine whether any differentials in funding costs are observed that go beyond what one would expect from risk-sensitive investors and depositors exercising subjective judgement about the relative offers of different firms, and thereby prevent firms from competing on their merits.

10.135 The following paragraphs:

[417] Challenger roundtable summary.
[418] Challenger roundtable summary.

(a) provide an overview of recent trends in banks' mix of wholesale and retail funding;

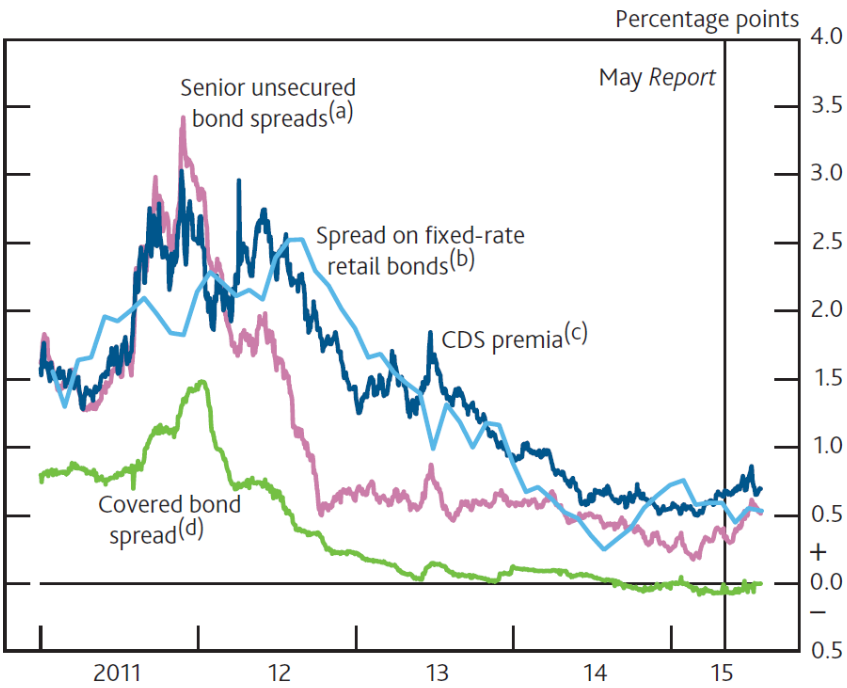
(b) consider the extent to which larger incumbents are able to access different forms of funding more readily and/or cheaply than new entrants or smaller firms and could thereby hold a competitive advantage. As part of this we will consider data on retail and wholesale costs of funding; and

(c) consider the role played by alternative public sector funding support in the form of the FLS as well as regulatory intervention to address TBTF concerns.

Recent trends in the mix of wholesale and retail funding

10.136 The mix of funding used by banks and hence their average cost of funding is influenced by macro as well as micro-economic conditions and was heavily impacted by the recent financial crisis. During this period, levels of unsecured wholesale funding fell significantly as prices spiked. With the funding cost of retail bonds also rising, retail deposits such as current accounts and savings (which were seen as a less risky 'safe haven' by investors) became more important to banks.

Figure 10.2: UK banks' indicative long-term funding spreads (the difference between funding costs and the risk-free rate)

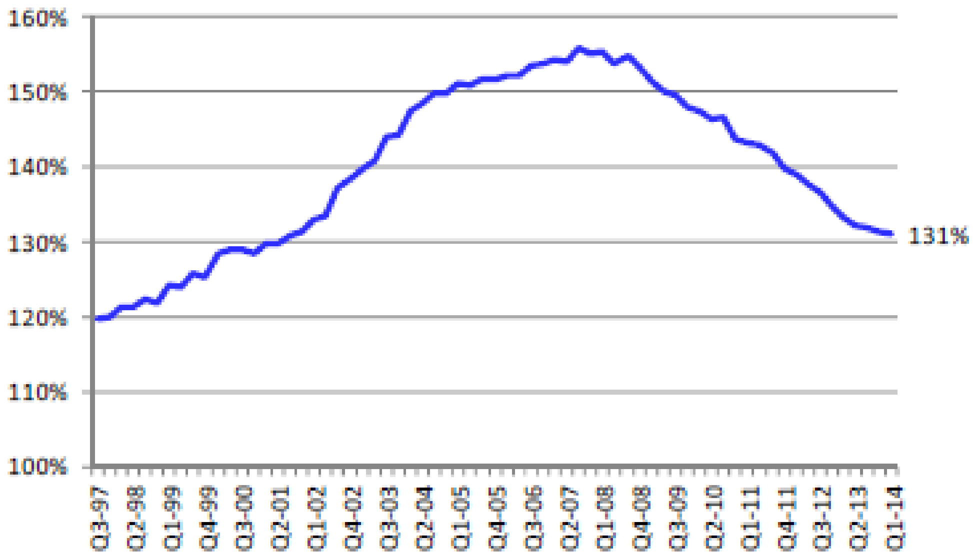


Source: BoE August 2015 Inflation Report, Chart 1.13.
Notes:
(a) Constant-maturity unweighted average of secondary market spreads to mid-swaps for the major UK lenders' five-year euro senior unsecured bonds or a suitable proxy when unavailable.

(b) Unweighted average of spreads for two-year and three-year sterling fixed-rate retail bonds over equivalent-maturity swaps. Bond rates are end-month rates and swap rates are monthly averages of daily rates. Bond rates data for July are flash estimates.
(c) Unweighted average of the five-year senior CDS premia for the major UK lenders.
(d) Constant-maturity unweighted average of secondary market spreads to swaps for the major UK lenders' five-year euro-denominated covered bonds or a suitable proxy.

10.137 While funding spreads have reduced since the end of 2012 (see Figure 10.2), banks have continued to shift towards retail deposit funding with the overall demand for unsecured wholesale bank funding remaining low.[419] This is illustrated by Figure 10.3 on household (consumer) loan-to-deposit ratios.[420]

Figure 10.3: Trends in household loan-to-deposit ratios



Source: Deutsche Bank UK Retail Banking 2014 (Figure 97).
Notes:
1. Based on Deutsche Bank estimates and BoE data.
2. Monetary and financial institutions (MFI) + other lenders' total lending to individuals (mortgages, credit cards, other consumer credit, student loans) divided by MFI sterling household deposits.

10.138 Figure 10.3, while focused on household deposits, is in line with the downwards trend of loan-to-deposit ratios observed more widely. Table 10.1 provides more detail on banks' current loan-to-deposit ratios based on most recently available published information.[421] These loan-to-deposit ratios are calculated at Group level, which is most relevant to our analysis as banks have told us that they do not tend to segregate their funding by business line

[419] See BoE Bank Liabilities Survey, Q2 2015.
[420] A loan-to-deposit ratio is the ratio of customer loans (advances, or assets to the banks) to customer deposits (customer savings). A ratio of more than 100% means that a bank has advanced more loans than it holds in customer deposits; a ratio of less than 100% means that a bank has more customer deposits than it has advanced loans to customers.
[421] Handelsbanken's loan-to-deposit ratio is to be considered in the context of its unusual operating circumstances: its UK business draws on wholesale funding through its parent bank in Sweden to a significant degree. We have not included Handelsbanken in this table as its position does not therefore appear fully comparable.

(the ratios will therefore include products that are not within the scope of our market investigation reference).

Table 10.1: Reported loan-to-deposit ratios at Group level (for 31 December 2014 unless otherwise stated)

	%
Bank	*Loan-to-deposit ratio*
Barclays	88*
HSBC Bank plc‡	74
LBG	107
RBSG	94§
Santander	124
Nationwide	117*
Clydesdale	115†
Aldermore	109*
OneSavings Bank	99*
Secure Trust	102*
Shawbrook	102*
Tesco Bank	112¶
TSB	77
Virgin Money	107*

Source: CMA estimates from published data. AIB, BoI and Danske were omitted as their published results are not UK specific.
*30 June 2015.
†30 September 2014.
‡Note that this figure is not UK-specific as HSBC Bank plc also reports Europe.
§Based on net loans and advances to customers.
¶28 February 2015.

10.139 Table 10.1 suggests that larger banks tend to have lower loan-to-deposit ratios, so that overall they tend to have more flexibility to fund further lending from their retail deposits whereas smaller banks or new entrants are lending at close to their current retail funding capacity and therefore more constrained by their level of retail deposits. However, information provided by banks to the CMA also suggests that larger incumbent banks tend to use a more diversified mix of funds.

10.140 A number of smaller banks reported they did not use, or relied to a minimal extent on, wholesale funding:

(a) For example, [✂]; Shawbrook commented that it does ‘not have a current need for such funding’; and Metro indicated that ‘it is not the bank’s business model to use wholesale funding’.

(b) The main type of non-retail funding, where used, was FLS, which a number of smaller banks considered to be an important source of funds. At the larger end of the smaller banks (firms such as Aldermore, Coventry Building Society, Tesco Bank, Virgin Money and Yorkshire

Building Society), secured wholesale funding (for example via the asset backed securitisation markets) is also used.[422]

10.141 The next subsection looks in more detail at the cost, and potential barriers, for smaller banks and new entrants, in relation to retail and wholesale funding as well as the role of TBTF and FLS.

Retail funding

10.142 The cost of retail funding is effectively the interest rate that is paid to depositors, although this will be a lower bound given that there are also shared costs associated with providing the payments system, branch and/or ATM infrastructure to support this which are difficult to measure.

10.143 In practice, the cost of retail funding tends to be lower than the cost of wholesale funding given that retail customers are (unlike wholesale customers) not using deposits solely as an investment vehicle but have wider considerations of security and ease of access in mind and may be willing to accept a lower return for this convenience.[423] Term deposits will incur higher costs relative to current accounts or instant access savings accounts as customers look for a higher return in exchange for some liquidity constraints.

10.144 Deposit protection schemes, which provide compensation to depositors in the event of bank failure, are important in providing customers with the security they seek. Deposit guarantees will therefore tend to equalise the cost of retail funding across banks, as they reduce the risk-sensitivity of depositors. This benefits smaller banks and new entrants in particular, who might otherwise be seen as riskier. Since the financial crisis, these protections have been strengthened with regulators raising the compensation threshold for depositors to £85,000 via the FSCS.[424] Under these protections the credit risk for retail deposits is low and this also contributes to their lower cost.

10.145 For consumer (household) deposits, a 2014 report by Deutsche Bank estimated the weighted average cost of retail funding across the industry as 108 basis points at July 2014 (as Table 10.2 shows). This is down from 180 basis points in 2012, driven both by a fall in saving account rates, and a rise in the proportion of non-interest bearing balances over time as lower interest

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[422] Company annual reports, available on the companies' websites.
[423] BoE paper on bank funding costs.
[424] See Appendix 3.1 on the regulatory framework. The limit is set in euros and will change to £75,000 from 1 January 2016 due to foreign exchange rate changes.

rates have reduced customer incentives to move money into savings or keep it locked up for a period of time.

Table 10.2: Cost of household deposit by type (stock)

	Balance at July 2014	*Rate (%)*
Notes and coin	56,756	0
Non-interest bearing	141,432	0
Sight deposits	546,616	0.77
Time deposits	221,026	2.06
Cash ISA	235,415	1.81
Total	1,201,245	1.08

Source: Deutsche Bank, BoE. Figure 99 from Deutsche Bank Equity Research (September 2014), *UK Retail Banking 2014: Bank to the Future*.

10.146 The report by Deutsche Bank also estimated the average costs of UK customer deposit funding for some of the UK banks. This shows a mixed picture, with the figure for some banks (eg HSBC Bank plc, RBSG and Metro) lower than the industry average and others (eg LBG, Santander and BoI) higher than the average, with TSB close to the average. This is partly driven by a differing deposit mix between banks (some include SMEs, some are predominantly household deposits).[425]

10.147 [✂][426,427]

10.148 We have also considered the extent to which personal current accounts (as opposed to deposit accounts) contribute to any retail funding advantages.

(a) While they represent a minority of household retail deposits (a slight majority for SME deposits)[428] current accounts are generally cheaper than savings accounts or wholesale funding and, all else equal, a bank with a large current account book can therefore be expected to have a lower average cost of funds than a bank that is relying on either wholesale market funding or competing solely for savings accounts. However, this does not take into account the more costly nature of operating a current account vs a savings account – in particular, a number of SME deposit-takers do not offer BCAs. The cost of acquiring a PCA customer also appears to be rising as banks compete with new products offering higher interest rates and cashback offers (as discussed

[425] Deutsche Bank Equity Research (September 2014), *UK Retail Banking 2014: Bank to the Future*.
[426] [✂]
[427] [✂]
[428] See Table 10.2 for household deposits. For SME banking, BCAs contribute a higher proportion (57% in June 2015) of SME retail deposits than PCAs for household (consumer) deposits. BCA estimates are based on data from the British Bankers' Association. See *Bank support for SMEs – monthly release aggregates Q2-2015*.*Bank support for SMEs – monthly release aggregates Q2-2015*. CMA analysis, calculated as current account credit balance / current account credit balance + deposit account balances. This figure is 64% for small SMEs, 50% for medium SMEs, and 57% on aggregate.

in more detail in Section 7) and this will increase the costs of retail funding.

(b) Furthermore, there is a link between current account holdings and deposit holdings, at least for PCAs. The FCA, in looking at the cash savings market concluded that, all else equal, links between PCA and savings accounts arising in particular from consumers' preference for the convenience of holding accounts with the same provider make it harder for small and medium providers, compared with larger providers, to attract and retain retail deposits unless they not only offer higher interest rates than the larger providers, but also maintain these higher interest rates.[429] This is particularly true of easy access accounts.

10.149 Parties have expressed a range of views regarding the advantage that incumbents may hold in relation to costs of retail funding due to ready access to an established, larger customer base:

(a) Yorkshire Building Society told us that larger banks use their large base of cheap current account deposits to cross-subsidise loss-leading savings accounts.[430] This provides them with funding advantages over smaller banks and new entrants.

(b) Some members of the Challenger Bank Panel of the British Bankers' Association noted that systemically important incumbent banks could subsidise the cost of acquiring new savings deposits by cutting rates to their existing inactive customers and that rules prevented local authority and government from placing their deposits with smaller non-rated banks.[431] However, OneSavings Bank considered that it was relatively easy to attract savings deposits from incumbents for this same reason (ie that customers did not like the incumbent banks' use of teaser rates and rate changes).

(c) 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. Nevertheless, our case study found that despite this potential barrier, Metro has been able to rapidly grow its deposits to support its funding requirements.[432]

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[429] FCA cash savings market study report, January 2015.
[430] Yorkshire Building Society IS response.
[431] Challenger roundtable summary.
[432] Metro case study in Appendix 10.2.

(d) LBG disagreed that its larger customer base enabled it to subsidise new deposits. It said that the suggestion that having existing deposits would give an advantage on acquiring new customers did not actually make any economic sense, as the amount a provider was willing to spend on acquiring a new customer was determined by that customer's expected value, independent of any existing customer base. Furthermore, it noted that larger banks such as LBG were carrying significant additional costs arising from the provision of BBAs compared to smaller banks and new entrants who do not have to provide BBAs.[433]

(e) 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.[434]

(f) Clydesdale considered that very large-scale players with very large existing customer bases had an advantage in terms of funding as by comparison, the wholesale market was either very short-term or very expensive; but unless these customers were well-served it was equally possible to lose those customers and therefore that advantage.[435]

(g) Atom considered that although current accounts can provide an important source of funding, banks spend a significant amount on customer acquisition. Incumbents therefore benefit from their scale and the inertia of their existing customers. In contrast, new entrants have been able to attract reasonably priced funding (via savings). Atom noted that whether this will remain the case after the end of FLS is a key consideration for new banks (see also paragraph 10.166 for further discussion of this).

10.150 Against larger incumbent banks' larger retail funding base, we note the offsetting costs of providing (generally cheaper) current accounts that are not readily quantifiable (particularly relevant when comparing their position against banks which do not provide current accounts), and that deposit guarantees tend to rebalance outcomes in favour of smaller banks and new entrants who might not otherwise have the track record to attract risk-averse consumers.

10.151 However, both the cost and availability of retail funding contribute to its overall effect. We have evidence (as discussed in Sections 7 and 8) that

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[433] LBG hearing summary.
[434] See Virgin Money case study in Appendix 10.2.
[435] Clydesdale hearing summary.

barriers to customer searching and switching exist which impede smaller banks and new entrants from effectively competing to expand their PCA and/or BCA base, and the FCA has found that small and medium providers have some attendant disadvantage relative to larger providers in competing for cash savings. This reduces the availability of retail funding for smaller banks and new entrants, enabling larger banks to benefit from continued and stable funding from a significant inactive base of customers, as argued by a number of banks in paragraph 10.148. Such barriers to customer acquisition are, in our view, the more material issue for smaller banks and new entrants in managing their costs of funding and the retail funding contribution to this.

Wholesale funding

10.152 As described above, wholesale funding is a much less significant part of total funding than before the crisis, because it has become more expensive and harder to access. However, to the extent it is needed, the availability and cost of wholesale funding vary across banks and we will explain why these differentials may arise and why apart from any TBTF component (which is discussed in paragraphs 10.158 to 10.163) it is difficult to assess their competitive impact.

10.153 The major factor to consider is that smaller banks and new entrants are likely to face some challenges in accessing wholesale markets relative to larger incumbent banks. This can be for a range of factors, all of which stem from risk-sensitive behaviour that is rational and not unique to retail banking:

(a) Such banks can be seen as more risky, in part because there is limited coverage at the smaller end of the market by ratings agencies and a higher proportion of smaller/newer banks are privately held. Hence investors have less public information and reassurance to draw on as well as (for new entrants) less trading history overall.

(b) For similar reasons, larger banks' debts are more readily traded in secondary markets than smaller banks', and this liquidity disadvantage further reduces demand for the latter. Larger banks will also find it easier to access cheap interbank lending for their short-term funding needs.

(c) For secured lending, the quality of collateral is important and smaller banks and new entrants may face some intrinsic disadvantages in this regard from having less choice in what they can offer.

10.154 Given the above factors, smaller banks and new entrants may be unable to access wholesale markets or can only do so at a higher cost than incumbent banks. While this was generally acknowledged, evidence on the impact of this given current wholesale funding needs is mixed. Metro stated that while wholesale funding was not part of its business model, it was relatively expensive for new entrants to access wholesale markets, and they faced difficulties in obtaining a high quality credit rating from a rating agency due to lack of a track record. Aldermore said that incumbent banks could draw on a wider variety of funding, which would reduce their funding costs.[436] Shawbrook, on the other hand, did not consider it faced any material barriers in accessing wholesale markets and had received in-principle indications of interest from some investment banks.

10.155 We also received evidence from Secure Trust. It estimated the cost of funding a two-year fixed rate mortgage as 2.3% for a smaller bank (based on a two-year fixed rate bond) and 1.2% for a larger bank (based on the market swap rate). Examination of the best buy rates available in the market for two-year fixed rate bonds suggests that these range from 1% to 2.4% with a mix of both smaller and larger banks at the lower end but predominantly smaller banks at the higher end.[437] It is therefore not clear to us that smaller banks are necessarily disadvantaged by not having the same access to wholesale markets.

10.156 Furthermore, favourable wholesale funding costs for incumbent banks are not inconsistent with a risk-sensitive view of the market, and we are unable to readily ascertain the extent to which (beyond any TBTF differentials, which will be discussed further below) observed cost differentials are not aligned with market risk expectations. In particular, for systemically important banks, to the extent that regulators are requiring higher resilience from these banks, one would expect to see a benefit to their funding costs. For example, TSB told us that larger banks were typically more able to manage the risks in their business, were more profit-resilient and tended to have better credit ratings, allowing them to raise wholesale money cheaper than smaller banks.[438]

10.157 We also note that any advantages in the use of wholesale funding between larger systemically important banks and other banks is likely to have limited impact at the current time, although this may change in future as the relative

[436] Aldermore's IS submission.
[437] Moneysupermarket.com at 8 October 2015. 1% for Santander, 1.1% for M&S Bank, 1.15% for Saffron Building Society, 1.38% for Britannia Building Society, 1.4% for West Bromwich Building Society, 1.4% for Barclays, 2% for Nationwide, 2.06% for Virgin Money, 2.15% for Shawbrook, 2.25% for Aldermore and 2.4% for Paragon Bank.
[438] TSB hearing summary.

importance (and cost) of retail and wholesale funding varies with the wider macro-economic environment and as public sector support is withdrawn.

- *The 'too-big-to-fail' subsidy*

10.158 Some members of the challenger bank panel of the British Bankers' Association argued[439] that large systemically important firms, particularly during the financial crisis, benefited from a TBTF[440] subsidy where they were seen as less risky because governments would be reluctant to risk financial turmoil and contagion by allowing them to fail. From a prudential point of view such a subsidy is undesirable as it creates a moral hazard by incentivising beneficiary banks to behave in a more risky manner as they will not bear all of the cost of doing so. From a competition point of view, banks that are deemed TBTF have an advantage as this reduces the perceived risk of beneficiary banks for wholesale investors and hence lowers (subsidises) their cost of wholesale funding.[441]

10.159 Regulators have recognised this issue. Since the financial crisis much regulatory activity has focused on taking steps to address this by reducing the probability of failure (increasing the capital demands on systemically important banks)[442] and making it easier to manage bank failure and exit (strengthening the bank resolution[443] regime[444] and, in the UK, implementing the ring-fencing of UK retail banks by January 2019[445]).

10.160 For wholesale funding, the work done to improve the resolution of a bank should ensure that wholesale lenders to a bank see themselves at risk if a systemically important bank fails and are therefore more sensitive to its actual underlying risk (ie price it more accurately).

10.161 TBTF has been a major issue for financial stability in the wake of the financial crisis, and accordingly an issue that has been much analysed.

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[439] Challenger roundtable summary.
[440] Also referred to as 'too-important-to-fail', given that the interconnectedness of the firm in question to the financial system is the main risk factor to the stability of the wider economy.
[441] While it is feasible that there may be some TBTF effects for retail funding, there is limited relevant evidence of this, possibly because deposit protection may largely circumvent this.
[442] See the discussion earlier in this section on banks' capital requirements and Section 3 on the regulatory framework.
[443] Resolution is the process by which the authorities can intervene to manage the failure of a firm in an orderly fashion.
[444] For example, resolution and recovery measures introduced in the Banking Act 2009, the Financial Services Act 2010 and the Bank Recovery and Resolution Directive (BRRD). See Appendix 3.1, paragraphs 282 & 283.
[445] The Financial Services (Banking Reform) Act 2013 provided for the ring-fencing of UK retail banks, in response to the recommendations contained in the Independent Commission on Banking's report. This legislation aims to separate the retail banking activities of systemically important UK banks from their investment and wholesale banking activities. The affected banks must implement the ring-fence by January 2019. See Section 3 on the regulatory framework.

Estimates of the size of TBTF have been considerable, but there is evidence that the measures taken and ongoing to address this have reduced its magnitude:

(a) An IMF study in 2014 used a range of approaches to estimate the TBTF subsidy on bond spreads in the UK as between 20 and 60 basis points (by one estimate, equivalent to $20–$110 billion in subsidies to G-SIBs alone in the UK in 2011/12). The study also indicated that these subsidies have been declining from their post-crisis peak in recent years (by one estimate, having reverted to close to the pre-crisis level in the UK).[446]

(b) There are also clear signs of the market reacting to TBTF reforms. Credit agencies including Moody's, Fitch and Standard & Poor's have announced reviews and/or adjustments to their ratings based on changes in expectations of government support. For example, in May 2015 Fitch announced a three-notch downgrade for RBSG and LBG on its senior unsecured debt ratings at both holding company and operating company levels on this basis.[447]

10.162 A report by PwC on the impact of structural reform in the EU banking sector which analyses the existence and magnitude of any implicit subsidy on bond spreads for EU banks concludes that 'we do not find any evidence of cost of funding advantages for banks that are designated as G-SIBs', size is statistically insignificant in explaining spreads but credit risk is a material factor, and 'on average, funding cost differences exist between large and small firms in other sectors similar to financial institutions'.[448] However, this analysis applies at an EU rather than UK level.

10.163 Overall, while data generally suggests systemically important UK banks still retain some TBTF advantage, its magnitude is reducing and can be expected to diminish further given the measures already taken and still ongoing to make banks more resolvable.

Funding for Lending

10.164 FLS was introduced in 2012 to incentivise banks to boost their lending to the UK real economy, and evidence suggests that its availability as a cheaper alternative to wholesale or retail funding has partially mitigated any

[446] IMF (April 2014), *Global Financial Stability Report*, Chapter 3.
[447] Published announcements from ratings firms.
[448] PwC report for the Association for Financial Markets in Europe (November 2014), *Bank structural reform study: Supplementary report 1: Is there an implicit subsidy for EU banks?*

disadvantage to smaller banks and new entrants from the higher costs of funding they face compared to larger incumbents:

(a) A BoE report in May 2014 observed that banks' marginal retail and wholesale funding costs fell around 150 to 200 basis points between the launch of the FLS and the end of 2013. While noting the difficulty of assessing the FLS' contribution to these developments, the BoE concluded that, overall, 'it is probable that the FLS helped to reduce bank funding costs and, more generally, boosted lending to the real economy over the period of its operation'.[449]

(b) A KPMG report noted that the 'Smaller Challengers' achieved an 80 basis points increase in average [net interest margin] between 2012 and 2014, primarily as a result of FLS having lowered their costs of funding. The report states that FLS 'has reduced competition for savings and allowed the Challengers to re-price their deposits and diversify their deposit products. The Larger Challengers have also benefited from the introduction of the FLS. However, this has been offset by an average reduction in asset yield of 60 basis points between 2012 and 2014, primarily reflecting increased competition in prime residential mortgages lending'.[450]

(c) The FCA found in respect of cash savings accounts that FLS 'has reduced banks' reliance on retail deposits, and average interest rates on retail deposit accounts have declined across the board as a result'.[451]

(d) Atom said that FLS has played a role in underwriting the assets of new banks and allowing them to expand by giving them access to a cheap source of funding to build their business and brand. This is important because new banks are not rated by the agencies and so see a lower demand for their debt and have to price it more attractively.

10.165 However, some banks also criticise FLS, arguing that they are disadvantaged relative to the larger banks as they are not able to provide the collateral required to access FLS to the extent desired,[452] and noting that

[449] BoE Inflation Report, May 2014.
[450] KPMG (May 2015), *The game changers: Challenger Banking Results*. Smaller challengers are defined in the report as Aldermore, Handelsbanken, Metro, OneSavings Bank, Shawbrook and Secure Trust. Larger challengers are defined in the report as first direct, National Australia Bank, Nationwide, Post Office, TSB, Virgin Money and Williams & Glyn.
[451] FCA (January 2015), *Cash savings market study report: Part I: Final findings Part II: Proposed remedies*, paragraph 3.57.
[452] See, for example, Secure Trust's response to the UIS. Secure Trust also stated that disparities between the standardised and IRB approaches to capital requirements for low loan-to-value mortgage asset classes (see the discussion of capital requirements earlier in this section) contribute to this as banks using the standardised approach are less able to compete for prime mortgage assets.

LBG draws down on the scheme more than any other firm. The BoE is aware of these concerns and has taken a number of steps to broaden the range of collateral accepted and to reduce costs and effort for smaller institutions. For example, since April 2011 the BoE has accepted loan pools as collateral, which means that participants no longer need to securitise their assets in order to access funding from the BoE. The BoE has also expanded eligible loan collateral to a wide range of asset classes including but not limited to residential mortgages, auto loans, social housing, SME, corporate and unsecured consumer loans. A number of small banks and building societies participate in the FLS.[453]

10.166 The FLS is due to expire in January 2016, so that any impact from the FLS on reducing funding cost differentials will end when the temporary scheme closes. The Co-op, while acknowledging that the availability of government support, such as the joint BoE/government FLS, to the extent it provides access to cheaper and more attractive funding than other sources, reduces the need for banks to fund themselves in the retail or wholesale markets, also noted the risk that significant reductions in or withdrawal of government support will increase the cost of funding both for those who have drawn on that support and in general as competition increases for the remaining available funding.

10.167 We will consider before our final report what, if any, similar schemes the government puts in place to replace or further extend the FLS.

Summary

10.168 Retail funding is currently a more important source of funding than wholesale funding, which fell significantly during the financial crisis and remains at relatively low levels. This reliance on retail funding increases for new entrants and smaller banks where, as in other sectors, such less established firms may be seen as less attractive by wholesale investors. On the SME side, the majority of retail funding is drawn from BCAs, while for personal customers, savings deposits represent a higher proportion of funds. In both cases, the importance of current accounts as a source of funding may diminish as interest rates rise from their current atypically low levels so that the time value of money (and hence the relative attraction of term deposits over current accounts) increases.

10.169 Incumbents, particularly during the financial crisis, derived cost advantages from TBTF. However, this has been a focus area for regulators following the

[453] The list of participants in the FLS can be found on the BoE website.

financial crisis, and they have taken proactive steps to address this. Evidence that ratings agencies consider these steps to have had credible impact confirms that the TBTF advantage, while remaining, has reduced and can be expected to further diminish over time.

10.170 On wholesale funding, beyond TBTF any cost differences between incumbents and smaller banks and new entrants are difficult to disentangle from 'normal' differences in demand/pricing reflecting risk in wholesale markets. Differences between the wholesale costs of funds for firms of different sizes are seen across many sectors and we have not seen evidence that retail banking is out of line in this regard. TBTF advantages can be expected to shrink further as regulatory measures to address this continue, and in the meantime the availability of public sector support such as FLS is mitigating any disadvantages faced by smaller banks and new entrants. However, FLS will expire in January 2016 and, in light of the support it has provided to banks to date, the CMA's final report will also consider, to the extent possible at that time, the impact of its withdrawal or replacement on smaller banks and new entrants.

10.171 On retail funding, deposit protection tends to counteract the effect of credit risk differentials across banks. However, incumbent banks will still benefit from cheaper, more stable retail funding, given their more substantial holdings of current accounts which tend to have lower effective rates and the advantages in cash savings identified by the FCA. It is difficult to assess the materiality of this compared to smaller banks or new entrants once the substantial ancillary costs of operating these current accounts are taken into account. However, this differential would reduce if smaller banks and new entrants were readily able to enter or grow in the provision of current accounts. The barriers to customer acquisition discussed in retail banking (as further discussed later) therefore sustain the advantage that incumbent banks have in relation to retail funding.

Payment systems

10.172 Payment systems enable the electronic transfer of funds between people and institutions.[454,455] Over 98% of sterling payments (by value) are made electronically in the UK.[456] Thus, to compete in the retail banking market, financial institutions require access to the payment systems infrastructure

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[454] PSR (November 2014), *The PSR and UK payments industry.*
[455] The Financial Services (Banking Reform) Act 2013 defines a payment system as: 'a system which is operated by one or more persons in the course of business for the purpose of enabling persons to make transfers of funds, and includes a system which is designed to facilitate the transfer of funds using another payment system'.
[456] BoE Settlement Accounts, p4.

which they may acquire either directly or indirectly via an indirect access provider (IAP).[457]

10.173 The main interbank payment systems in the UK are Bacs, Cheques and Credit Clearing (C&CC),[458] CHAPS, Faster Payments Service (FPS) and LINK. Banks will usually also need access to the core UK card systems, Visa and MasterCard, for card issuance. Since March 2015, each of these payment systems has been regulated by the PSR.[459]

10.174 In our working paper 'Barriers to entry and expansion: capital requirements, IT and payment systems', we set out the evidence gathered during the course of our enquiry from market participants and other stakeholders. This highlighted two broad areas of concern in relation to payment systems, which were:

(a) barriers to attaining direct access; and

(b) market failures in respect of indirect access.

Direct access

10.175 To attain direct access to payment systems (to become a 'direct participant'), payment service providers (PSPs) must fulfil a number of eligibility criteria. For some payment systems it is a condition of membership that settlement bank members have a settlement account at the BoE.[460] Further, a range of technical and operating requirements[461] must be satisfied, and other requirements, such as legal, regulatory and risk management requirements apply.

10.176 These access criteria impose a cost, in capital and resource, on PSPs seeking to become direct participants of the main interbank (and card) payment systems. Fees/tariffs (usually consisting of an annual account

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[457] See PSR indirect access market review terms of reference, Glossary, p16. An indirect access provider is a Payment Service Provider (PSP) that provides indirect access to a payment system to other PSPs for the purpose of enabling the transfer of funds within the UK. Our working paper *Barriers to entry and expansion: capital requirements, IT and payment systems* referred to 'sponsor banks'; sponsor banks are one type of IAP.
[458] Northern Ireland Cheque Clearing (NICC) is the equivalent interbank payment system in NI that processes cheques and other paper instruments.
[459] HMT (March 2015), *Designation of payment systems: response to the consultation*, p9.
[460] This is a requirement for direct access to Bacs, CHAPS, C&CC and FPS. Under the BoE's current policy, banks and building societies are eligible for settlement accounts but e-money institutions and payment institutions are not.
[461] Technical and operating requirements are scheme-specific. For example, to become a direct member of CHAPS, participants must have SWIFT interfaces (known as Computer Based Terminals) located within their systems to connect to the network and process messages to and from participant payment systems. See *CHAPS Technical requirement document*.

management fee plus a per-item usage fee) also apply and are set unilaterally by individual payment schemes.

10.177 Smaller market participants have told us that the cost of attaining and maintaining direct member status means that new banks wishing to provide a transactional service may only have the option to use an agency banking arrangement (ie via an IAP). The PSR estimates that the fixed cost associated with becoming a direct member is in the region of £[✂] million (though this varies between providers and will not be mutually exclusive of IT expenditures). It is evident that direct members of payment systems tend to be larger than indirect members (measured by total business revenue) and they tend to process more inbound and outbound transactions; thus, they are more likely to benefit from economies of scale.[462]

10.178 Notwithstanding the apparent barriers to direct access in payment systems, the PSR has told us that it is seeing improvements in the process for becoming a direct member. The PSR told us that the time taken to acquire direct access has reduced from between 12 and 18 months to between six and nine months. Transparency of information in the IAP market has also improved, according to the PSR. For example, some scheme operators have published more information around what potential direct members can expect and the type of fees that would be incurred as a direct member. Around [✂] new direct members into the interbank and card payment schemes respectively are expected in 2016.

Indirect access

10.179 Indirect access provides an alternative channel through which PSPs can connect to the payment systems infrastructure (eg via a sponsor bank). According to the PSR's definition, a PSP has indirect access to a payment system if it has a contractual arrangement with another PSP (an IAP) to enable it to provide payment services (ie transfer funds using that payment system) to its own customers.[463] The majority of indirect access in the UK is currently provided by the four largest banks: Barclays, HSBCG, LBG and RBSG.

10.180 While the option to access payment systems indirectly via an IAP can facilitate entry to retail banking, a number of concerns have been raised in respect of indirect access. These concerns fall broadly into four categories:

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[462] See Appendix 10.1 for a list of which banks have direct membership of payment systems.
[463] See *PSR indirect access market review terms of reference*, p4.

(a) **Quality of service provision by IAPs** – The quality of service that indirect participants can offer their customers is constrained by the quality of service (in terms of speed, reliability and security of supply) that the IAP provides, weakening their ability to compete on all aspects of service.

(b) **Fee arrangements between IAPs and indirect participants** – Transaction fees are in part dependent upon the volume of transactions processed; entrants and smaller market participants may not benefit from the scale advantages enjoyed by larger players. A mark-up on the amount payable by the IAP to scheme operators is also understood to be charged, though this may reflect the costs associated with providing the service.

(c) **Information provision by sponsor banks to enable comparison by (potential) indirect participants** – Information about fees and service provision is complex and opaque, reducing the ability of prospective indirect participants to compare offerings and to negotiate terms and prices. This may also reduce the ability of indirect participants to switch amongst IAPs, providing limited incentive for IAPs to improve their proposition.

(d) **Reliance by indirect participants on downstream competitors** – The nature of this relationship may limit or reduce the incentives of IAPs to improve the service they provide to PSPs. In our working paper we noted that the sharing of commercially sensitive information between indirect participants and the IAP may give rise to concerns, particularly given that there is currently no legal framework governing the handling of that information. However, we have not received any evidence to suggest that this is an issue and Barclays responded to our working paper noting that it has rigorous safeguards and controls to ensure that commercially sensitive information is handled appropriately. We would expect all IAPs to have similar procedures in place.

10.181 Further evidence provided by members of the Challenger Bank Panel of the British Bankers' Association suggests that the advantages associated with having newer, more efficient IT systems do not extend to payment systems where these are accessed via an IAP.[464] Metro told us that the 'cost of integrating into the legacy systems of large banks [for access to payment systems] is huge' and while '[Metro] has better systems in many areas, it becomes unstuck where it has to interact outside of its own IT ecosystem'.

[464] Challenger roundtable summary

Ongoing work in the area of payment systems

10.182 There is an extensive programme of work underway in the area of payment systems. This includes the work of the PSR and industry-led initiatives.

The work of the PSR

10.183 An extensive programme of work is underway by the PSR, and it includes the following:

(a) **Two market reviews** – The PSR is undertaking two market reviews into the supply of indirect access to payment systems[465] and into the ownership and competitiveness of infrastructure provision.[466] Through its indirect access market review the PSR will seek to understand what prices, service, and choice indirect PSPs want and receive, and what factors may limit the number of IAPs in the market. It will also seek to determine the overall state of competition in the provision of indirect access. Depending upon the findings from this market review, the PSR will explore what options are available to improve indirect access to interbank payment systems. The infrastructure market review's focus will be on determining whether there is effective competition in the provision of infrastructure services related to interbank payment systems and, if not, what the main reasons are for this. These market reviews are expected to conclude in the second quarter of 2016.

(b) **Access directions[467]** – The PSR has issued a general access direction to certain operators of regulated payment systems[468] requiring them to have objective and risk-based access requirements that permit fair and open access to the regulated payment system concerned. All regulated payment system operators are also required to publish their access requirements and, on an annual basis, report to the PSR on progress and changes. This is meant to improve direct access for PSPs. A specific direction on access has also been issued, requiring the four sponsor banks to publish clear and up-to-date information on their indirect access services, including their eligibility criteria. The PSR will be monitoring the type of information being provided and how accessible it is.

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[465] See PSR indirect access market review terms of reference.
[466] See PSR infrastructure market review terms of reference.
[467] PSR update on access, August 2015.
[468] This applies to those regulated payment systems which are not covered by the Payment Services Regulations 2009. Part 8 of the Payment Services Regulations imposes similar access obligations on those payment systems that are covered.

(c) **Directions on the governance of payment systems** – Under its new directions, the PSR will require scheme operators to address specific conflicts of interest, to improve service-user representation in decision making and to publish their board minutes.

10.184 The PSR has also created an independent industry forum, the payments strategy forum, to promote strategy setting and innovation in relation to payment systems for the benefit of service-users, but only where collaboration is needed (because of the network effect of some aspects of payment systems).[469]

10.185 To monitor the impact of its work and changes in the market, the PSR will undertake regular reviews of the effectiveness of its policy initiatives.

10.186 The PSR also continues to work closely with the BoE which acts as settlement agent for most of the major payment systems in the UK and is also responsible for ensuring payment systems are designed and operated in such a way that improves or maintains UK financial stability.[470] The BoE has indicated support for the PSR's work, in particular the initiatives aimed at improving direct and indirect access to payment systems.[471] In its regulatory work, the PSR is required to have regard to the importance of payment systems in relation to the Bank's role as monetary authority and to the importance of maintaining stability of, and confidence in, the UK financial system. The authorities have put in place a Memorandum of Understanding that sets out the various roles and responsibilities of the BoE, the FCA and the PRA in relation to payment systems.[472]

Industry-led initiatives

10.187 FPS is currently undertaking a programme of work looking at an alternative model for accessing FPS. This would enable PSPs to connect to a 'technical aggregator' that combines demand from multiple PSPs. This, FPS believes, will create economies of scale and facilitate access to PSPs at a lower per-transaction cost than would be achieved by connecting directly to the central infrastructure. It should also increase the quality of access to FPS, which has been raised with us as an issue by a number of parties that currently have indirect technical access to FPS.[473]

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[469] See PSR press release (September 2015): Payment Systems Regulator confirms members of the new strategy-setting Payments Strategy Forum.
[470] Banking Act 2009, Part 5.
[471] BoE response to the PSR November 2013 consultation paper.
[472] MoU between PSR and other financial regulators.
[473] See Appendix 10.1 for more information on technical access.

10.188 Santander told us that six fintech providers have recently committed to developing services under the alternative access model for FPS. In its response to our working paper 'Barriers to entry and expansion: capital requirements, IT and payment systems', Virgin Money told us that it welcomes the PSR's support for improved access to payments by means of direct technical access (those currently being considered by FPS). This, Virgin Money believes, could make it much easier for new banks to access payment systems.

10.189 In addition, Payments UK[474] has set up a 'world class payments project' working with representatives from a range of financial institutions and the interbank payment and card schemes to 'create a vision for what world class payments for the UK should look like'. Payments UK's objectives for this project are to ensure: (i) that customers' needs are met; (ii) that change supports competition and new entrants to the payments market; and (iii) that the critical resilience, efficiency and reliability of payment systems are maintained.[475] In August 2015, Payments UK published its initial report on the project in which it sets out evidence gathered from a range of stakeholders and the areas of focus for the project, which are twofold:

- *(a)* **Open access to the payments infrastructure** – Improved access to the payments infrastructure for all those who offer payments to customers; this includes new and existing providers in the marketplace. Payments UK believes this is a prerequisite for healthy competition and innovation in the industry and as such is the focus of its work.

- *(b)* **New features and services for customers** – Features and services that give customers more control and confidence, supporting growing demand for real-time payments.

10.190 Other initiatives include the industry code of conduct, which has been designed to address some of the issues identified in respect of indirect access. The code is focused on the suppliers of indirect access services and is meant to help to increase confidence in the supply of indirect access services and to improve outcomes for service-users.[476] In particular, the code should help to address concerns regarding the continuity and security of supply, contractual arrangements, reliance on downstream competitors, and the communication of information to indirect participants.[477] The code of

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[474] Formerly the Payments Council, Payments UK is the trade association launched in June 2015 to support the UK's payments industry. See Payments UK website.
[475] Payments UK, World Class Payments.
[476] PSR Consultation 15/1, p49; and PSR hearing summary.
[477] See PSR indirect access market review terms of reference, p5.

conduct was published (in interim form)[478] in September 2015 and was subsequently welcomed by the PSR.[479] The code sets out four commitments between the Code subscriber (the IAP) and the Code beneficiary (the indirect PSP):

(a) Entitlement to a written agreement for the supply of indirect access.

(b) Support Services and communication of important information.

(c) Managing the security of supply of the service.

(d) Ensuring the security of the indirect PSP's information.

10.191 Compliance with the Code will be assessed via a self-certification approach and monitored on an ongoing basis by the Code Administrator (currently Payments UK).

Broader regulatory landscape

10.192 As discussed in Section 3 on regulatory background, a second payments services directive (PSD2) is currently being negotiated.[480] The PSR told us that the provisions on access proposed under PSD2 are broadly supportive of its own initiatives. The PSR also continues to work closely with the FCA, which is the lead UK authority on PSD2, to understand any implications for its own work.

Summary

10.193 The information we have received from parties suggests that indirect participants of payment systems are at a competitive disadvantage compared to direct participants. We are continuing to liaise closely with the PSR, which has responsibility for regulating the UK payments industry, as it undertakes its programme of work described in paragraphs 10.183 to 10.186 above.

10.194 As the economic regulator with concurrent competition powers in relation to the participation in payment systems, we consider that the PSR have the relevant powers and tools to assess the issues raised and address them where deemed appropriate. Furthermore, the PSR has confirmed that the

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[478] Payments UK (August 2015), *Code of Conduct for Indirect Access Providers, Version 1.0*. The code of conduct has been published in interim form with an industry consultation exercise happening later in 2015 ahead of code finalisation early 2016. See Payments UK press release (September 2015): New Code of Conduct launched to benefit Payment Service Providers with Indirect Access to UK Payment Systems.
[479] PSR (September 2015), *Industry code of conduct for indirect access - our response*.
[480] Also see Appendix 3.1 on the regulatory framework for more details.

issues we have identified are within the scope of the PSR's ongoing work programme.

10.195 Given that the PSR is looking in more detail at these issues and will be able to monitor relevant developments in the industry over time, the PSR is the best placed authority to take this work forward and provide a thorough assessment of these important issues, taking and enforcing any remedial actions as appropriate. We have therefore decided to deprioritise further assessment of payment systems, but will continue to liaise with the PSR and offer the PSR our full support.

IT systems and infrastructure

10.196 Another essential input to the provision of retail banking services is IT. Broadly, the required IT consists of two parts:[481] (i) the core IT platform (the hardware architecture); and (ii) the IT software and applications that connect to the core platform.

10.197 To support PCA and BCA provision, banks' IT systems must be capable of processing large volumes of transactions. These systems have traditionally been very expensive to develop and maintain, accounting for approximately two-thirds of the cost of entry according to HSBCG.[482]

10.198 Two technological innovations have significantly reduced the capital outlay necessary to develop operational IT systems:

(a) **'Off-the-shelf' solutions** – Pre-configured/packaged core IT platform solutions with modular architecture which are available to purchase 'off the shelf'; also known as 'bank-in-a-box'.[483]

(b) **Outsourced solutions** – 'Software as a service' enables applications to be centrally hosted by vendors on behalf of a customer. Core IT platforms may also be outsourced in a similar way. Access in both cases is provided via the internet.

Off-the-shelf solutions

10.199 The first UK bank to use an off-the-shelf IT solution was Metro. Metro employed Temenos' pre-configured T24 Model Bank IT platform, which had

[481] Referred to in this section collectively as 'systems'.
[482] See Appendix 10.1.
[483] For example, Temenos' T24 banking solution.

a high level of fit with its own business model.[484] As well as choosing an off-the-shelf solution, Metro opted to outsource its core banking system to a third party.[485] Metro told us that employing Temenos' pre-configured solution minimised the size of its initial capital outlay and cut implementation time by around one-half. Metro has an account-based pricing agreement with Temenos for the core banking platform and pays a fixed monthly rental to Niu Solutions for hosting it, enabling it to 'better control its cash flows'.[486]

10.200 Atom and CivilisedBank, which are due to launch later in 2015 and 2016 respectively, have each followed an approach similar to Metro's, acquiring off-the-shelf solutions on an outsourced basis. CivilisedBank told us that it expects its core IT platform to cost in the region of £5 million.[487] This is significantly lower than the cost incurred by some providers to integrate existing 'legacy' systems with new ones for the provision of PCAs or BCAs.[488] Opting for a hosted solution further lowers IT maintenance costs by being centrally managed and updated (discussed below).[489]

10.201 Santander told us that while new entrants are able to enter at relatively low cost by using off-the-shelf IT solutions, it is not the case that 'one size fits all'. In particular, off-the-shelf solutions may be suitable for organic entrants, but for providers who have existing customers, integration into pre-configured solutions is not always possible, and at least in the short term may create a barrier to expansion. [✂]

10.202 Similarly, the IT costs associated with entering the BCA market were sufficiently high (relative to other options to invest in its retail infrastructure) to deter Nationwide from entering the BCA market.[490]

10.203 [✂]

Software-as-a-Service

10.204 Software-as-a-Service (SaaS) solutions allow banks to outsource hardware (whether it is pre-configured or bespoke), the maintenance of hardware and software, and user-support to an external third -party. This creates scale efficiencies (eg system updates can be applied to a number of users at

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484 See Appendix 10.1.
485 Niu Solutions Holdings Ltd hosts Metro's core banking systems.
486 Metro, see Appendix 10.1.
487 See Appendix 10.1.
488 For example, Tesco and Santander. Santander told us that it spent approximately £[✂] million on its SME IT system alone.
489 RBSG, see Appendix 10.1.
490 See Appendix 10.2 or our Nationwide case study for more information on its plans to enter the BCA market.

once) and lowers individual firms' costs. In addition to the cost advantages afforded, new IT systems are designed to be more flexible and to facilitate the addition of new functionality.[491] Software applications can be added to these systems on a 'plug-and-play' basis, creating an 'ecosystem' of applications hosted virtually in cloud technology.

10.205 Although it has been raised with us that there may be a critical size at which off-the-shelf and hosted solutions cease to be adequate, we have not received any evidence to support this. HSBCG stated that innovative low-cost IT solutions are fully scalable. HSBCG also noted that to the extent that a bank faces IT costs as it expands, there is 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. It told us that larger banks in fact face a clear competitive disadvantage in relation to IT costs because of their inability to use innovative IT solutions in conjunction with their legacy systems.

Summary

10.206 IT costs, which are largely 'sunk' (ie cannot be recovered upon exit), are a cost of entry to the retail banking market. However, recent technological innovations, namely the availability of off-the-shelf IT platforms and hosted solutions, have led to a significant reduction in the upfront capital and maintenance costs of IT systems for entrant banks. In the light of these positive developments, we do not consider IT costs to present a significant barrier to entry to retail banking, and neither do we have evidence to conclude that IT costs act to constrain the ability of entrants to expand.

Strategic and 'first-mover' advantages

10.207 In this section we focus on access to proprietary information and access to intermediaries.

Access to proprietary information

Overview

10.208 Incumbent banks, because of their 'first-mover advantage',[492] have access to a significant volume of customer transaction data that they source from their

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[491] ACI, *Replacing legacy payment systems*.
[492] 'First-mover advantage' is the gain obtained by banks from entering the market first. In this case they benefit from the acquisition of a large customer base and the information that they have been able to accumulate over time on customers' behaviour towards financial services.

customers' BCAs and PCAs. This access to data gives them an advantage over other market participants and may act as a barrier to entry and expansion for new banks.

10.209 There are four main ways that access to customers' transaction data may create advantages for incumbent banks and act as a barrier to entry and expansion for new banks:

(a) First, incumbent banks may be able to better develop, target and sell products to their customers. This in turn leads to higher acquisition costs for new entrants who have to dedicate more resources to attract customers away from incumbent banks.

(b) Second, it allows incumbent banks to better assess credit applications, leading to more optimal decision making and better pricing of loans and overdrafts. Where new entrants have less information on the credit quality of borrowers, they are more likely to misprice loans and overdrafts and potentially reject profitable opportunities.

(c) Third, it allows incumbent banks to process credit applications more efficiently and with reduced paperwork. One of the main reasons provided by SMEs for going to their main bank is reduced 'hassle' and the opportunity to obtain funds more quickly.

(d) Fourth, incumbents are able to use historical and pooled data on their customers to better assess the risk of lending to customers and to better predict the needs of customers through the use of 'propensity' models.

Better develop, target and sell their products

10.210 Evidence outlined in Section 9 and Appendix 9.1 showed that there is a relationship between customers' consideration of switching and the number of products they hold. For example, the proportion of SMEs that considered switching from their main bank declined significantly as the number of products they held rose. This was supported by qualitative research conducted by the FCA, which found that 'having multiple products linked to the account was a potential barrier to switching. Amongst businesses this was occasionally referenced by those who had overdrafts and/or lending linked to their account or international banking arrangements'.[493] This would suggest that access to customers' transaction data may create advantages for incumbents and raise entry costs if banks are able to use this data to

[493] See 'Engagement with current accounts and the switching process' Optimisa Research for FCA, p32.

better target and sell products to their customers (at least in relation to SMEs).

10.211 In response to our inquiry a number of new and smaller banks raised the issue of transaction data providing advantages to incumbents. For example, OakNorth and Secure Trust[494]both told us that by virtue of being a customer's current account provider, an incumbent bank had a much greater knowledge and insight into the customer's behaviour compared with other banks. This gives 'considerable advantages' to incumbent banks when it comes to cross-selling and credit decisions. Secure Trust also told us that incumbent banks ought to be able to innovate in a more informed and targeted manner than smaller rivals because of their unrivalled insights into their customer behaviour. This could give incumbent banks an advantage in attracting new customers and retaining existing customers through more targeted product offerings and marketing.

10.212 This was consistent with the information provided by some incumbent banks[495] who told us that access to customers' transaction data enabled them to better target and market products to their customers. In particular, access to transaction data enabled banks to identify suitable contact opportunities or stages in a customer's life where they may have a specific product need. For example:

(a) [✂] told us that the marketing of other personal products and services to customers who already have a PCA is facilitated because, among other things, the nature of the PCA product creates a rich source of high quality transactional and relationship data [✂][496] to better identify suitable contact opportunities. For customers that do not hold a PCA, there are less opportunities for contact, as generally there is less transactional activity, [✂].

(b) [✂] told us that one of the ways it learns about its customers and their needs is from PCA transactional data. The information is then used to provide customers with suitable marketing and products. [✂] also told us that it would contact customers if products that they had previously shown an interest in were on offer or if prompted by customer activity.

10.213 A number of banks, including HSBCG, LBG and TSB discussed the different approaches used to market to their PCA and non-PCA customers and highlighted that marketing to PCA customers can 'be more tailored to the

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494 Secure Trust's response to the UIS.
495 [✂]
496 [✂]

needs of [those] PCA customers, given [their] knowledge of those customers'.

10.214 Similar views were expressed with reference to SMEs. For example, [✂] told us that there are some differences in how it markets its SME banking products to BCA customers compared to other SME customers. In particular, it noted that it sends its BCA customers relevant information about other banking products where it has identified on the basis of customer behaviour or propensity that such customers may have a need for additional banking products. This information is sent using direct mail or email.

10.215 The growth of online and mobile channels has enhanced opportunities to use transaction data to market products. [✂] noted that the marketing of other business products to customers who already have a BCA is enhanced because of 'the wider range of channels available to interact with the customer (branch, mobile banking, etc.), more extensive data held on the customer, and the greater frequency of customer contact'. Online and mobile channels also provided greater opportunities to collect information on the customer as there was more frequent interaction between the bank and the customer.

10.216 As with PCAs, using transaction data to spot opportunities to further sell products was a common way of extending their product reach amongst customers. For example, [✂].

10.217 While incumbent banks may have an advantage over new entrants due to their access to current account data, we observed that banks with a pre-existing retail presence may have similar informational advantages. Banks with a retail presence can leverage information from their existing retail customers to help target financial products. In respect to this, M&S Bank told us that it leverages its retail activities when marketing to customers. M&S Bank products are promoted to M&S retail customers (subject to marketing preferences) via email, up to three or four times a year. Simultaneously, M&S retail offers and incentives are promoted to M&S PCA customers, Premium Club customers and some credit card customers (eg vouchers).

10.218 This is consistent with information supplied by LBG, which told us that while access to customers' transaction data had the potential to enable providers to better target and market products (to around half of customers that do not opt out of direct marketing), it had not yet been able to use data as effectively as it would like to target its products. It told us that the data that it had today was probably less relevant than the behavioural data that non-bank organisations held such as credit reference agencies, social media or supermarket spend patterns.[497]

10.219 Banks make use of transaction data to better target and market their products. However, this is common in many other retail industries; for example, supermarkets and online retailers widely use information on their customers shopping habits gathered from loyalty cards and their own databases to provide personalised offers and products. Indeed, we have seen evidence of high street retailers that have come into the banking market using their data from their retail activities to help inform their marketing for banking. This is a natural feature of many retail markets and likely to continue with the growth of digital banking. We have also not seen any evidence that this is a barrier to entry and expansion. Greater customer switching is likely to reduce informational advantages that are held by incumbent banks as more banks gather information on customers' transaction habits.

Better assess and more accurately price lending products

10.220 Lenders need access to borrowers' credit information to make an assessment of the risks associated with lending. Incumbent banks may be able to more accurately price lending products compared to new entrants as they have access to customers' transaction history and can use the information to more accurately assess creditworthiness of applicants.

10.221 As set out in Section 9, when making a credit decision, banks use four main sources of information to assess lending applications:

(a) Information from the application form about the person/SME, the product being applied for and plans for the future.

(b) Behavioural data (where available), from a person, SME or SME owner(s)' existing products with the bank or from historical bank statements (for new customers).

(c) External credit data from credit reference agencies.

(d) Other information, such as the sector and bank's appetite to lend to that sector.

10.222 Each bank applies different weightings to these sources. However, only where there is adverse information, such as outstanding debts or County

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[497] LBG hearing summary, paragraphs 36 & 37.

Court judgements, would this lead to an outright rejection on the basis of external credit data and no other data reviewed. In all other situations, an assessment is made on the basis of all four factors. Some assessments make no use of CRA data. Below is a summary of banks' use of data when assessing SME applications.

Table 10.3: Banks' credit assessments

Bank	*Loan amount*	*Information used for credit assessment*
Barclays	[✂]	[✂]
	[✂]	[✂]
HSBC	[✂]	[✂]
	[✂]	[✂]
LGB		[✂]
RBS		[✂]
Santander		[✂]
Metro		[✂]

Source: [✂].

10.223 Where banks cannot use or have limited transaction data because the customer is external to the bank, greater reliance is placed on the data supplied by CRAs and this can often be an imperfect substitute. For example, Barclays said that, where it cannot use transaction data in its models, more reliance on other sources (including CRAs) 'lessens the power of these models to measure the ability of the customer to repay the loan'. This in turn is likely to lead banks to either misprice loans because they cannot appropriately assess risk or to miss potential profitable opportunities.

10.224 As set out above, this is likely to be a greater issue in relation to lending to SMEs. The SME lending market is characterised by poor and asymmetric information. According to a review by the BoE,[498] there is a particular problem for younger and smaller SMEs where there is a lack of information on their performance. HSBCG estimated that 2.3 million firms are not registered. This makes it difficult for lenders to verify whether credit checks are being run on the correct SME or simply one with the same name. One respondent to the BoE discussion paper said that SMEs with no credit rating tend to be treated as having a high risk rating.[499]

10.225 There are several reasons why there may be poor CRA data on SMEs, including low availability of public data on these businesses. For example, financial accounts data from Companies House is limited because SMEs

[498] BoE (May 2014), *Should the availability of UK credit data be improved?: A discussion paper.*
[499] BoE (November 2014), *Summary of feedback received on the Bank of England's May 2014 Discussion Paper on UK credit data*, p8

that meet two or more of the following criteria are only required to provide very limited financial information:

(a) Turnover below £6.5 million.

(b) A balance sheet of less than £3.26 million.

(c) An average of 50 or fewer employees.[500]

10.226 HSBCG also commented that 'there are significant limitations in the data available from credit reference agencies, particularly for unincorporated businesses'.

10.227 Furthermore, where CRA data is not publically available elsewhere, access is governed by the principle of reciprocity. This means that all current lenders and new entrants can access data as long as they provide (or will provide) equivalent data. Within this, however, there are 'closed user groups' for particular data sets. These restrict data to certain types of lenders or to providers of certain products. Data on BCAs is held within a closed user group so only those banks that submit data on BCAs can access data on BCAs. This effectively prevents non-BCA providers from obtaining valuable information about SMEs.

10.228 Secure Trust told us[501] that 'data generally available to non-current account providers is much less powerful, is historic and relies on the accuracy of information supplied by lenders under the reciprocal code with the CRAs. [This is not] … as insightful as being able to review the behaviour of a customer's current accounts in real time.' Paragon Bank told us that although 'having an existing long-term relationship [with a customer] gives the lender more information on which to base a responsible lending decision'. It considered 'there is potential for recent government initiatives (such as improving SME credit data sharing and referrals to alternative lenders) to open up competition'. However, it recognised that it is too early to predict the impact of such policies.

Recent government initiatives

10.229 The government has recently introduced initiatives aimed at improving lenders' and banks' access to information on SMEs to enable them to make better credit decisions. The Small Business, Enterprise and Employment Act (SBEE Act)[502] requires banks (meeting certain market share thresholds) to

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[500] Companies House (July 2015), *Life of a company - part 1: annual requirements*.
[501] Secure Trust's response to the UIS.
[502] See Section 3.

share data on their SME customers with other lenders through CRAs and requires those CRAs to provide equal access to that data to all lenders. The SBEE Act will also make VAT registration data available to assist lenders with the verification of SMEs. This will particularly help CRA checks for some smaller SMEs, which are not incorporated but are eligible for VAT (ie have a turnover of over £82,000). This will not, however, help verify the identity of the smallest SMEs as they are not required to be VAT registered. The SBEE Act will become effective in 2016.

Be more efficient in assessing credit applications

10.230 Incumbent banks may be more efficient in assessing credit applications compared to new entrants because they have all the information on the customer readily available.

10.231 The process of applying for credit can be very time consuming and burdensome for customers if they choose to apply for credit in a bank other than the bank where they already have an account ('main bank'), as they have to provide more paperwork.

10.232 Although this is also an issue with respect to personal loans, there is more information on these compared to that on SMEs (especially younger and/or smaller SMEs), as described above. Additionally, because SMEs are more complex in nature than individuals, more extensive paperwork needs to be provided for SME loan applications (eg business plans, strategies, identities of all directors, etc.). Plus, when seeking a loan, banks will typically ask for 18 months' worth of statements to assess the creditworthiness of an SME if the SME is not a BCA customer of that bank.

10.233 This may lead many customers to seek credit products from their 'main bank' in an attempt to reduce the time and cost of applying for finance. This is especially the case as speed in lending decisions is a key requirement for SMEs looking for finance, and these typically seek finance at short notice.

10.234 This issue was also noted in the BoE's credit data discussion paper,[503] which stated that incumbent banks offering BCAs can assess loans much more quickly and cost-effectively as they can source their data from their own systems rather than require the SME to provide information.

10.235 With respect to evidence from the PCA side, some parties[504] have made comments that reflect incumbents' ability to more efficiently assess credit

[503] BoE (May 2014), *Should the availability of UK credit data be improved?: A discussion paper.*
[504] [✂]

applications through access to their customers' transaction data. In particular:

(a) [✄] noted that, for personal loans, it generates and maintains provisional loan limits for existing PCA customers, allowing them to instantly draw down those funds if they wish to, subject to completing a short application. This reflects the high speed at which credit can be provided for those that already hold a bank account with [✄].

(b) [✄] stated that marketing to PCA customers can be more specific, as it has information on a customer's credit score and associated lending limits. This suggests the high speed at which credit can be provided for those that already hold a bank account with TSB.

10.236 Also, regarding SMEs, Barclays made a comment that implicitly shows incumbents' ability to more accurately assess credit applications through access to their SME customers BCA. Particularly, Barclays stated that it sends [✄].

Use historical and pooled data where individual-level data is not available

10.237 Having access to data on a large number of customers allows incumbents to use pooled data where data for a particular customer is not available. This means they might be able to, for example, more accurately price risk by estimating the probability of default for different types of customers based on their historical, pooled data, and the expected loss from those customers defaulting. Also, they might use such data to identify similar types of consumers with a propensity to need/buy certain products.

10.238 With respect to PCAs, some parties have made comments that reflect incumbents' ability to use historical and pooled data on groups of customers to substitute for individual-level data. In particular:

(a) HSBCG noted that choosing which customers to target with marketing 'is built around propensity models (ie statistical analysis of the customer database to help predict which customers are likely to respond to the product offer; it is primarily used for mortgage offers, personal loan offers and credit card offers).' These help HSBCG identify which of its customers are most likely to have a need for other products. These models can be used to assess and potentially offer pre-approved credit card and personal loan applications.

(b) M&S Bank also uses propensity models to promote credit cards to PCA customers and to identify those that are most likely to respond.

10.239 In relation to SMEs, [✂] made a comment that illustrates incumbents' ability to better target, develop and cross-sell their products through access to their SME customers' BCAs, [✂]. [✂] mentioned that it sends its BCA customers relevant information about other banking products where it has identified on the basis of customer behaviour or propensity that such customers may have a need for additional banking products.

Summary

10.240 The lack of customer data may place new entrants in a disadvantaged position compared to that of incumbents with access to customers' transaction history through their current accounts.

10.241 This might potentially allow them to:

(a) better develop, target and cross-sell products;

(b) more accurately price lending products;

(c) be more efficient in assessing credit applications; and

(d) use historical and pooled data on groups of customers to substitute for individual-level data (particularly useful for younger and smaller SMEs).

10.242 There is some limited evidence ([✂]) that incumbents make use of transaction data for targeting and marketing. However, this is a common feature of many retail markets and is likely to grow with the expansion of digital banking. We do not consider this to be a barrier to entry and expansion.

10.243 On SME lending, access to customers' transaction data can provide greater insights into customers' probabilities of defaults and therefore allow banks to better price products. The absence of information in the market on SMEs (particularly younger and smaller SMEs) mean that the alternative sources for assessing credit quality are much more limited. However, we also note that there are ongoing reforms that are likely to reduce these advantages, although at this stage it is too early to tell the full impact of these. Given this, we consider that information asymmetry is a barrier to entry and expansion in lending.

Intermediaries

10.244 Different channels are used by banks to distribute their products and services. These channels include branches (discussed earlier in this section), telephone, online and intermediaries and other third parties. The use of distribution channels varies considerably by product and by bank.

10.245 Access to intermediaries and other third parties for the distribution of products may be restricted in a market if (exclusive) relationships exist between incumbents and distributors. This can create barriers to entry or expansion for new and existing banks.

10.246 We define intermediaries here in the broadest sense, to mean any business or individual that introduces a customer to a bank, including brokers, accountants, lawyers, business formation companies[505] and price comparison websites.

Intermediaries in the PCA market

10.247 The evidence we have collected suggests that intermediaries play a very limited role in the distribution of PCAs. As discussed in Section 7, price comparison websites are used by some PCA providers to promote their accounts. However, only two banks (HSBCG and LBG) told us that their use is significant in driving new account openings.

10.248 Intermediaries appear to play much more of a role in the sale of other financial products, including mortgages, which may be cross-sold to PCA customers. TSB told us that approximately 60% of all UK mortgages are sold via intermediaries. [✂]

Intermediaries in the SME market

10.249 Intermediaries are used by some banks and specialist lenders in the distribution of products to SMEs. Intermediaries are primarily used by providers of SME banking for the distribution of business lending and niche products such as asset finance and invoice discounting. Some providers also use intermediaries in the distribution of BCAs.

10.250 LBG told us that external professionals such as brokers, professional advisers and business groups contribute to the number of SME banking customers that are referred to it. LBG told us that [✂]% of SME customers that switched to it from another provider in 2013 came from paid brokers, other professionals or referrals from existing SME customers. LBG uses around [✂] brokers (typically small accountancy and legal firms) in the sale of invoice finance, hire purchase and leasing. In addition to these formal

[505] For example, introductions with a bank may be made when businesses register with Companies House through a business formation company.

(and paid) introducer relationships, LBG uses informal (unpaid) relationships with lawyers and accountants to encourage future customer introductions. These will often introduce start-up SMEs, SMEs that are dissatisfied with their existing provider and SMEs that have been declined for lending/other service by other providers.[506] The majority of LBG's focus for future investment is in alternative channels, in particular branches, online and mobile.

10.251 Barclays told us that it sells some SME loans (up to the value of £[✂]) through brokers. [✂] business loans to SMEs with annual turnover of [✂] were sold via intermediaries in 2014 (at a total value of £[✂] drawn debt). Barclays also uses intermediaries to sell its BCAs to SMEs. Barclays told us that it has established partnerships with [✂] business formation companies and [✂] indirect affiliates (small scale formation companies). It estimates that customer introduction through business formation companies results in the opening of around [✂] new BCA accounts annually. Barclays also uses a range of intermediaries including accountants, business advisers, brokers, and 'key business introducers' to acquire SMEs.

10.252 Metro also told us that external intermediaries are one of the main sources of new customers to SME finance.

10.253 However, a number of banks told us that intermediaries do not feature in the distribution of their products to SMEs. [✂][507] Charterhouse's follow-up survey supports this: 81% of SMEs applying for finance did so without obtaining advice from any source.

10.254 Handelsbanken told us that its branches are its main distribution channel, and it does not sell SME products via intermediaries. Handelsbanken's relationship managers do, however, play an important role in forging relationships with the business community in their locality, and this is likely to be a source of informal introductions. Similarly, [✂] does not use or pay referral fees to intermediaries to sell business banking products. [✂]

Summary

10.255 While some banks use intermediaries to distribute their products, there are wide variations between banks and product groups. Where intermediaries

[506] In some cases, LBG told us that these introductions result in LBG being invited to tender for the SME's requirements alongside a number of other providers.
[507] [✂]

are used as a channel of distribution, they are complementary to other channels rather than substitutes.

10.256 There is very limited use of intermediaries in the sale of PCAs across banks, with the exception of price comparison websites, which are important to customer acquisition for at least two banks.

10.257 A number of banks – smaller banks as well as incumbents – have a combination of formal and informal arrangements with intermediaries for the sale of SME finance and niche lending products. However, others do not use any formal arrangements with intermediaries for the distribution of their products. Branches, online, mobile and telephone services remain the main sales channels for these banks, and their ability to compete does not appear to be impeded by a lack of a large intermediary network.

Customer acquisition

10.258 The incentive for a new provider to enter the market is driven both by the cost of initial entry and by the speed and scale with which it can start to make profits. If customers are sticky or inert, or prone to going to their existing provider for new products, the cost of entry and/or expansion is likely to be higher as providers will need to make additional investments in order to attract new customers. There are also likely to be significant delays between the time at which the provider makes the investment and the realisation of returns, and/or firms may have to sustain loss-making while continuing to invest. If firms are unable to acquire customers or find it very difficult and costly to do so (due to demand-side features of the market), incentives to enter and compete in retail banking are likely to be dampened and entry may be deterred altogether.

10.259 As set out in detail in Sections 7 and 9 we have found that there is weak customer response. It is therefore difficult for new entrants and smaller banks to acquire customers for the following reasons:

(a) The cost of entry and/or expansion for firms is likely to be higher as they will need to make investments over and above the inherent costs of entry in order to attract customers.

(b) Incumbents will have a first-mover advantage as they already hold an established customer base. Such advantages as explained previously include access to customer information to develop products, target promotions and to cross-sell products in particular in relation to SME lending. They also include lower costs of funding arising from their retail

deposits and the ability to benefit from scale advantages in operating a branch network to facilitate customer acquisition and retention.

(c) Incumbents are able to take strategic action to maximise their advantages in this regard including by targeting their offers to more lucrative main banked customers and, in some cases, through significant investments in advertising and promotion. This is considered in detail in Section 7 in relation to PCA customers and Section 10 in relation to SMEs.

Summary

10.260 As extensively discussed in Sections 7 and 9, customer acquisition is a significant challenge for new entrants and smaller banks, giving incumbents an advantage arising from their established customer base.

Provisional conclusions

10.261 In this section, we have considered the following potential barriers to entry and expansion:

(a) **Regulatory barriers** – specifically capital requirements, the authorisation process, and AML regulation.

(b) **Natural or intrinsic barriers** – specifically access to distribution channels such as branches, funding, access to payment systems, and IT.

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

10.262 These potential barriers have been considered within the broader context of recent market developments. There has been entry and expansion into the provision of PCAs and, to a lesser extent, into the provision of SME banking services. Seven providers have entered the PCA market since 2004, and four providers have entered the BCA market since 1999, including Williams & Glyn, which will not be fully divested until the end of 2017. There has also been recent entry into the SME lending market including by specialist lenders such as Shawbrook, Paragon Bank, and, most recently, OakNorth. Moreover, there are a further 11 retail firms either in the application or pre-application stage of becoming a bank that plan to offer current accounts to personal and/or SME customers.

10.263 Of those that have recently entered, there has been a notable shift away from full-service provision to propositions focused according to:

(a) product (eg entering niche product areas such as invoice discounting);

(b) customer type (eg focusing on customers with particular characteristics); and/or

(c) service proposition and use of technology (eg a number of pipeline firms intend to offer digital-only propositions).

10.264 New entrants are not therefore necessarily trying to compete with incumbent banks across all product and service lines, but are seeking to target particular products or customers and/or provide a differentiated service model.

10.265 Based on the evidence we have provisionally found the following:

Regulatory barriers

10.266 **The authorisation process** – this has undergone significant change in recent years. These changes have enabled a more flexible approach to authorisation and include the option for firms to become authorised with restrictions before committing to large, potentially sunk, upfront investments. Whilst the cost and time implications of authorisation continue to be significant, the recent changes have facilitated entry by several new providers and a number of prospective providers are in the early stages of seeking authorisation. We therefore provisionally find that the authorisation process is no longer a barrier to entry.

10.267 **Capital regulation** – the capital regulatory requirements for banks are complex and impact on banks in different ways depending upon the balance of their asset book, their risk profile, whether they are classified as a systemic bank, and their internal approach to capital and to pricing of their products. We have found that there are significant disparities in the risk weights on residential mortgages applied to different banks depending on the approach they are authorised to adopt to calculate their risk weight. These have the potential to distort competition between banks and to act as a barrier to entry and/or expansion as some banks have to hold significantly more capital on certain classes of residential mortgage than other banks. Mortgages represents an important part of banks' lending activities and an area where banks derive a large proportion of their income. We will undertake further analysis of the impact of the capital regulatory regime on competition between banks in our reference markets and across banks' retail banking businesses and will continue to liaise closely with the PRA. We welcome evidence from parties on this issue.

10.268 **Anti-money laundering regulation** – AML regulation aims to prevent criminal activity and safeguard the economy from fraud. We have not found evidence that AML requirements in themselves are a barrier to entry and/or expansion. However, as described in Sections 7 and 9, banks' processes of implementing AML requirements can make account opening more difficult and time-consuming thus contributing to barriers to switching. This is particularly the case for SMEs where more information is required to properly identify a customer, which can slow down or complicate account opening especially for larger businesses and/or those with more complex ownership structures. We therefore provisionally find that AML is not a barrier to entry and expansion. Instead, it is our view that banks' implementation of AML could be enhanced to further support customer switching. (See Sections 7 and 9 for more detailed discussion on this).

Natural or intrinsic barriers

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

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

10.271 **Funding** – we have not found that accessing funding is a barrier to entry. Access to a large established base of customer retail funds gives incumbent banks funding cost advantages. However, this advantage is only maintained because a large proportion of customers do not switch their current account and maintain their deposits with their main bank. If customers could more readily switch to new banks and/or hold more of their deposits with alternative banks, then incumbent banks' funding advantage would be significantly reduced.

10.272 **Payment systems** – we have identified a number of issues with respect to payment systems that suggest that indirect participants (most new and smaller banks) are at a competitive disadvantage compared to direct members. The PSR, which has only been fully operational since April 2015, is currently looking in detail at these issues and we consider that it is best placed to address these issues. We have therefore decided to deprioritise further assessment of payment systems and will continue to liaise with the PSR and offer the PSR our full support.

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

Strategic/first mover advantage

10.274 **Access to customers' transaction data –** access to an established customer base gives incumbent banks access to information on their customers that can be used to develop products and target promotions. However, we have not found strong evidence that such access is acting as a barrier to entry and/or expansion. In relation to SME lending, we have found that an SME's BCA provider will benefit from better trading and credit histories on their existing SME customers than alternative providers. This gives an SME's BCA provider an advantage in pricing and assessing risk. This is particularly relevant for smaller SMEs as there is a lack of publicly available information on the trading and financial performance of such

SMEs. Access to information can also reduce the time involved and inconvenience to SMEs of the loan application process, which is considered in more detail in Section 8. There are a number of government reforms in train that have the potential to mitigate some of the informational advantages held by the BCA bank in relation to SME lending, however these have yet to be tested. We therefore provisionally conclude that access to transactional data is a barrier to entry and expansion to SME lending.

10.275 **Access to intermediaries** – while some banks use intermediaries to distribute their products to SMEs, and to a lesser extent, personal customers, there are wide variations between banks and product groups. Where intermediaries are used as a channel of distribution, they are complementary to other distribution channels. We found no evidence that new entrants have difficulty accessing intermediaries if the use of intermediaries is part of their customer acquisition strategy.

10.276 **Customer acquisition** – we have found that one of the biggest challenges for new banks seeking to enter and expand in the banking market is customer acquisition. As set out in Sections 7 and 9, PCAs, BCAs and SME lending are characterised by weak customer response. This means that new entrants seeking to enter and expand in the banking market have to invest large amounts of time and resources to attract customers away from the larger established incumbents. Even then, it is likely to take some time before they are able to acquire a sufficient volume of customers to recover their costs of entry and/or to have a sufficient presence in the market commensurate with their initial investment. We therefore provisionally find that customer acquisition is a significant barrier to entry and expansion, and one that can only be resolved by reducing barriers to searching and switching and improving customers' engagement with the banking market so they are able to respond and act to new offers and better products and services.

11. Market structure and market power

Introduction

11.1 The structure of a market at any point in time will reflect the results of current and previous competition in the market including entry, growth, decline and exit of firms in the market. Market structure is affected by both organic growth/decline and discrete structural changes, ie mergers and divestments. In relation to organic growth/decline, we have noted in previous sections that organic change in the PCA and SME banking markets occurs very slowly. At a deeper level, market structure will reflect underlying supply and demand factors including: on the supply side, the extent of economies of scale and scope; and, on the demand side, the extent to which customers demand a variety of differentiated products and levels of customer engagement.

11.2 Market structure and market power may interact in two important ways. First, in a more concentrated market structure with fewer firms, competition between them may be weaker, giving firms a degree of market power. Second, however, if competition is weaker and market power is greater, there is less competitive pressure on less efficient firms to contract or exit the market.

11.3 In this section we first summarise evidence on market structure (paragraphs 11.4 to 11.8). Then, we set out potential sources of market power, how they impact on market structure and why they are potentially harmful (paragraphs 11.9 to 11.21); outline representations made in response to the possible links between market structure and market power in the UIS (paragraphs 11.22 to 11.35); set out relevant evidence (paragraphs 11.36 to 11.54); and finally draw our conclusions (paragraphs 11.55 to 11.61).

Market structure

11.4 As noted in paragraph 11.1, market structure is the result of current and previous competition in the market. As discussed in previous sections, the factors affecting competition and hence market structure include: the level of engagement of customers; perceived and actual barriers to switching; economies of scale and scope; technological change and the requirements for entry. Of particular importance to market structure in PCA and SME banking markets are low levels of engagement and switching which mean that customer acquisition is costly and hence market shares change very slowly. Entry is costly both because of the cost of customer acquisition and because of economies of scale associated with fixed costs of, for example, IT infrastructure and direct access to payments systems.[508] However, as discussed in Section 10, technological change in particular in IT systems has reduced the costs of recent entrants, a point of particular significance because of legacy issues with IT systems of incumbent banks.

11.5 There are linkages between the markets, with around 50% of start-up SMEs opening a BCA with the bank where they have their PCA and 90% of SMEs taking out a general-purpose business loan doing so at the bank where they have their BCA. These linkages may mean that it is difficult to enter the BCA market and in turn to provide general-purpose business loans without having a PCA market presence. For example, Aldermore and Shawbrook provide commercial mortgages and invoice and asset finance but not BCAs. In principle, however, these linkages also make it easier for PCA providers such as Nationwide and Santander to enter/expand in BCAs.[509]

11.6 The largest four banking groups account for over 80% of the BCA markets in each of GB and NI, see Section 6.[510] These banking groups are, together with Clydesdale, the successors through merger to the ‘clearing banks’, which cleared cheques between themselves and thus provided payment transaction services prior to the advent of electronic transactions.[511] The same banks are also important in other SME banking markets, though other providers have a larger share in business deposits and, within loans, asset finance and invoice finance than in BCAs (see paragraphs 6.25 to 6.37). The position in PCAs is broadly similar except that there is stronger competition from former and continuing building societies, in particular from Santander and Nationwide, and in NI LBG through its Halifax brand (see Table 11.1).[512] The level of HHI indicates that the markets are concentrated, although the BCA market in NI is around the threshold in our guidelines to be classified as highly concentrated.[513]

[508] Indirect access to payments systems may reduce annual costs for smaller banks but may be an imperfect substitute for direct access.
[509] Nationwide has not entered the BCA market, though Santander has done so (see Nationwide case study, Appendix 10.2).
[510]These are Barclays, HSBCG, LBG and RBSG in GB; and AIB, BoI, Danske and RBSG in NI.
[511] See paragraph 5.8.
[512] LBG’s other brands (Lloyds and BoS) by themselves represent one of the largest four shares in GB but are small in NI.
[513] Markets with HHI between 1,000 and 2,000 are described as concentrated and markets with HHI over 2,000 as highly concentrated, see *CC3*.

Table 11.1: Market structure in GB and NI, 2014

	BCA	*PCA*
GB		
Share of largest four banks %	83	71
HHI	1,779	1,550
NI		
Share of largest four banks %	86	72*
HHI	2,044	1,511

Source: CMA analysis of GfK FRS and data submitted by banks (see Sections 5 and 6). BCA shares are based on active accounts for GB and all accounts for NI (figures for all accounts for GB show slightly lower levels of concentration than figures for active accounts). PCA shares are based on main accounts.
*This is the share of the largest four providers of PCAs. Unlike in GB, these are not the same as the largest four BCA and loan providers. The share of the largest four SME providers, the successors to the original NI clearing banks is 66%.
Note: Precise figures are not available for SME loans and deposits. The share of the largest four providers of general-purpose business loans (including commercial mortgages but excluding other types of loan such as peer-to-peer lending, business credit cards, invoice finance and asset finance) is 79% and the HHI on the same basis is about 1,800.

11.7 Some banks argued that concentration levels were modest and lower than in other markets which have been found to be competitive (for example, HSBCG referred to retail mobile phones).[514] One bank referred to a statement in our merger guidance that previous phase 1 merger decisions involving retailers suggest that the CMA has not usually been concerned about mergers that reduce the number of firms in the market from five to four (or above).[515] However, each market has individual characteristics and statements about other markets are not necessarily relevant to the PCA and SME banking markets. Therefore, we do not consider we should dismiss issues relating to the level of PCA and SME banking concentration simply because the level of concentration is not as high as in some other markets which have been found at some point in time by a competition authority to be competitive.

11.8 Banks also referred to the fact that levels of concentration have been declining. Levels of concentration have declined over the last three years as the market shares of the largest banks have tended to decline and TSB has been divested from LBG. A further decline in concentration will occur next year when Williams & Glyn is divested from RBSG. Over a longer period (around ten years), concentration has declined in the GB and NI BCA markets, but increased in the GB PCA market and remained stable in the NI PCA market.[516]

[514] HSBC response to the UIS, paragraph 5.18.
[515] *Merger Assessment Guidelines*, paragraph 5.3.5.
[516] Concentration in the GB PCA market has increased due to the net effect of mergers and divestments, in particular the merger of LBG and HBOS increased concentration more than the subsequent divestment of TSB reduced it.

Market power

11.9 Market power may arise through firms having unilateral market power or as a result of firms coordinating their behaviour.[517]

11.10 In relation to coordinated behaviour we stated in the UIS that, in line with our statement of issues, we did not consider that coordinated behaviour was a feature in the provision of PCAs or SME retail banking services. This was because the market conditions necessary for coordination to be sustained, as set out in our Guidelines,[518] were not met. None of the respondents to the UIS provided evidence that the conditions for coordination were met or that coordinated behaviour was a feature of the markets.

11.11 We have therefore continued to focus our analysis on unilateral market power.

Unilateral market power

Weak customer response

11.12 As discussed in previous sections, competition in the PCA, BCA and SME loan markets is affected by weak customer response associated with, barriers to searching and/or switching including information asymmetries in SME lending, lack of engagement and the linkages between PCA, BCA and SME loans markets. This means that incumbent PCA and SME banking providers have market power over existing customers. In the PCA markets such market power tends to be manifested mainly with respect to certain groups of customers – those frequently going into overdraft and those who are less financially sophisticated and/or less confident in the use of the internet; while in the SME banking markets it would tend to be more significant in relation to smaller SMEs at the end of their free banking period and/or who are less likely to be able to negotiate terms with their existing bank.

11.13 As also discussed in previous sections, weak rivalry for existing customers may be offset to some extent by stronger rivalry for new customers. All existing customers were new customers once. Hence they may have benefited from more favourable terms in the past, for example PCA customers may have benefited from interest-free overdrafts on student accounts and SME customers may have benefited from the period of free banking offered to start-ups. Those customers who have switched banks

[517] *CC3*, paragraph 170.
[518] *CC3*, paragraph 251.

may also have benefited from offers directed at switchers. While the existence of stronger rivalry for new customers is an important aspect of the PCA and SME banking markets, we do not consider it likely that it fully offsets the market power of incumbent providers. This is because there are barriers to searching and switching, low levels of customer engagement and linkages between PCA, BCA and SME loans markets; also the proportion of new customers is low.

11.14 In the UIS, we set out two specific ways in which market structure may increase banks' market power and adversely affect customer outcomes.[519] These may be summarised as follows:

(a) Product differentiation means that higher concentration is associated with greater market power.

(b) Banks with higher market shares have weaker incentives to lower prices and/or improve quality and/or innovate because they have a larger existing customer base of inactive customers relative to the active customers over which all banks compete. As discussed below, this applies when banks experience difficulty in charging different prices to different customers (price discrimination),

Product differentiation

11.15 The PCA, BCA and loan markets are characterised by a degree of product differentiation – banks each have their distinct brands, branch networks and/or websites and the characteristics of their products and services differ. Consequently, the products of different banks are imperfect substitutes for each other. Each bank will tend to be constrained by the products of other banks; therefore, other things equal, the smaller the number of banks, ie the higher the level of concentration, the weaker the competitive constraint will tend to be on each of them. However, in this context it is large, rather than niche, competitors that are relevant as these have the most customers and are most likely to exercise a constraint on each other.

11.16 In the PCA market, some banks have more than one substitutable brand (the main examples are LBG with Lloyds/BoS and Halifax, and HSBCG with HSBC, First Direct and M&S Bank).[520] While these brands are substitutes for each other, the incentive to compete is less than if they were under separate

[519] See the UIS, paragraph 99.
[520] Additionally LBG and RBSG have geographically differentiated brands (Lloyds and BoS and NatWest and RBS respectively). Since each of these brands is only present in one part of the GB market, the extent of substitutability between them is likely to be low. As also noted in Section 4, the geographically differentiated brands have similar strategies, products and pricing.

ownership.[521] Hence, it is concentration at ownership rather than brand level that we are mainly concerned with in this section.

11.17 As a result, a more concentrated market structure would tend to be associated with weaker rivalry between banks for new customers and hence banks' market power would be increased.

Effects associated with larger customer base

11.18 As already discussed (see paragraph 11.15), incumbent PCA and SME banking providers have market power over existing customers due to weak customer response. In the absence of price discrimination, this could create a link between market share and price since banks have to balance the gain from charging a higher price to their existing customers against the loss from attracting fewer new customers. Banks with more existing customers, ie larger market shares, may have incentives to set higher prices than those with fewer existing customers, ie smaller market shares. Then, banks with higher market share would experience declining market share since, as a result of competing less vigorously for new customers,[522] their share of new customers would tend to be less than their share of all customers. This would continue for a period, ie as long as the advantages of higher prices exceeded the disadvantages of declining market share. It could not continue indefinitely since at some point a bank with initially high market share would have lost sufficient market share that it changed its behaviour. However, given the slow rate of change in market shares in the PCA and SME banking markets (see Sections 5 and 6), the period could be quite long.

11.19 Effects of this nature have been found in previous inquiries:

(a) In a report on a previous proposed merger, the CC found that the merger would reduce unilateral incentives to compete in PCAs by increasing the merged bank's customer base and thereby encouraging it to attach more weight to the enhancement of margins than to the growth of market share.[523]

(b) In a report on a subsequent merger, the OFT identified a theory of harm under which, by increasing the merged bank's customer base and its

[521] If a bank gains a profitable customer from another bank, it will make a future profit. If it gains a customer from a brand under the same ownership there is both a future profit (for the gaining brand) and a future loss (for the losing brand) to consider. Hence the incentive to compete is less.
[522] The pool of potential new customers would include new-to-market customers, customers who are usually inactive but pushed to search and switch by dissatisfaction with their existing bank (ie temporarily active customers who can be expected to be inactive in future) and those more active customers who regularly search the market.
[523] CC (2001), *Lloyds TSB Group Plc and Abbey National Plc: A report on the proposed merger*, Summary.

ratio of inactive customers to the total number of active customers in the market, the merged bank would be encouraged to attach (even) more weight to the enhancement of margins than to the growth of market share.[524]

11.20 We identified in the UIS that this mechanism requires banks to experience difficulty in discriminating between their existing customer base of inactive customers and more active potential new customers. This is because, if there is no such difficulty, banks can charge a higher price to their existing inactive customers while charging a lower price to attract new customers and retain existing active customers.[525] Then, inactive customers would pay higher prices and active customers lower prices, but overall outcomes would not be affected by market structure (at least in regard to this mechanism).[526]

11.21 As we said in the UIS, we consider that these mechanisms represent possible ways in which market structure could adversely affect customer outcomes and that such effects needed to be tested.[527] Moreover, we do not regard them as independent of each other – most likely, if there is an association between market share and outcomes, both would contribute to some extent.

Representations by parties in response to the UIS

11.22 In this section we summarise representations by parties in response to the two mechanisms we identified. In the UIS we also asked whether other mechanisms should be considered.[528] We therefore consider representations on:

(a) product differentiation;

(b) effects associated with a larger customer base; and

(c) other mechanisms.

Product differentiation

11.23 We set out the hypothesis in paragraph 11.15 above.

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[524] OFT report to Secretary of State on Lloyds TSB's acquisition of HBOS (October 2008), paragraph 124.
[525] The mechanism requires there to be difficulty in discriminating on both price and quality. As there appears less difficulty in discriminating on price than quality, the subsequent discussion focuses on price discrimination.
[526] There could still be a link between market structure and outcomes due to more concentrated markets having weaker competition for active customers, ie the first mechanism.
[527] See the UIS, paragraphs 101–109.
[528] See the UIS, paragraph 100.

11.24 Several parties, including Nationwide, Tesco, Yorkshire Building Society and Virgin Money agreed that this mechanism should be considered. Other parties, including Barclays, HSBCG, LBG, RBSG and Santander disagreed.[529]

11.25 Among the points made by the latter parties were that product differentiation was pro-competitive and in customers' interest; and that the mechanism failed to capture the dynamic element of competition whereby more successful firms achieved higher market share. HSBCG, for example, said that product differentiation resulted from competition on non-price elements such as service and expertise; and the fact that it also resulted in banks pricing above marginal cost was entirely consistent with a well-functioning market as pricing above marginal cost was necessary to cover fixed and common costs.[530] Barclays said that concentration arose from intense competition when firms needed to increase their market shares to recover sufficient price-cost margins to cover their fixed costs. Barclays also suggested that retail banking was characterised by economies of scope which reduced the cost of providing a variety of services using common platforms and distribution channels and that this too tended to increase the level of concentration.[531]

11.26 We agree that higher concentration is not necessarily associated with worse customer outcomes since, where there are fixed and common costs, firms with larger market shares can cover such costs at a lower margin. We do not agree that concentration necessarily arises from intense competition resulting in compressed margins. In the presence of product differentiation,[532] higher concentration may weaken competitive constraints with the result that margins are higher than needed just to cover fixed and common costs. In the UIS we identified this as a mechanism through which there might be a link between concentration and outcomes. We did not suggest it created an automatic or necessary link. Therefore, it is an empirical matter whether or not concentration is associated with worse outcomes – we consider the evidence below.

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529 Responses to the UIS.
530 HSBC response to the UIS.
531 Paper on competition and concentration in retail banking (prepared by Brattle).
532 The banks themselves said that the products were differentiated. Other evidence on the extent of product differentiation was mixed. The British Chambers of Commerce said that its members struggled to differentiate between major banks' offerings (British Chambers of Commerce response to the UIS). The GfK PCA qualitative research suggested that some customers regarded PCAs as generic products with little differentiation (GfK PCA report, paragraph 190). However, the GfK PCA consumer survey showed that 49% of respondents agreed there were real differences between banks in the PCAs they offered (GfK PCA consumer survey, detailed table 1016). Qualitative evidence in regard to BCAs suggested a perceived lack of differentiation between banks (see paragraphs 8.61–8.63.

Effects associated with larger customer base

11.27 We set out the hypothesis in paragraph 11.18 above.

11.28 A number of parties agreed this mechanism was relevant – these included the same parties who agreed the first mechanism was relevant (see paragraph 11.23). It also included Santander and TSB, both of which encouraged us to investigate this mechanism further.[533]

11.29 Santander also noted that, because banks seeking to expand had to induce customers to switch from other banks, their customer base was likely to be made up of a pool of more engaged customers compared with larger incumbent banks which were able to profit from a large degree of 'back book customer inertia'. We agree that this is a likely consequence of the weak customer engagement discussed in Sections 7 and 9.

11.30 Other parties, including Barclays, HSBCG, LBG and RBSG, disagreed that this mechanism was relevant.[534] The key point made by these latter parties was that banks were able to discriminate between existing/inactive and new/active customers. Banks pointed to offers made both to new-to-market customers and switchers, which reduced their price compared with the price paid by existing customers. For example, LBG said that banks were able to target introductory offers at new customers as an incentive to switch provider; and that all providers were able to target customers in this way, irrespective of their size; hence the mechanism linking market share to customer outcomes could not hold:

(a) in relation to BCAs, all providers could target free banking offers to new and switching customers. Negotiation of prices was also prevalent for larger SMEs, which meant that providers were able to offer further incentives to acquire or retain these customers; and

(b) in relation to PCAs, all providers could identify which customers were new or switching. All providers could and many did offer switching incentives or introductory offers to new customers. Such introductory offers and switching incentives were common in other retail financial services markets such as savings and credit cards, and other markets, such as magazine subscriptions and pay TV. LBG offers the same underlying products and prices to all of its PCA and BCA customers

[533] Santander response to the UIS, paragraph 7.5; TSB response to the UIS, paragraph 23.
[534] Responses to the UIS.

once any introductory offer has expired, and makes it as easy as possible for customers to switch between products.

HSBCG also referred to banks' ability to differentiate between existing customers either *(a)* in response to an approach from a customer indicating they were considering switching; *(b)* through analysis of customer activity data; or *(c)* through ongoing active contact with customers.[535]

11.31 We agree that banks discriminate between existing and new customers through offers to new-to-market customers and to switchers and that this is an important consideration in regard to the second mechanism. However, differences in customers' propensity to search and switch, which are difficult for banks to observe, may limit their ability to discriminate effectively. Ideally, from a bank's point of view, as well as discriminating between existing and new customers it would also wish to discriminate between *(a)* new customers who are temporarily active, for example because of dissatisfaction with their existing bank, but likely to be inactive in the future and *(b)* new customers who are regularly active in searching and switching – a bank would wish to offer a bigger incentive to group *(a)* because expected future profits would be higher. And, once it had acquired a customer, a bank would wish to discriminate between customers according to how engaged they were – ideally, a bank would wish to charge higher prices to inactive customers than to customers who regularly search the market for the best deal.

11.32 We did not see evidence that banks were necessarily able to discriminate sufficiently between new customers who would be less or more active in future. Similarly, despite HSBCG's points (see paragraph 11.30), we considered there were limits to the extent to which banks were able to distinguish between active and inactive existing customers. This is because existing customers would not necessarily approach their bank before switching and there are limits to the information that can be gleaned from customer activity data and active contact.[536]

11.33 Because of these limits to price discrimination, we consider that it may still be the case that larger banks have an incentive to set higher prices than smaller banks.

[535] HSBC response to the UIS, paragraph 5.12(a).
[536] However, this would not apply to SMEs with full relationship management (these are mostly larger SMEs). Nor would it generally apply to SME loans where terms are to a large extent customer-specific.

Other mechanisms

11.34 The only party to suggest another mechanism was Nationwide, which referred to the ability of large banks to leverage their 'back-books' in one product/brand to cross-subsidise competition for active customers through another product/brand. Nationwide said the large incumbent banks habitually made offers and/or new products available to attract switchers but did not promote equivalent benefits to their existing customers. Nationwide also commented that it potentially also gave large incumbents an advantage over challengers since incumbents had a larger 'back-book' of inactive customers than challengers and that this limited the ability of challengers to achieve growth and scale.[537] A similar point was made by TSB.[538]

11.35 We have discussed banks' policies for retention of their existing customers in Section 7; their ability to differentiate between inactive and active customers in paragraph 11.31; and the impact on entry and expansion in Section 10. We noted that some large banks offered switching incentives which were not available to their own customers,[539] but some also offered reward accounts (eg Santander 123, Lloyds Club) which were available to their own customers. We also noted that offers to attract new customers are also made by smaller incumbents such as Clydesdale, Co-op and Nationwide itself.

Evidence

11.36 We set out in the UIS the range of evidence we would be considering in relation to market structure and market power.[540] We consider the evidence under the following headings:

(a) Market shares versus outcomes.

(b) Change versus level of market share.

(c) Other evidence.

Market shares versus outcomes

11.37 We might expect to observe higher market shares associated with worse outcomes due to the incumbency advantage of longer established providers

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537 Nationwide response to the UIS, paragraph 5.3.
538 TSB response to the UIS, paragraph 22.
539 We also noted that in some cases switching incentives were available to customers of other brands within the same banking group. For example, First Direct's switching incentive was available to HSBC customers and Halifax's switching incentive was available to Lloyds customers, though not to BoS customers.
540 See the UIS paragraphs 101–109.

and to the mechanisms set out in paragraph 11.14 underlying a specific link between market structure and outcomes.

11.38 We have set out evidence on pricing and quality in Section 5. We recognised that there were a number of limitations to the analysis that we had been able to carry out including: small sample size; difficulty in making objective comparisons of quality and in interpreting satisfaction and NPS data from surveys; issues in making accurate price comparisons (including linkages with other products such as savings accounts, the impact of possible differences between providers in willingness to provide arranged and unarranged overdrafts, and adjusting for different eligibility requirements of different PCAs); and absence of combined measure of price and quality.

11.39 Furthermore, comparing PCA prices is not straightforward due to the complexity of services provided by a PCA and of PCA pricing.[541] In particular, where brands have more than one standard/reward PCA product, the prices we have calculated reflect a measure of averaging across different PCA products.[542] And our calculated prices for banking groups with more than one brand reflect averaging across their brands.[543]

11.40 Given this measure of averaging in the calculation of prices, the prices we have calculated may be affected by differences between brands and banking groups in the proportion of more active customers. We observed a tendency for banking groups whose customers had held their accounts for a long time to have higher average prices (see Figure 5.7), and we considered that this was consistent with incumbency advantages, ie newer and more rapidly growing banks having a higher proportion of active customers paying lower prices. We also saw evidence that banking groups with a higher market share (which tended also to be those whose customers had held their accounts for a long time) tended to have higher average prices (see Figure 5.8) and lower overall quality (see Figures 5.10 and 5.11).

11.41 We have set out in Section 6 similar evidence in relation to BCA prices and quality. Our comparisons of BCA prices are more limited than our PCA price comparisons since our BCA price comparison relates only to transactions list prices and does not take account of incentives offered to start-up SMEs and switchers nor of overdraft pricing.[544] Data on BCA quality is also somewhat more limited. Furthermore, comparisons of BCA pricing and quality are more

[541] See paragraphs 5.61 to 5.63, and paragraph 5.64 for the approach we have adopted.
[542] This is necessary because different PCA products have different eligibility requirements, see Appendix 5.4.
[543] See Appendix 5.4.
[544] It is also limited to SMEs with turnover of less than £2 million and does not take into account interest paid on credit balances by some banks. Transactional charges and fees make up just under 50% of the charges on BCAs for SMEs with a turnover of less than £2 million (see Appendix 6.2).

difficult to interpret due to differences between SMEs and because there is more negotiation of BCA prices. Overall, we did not see any evidence of a clear association between BCA market share and outcomes.[545]

11.42 We were not able to make price comparisons for business loans as loan charges and rates are not published and are difficult to compare as they depend on the characteristics of the loan and the borrowing SME.

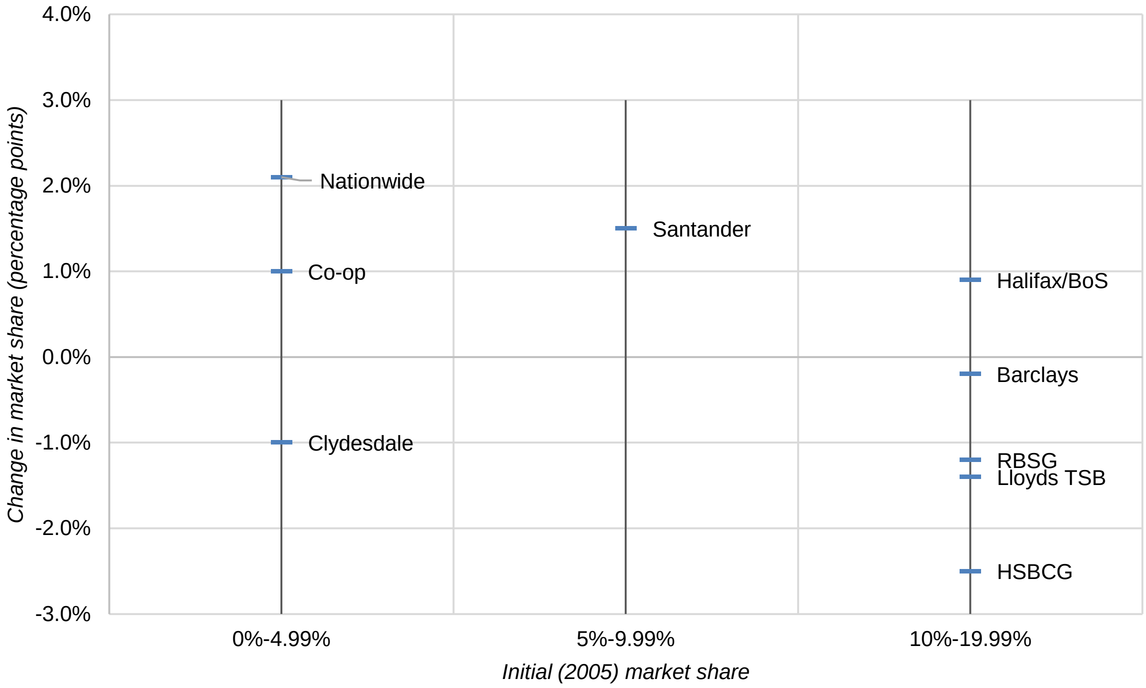
Change versus level of market share

11.43 If smaller banks make better price/quality offers to customers than larger banks, we would expect them to grow more rapidly. Hence we would expect to see banks with lower market share increasing their market share at the expense of banks with larger market share. We recognise nonetheless that there are other potential reasons why smaller banks might be growing more rapidly and increasing their market shares – for example, their brand might be gaining increased recognition or they might be expanding geographically.

11.44 Figure 5.1 sets out evidence on PCA market shares over time. The relationship between market share and change in market share depends on whether change is measured in absolute or proportionate terms. However, Figure 11.1 (which shows absolute change over nine years against initial 2005 market share) and Figure 11.2 (which shows proportionate change) suggest there is some general tendency for the PCA market shares of smaller banks to increase and for the market shares of larger banks to reduce.[546] The main exception to this is Clydesdale, a long-established smaller bank which has experienced declining market share. [excised] Also, HSBCG experienced a bigger decline in market share than the other large banks (despite already being the smallest of the four longer-established large banks in 2005).

[545] Our comparisons suggested that one small bank (Handelsbanken) appeared to have exceptionally high quality but also that its prices were also relatively high.
[546] Banks with less than 1% market share are omitted.

Figure 11.1: Absolute change in GB PCA market share, 2005 to 2014, versus 2005 market share



Source: CMA estimates based on GfK FRS data.
Note: Initial market shares are based on banking groups at the start of the period, except for Abbey National and Alliance & Leicester for which figures are not available as these brands were acquired by Santander. Lloyds TSB acquired Halifax/BoS in January 2009: therefore growth reflects about three years under separate ownership and six years under common ownership. TSB was divested from LBG in 2014: Lloyds TSB figures include both Lloyds and TSB.

Figure 11.2: Proportionate change in GB PCA market share, 2005 to 2014, versus 2005 market share

[✂]

Source: CMA estimates based on GfK FRS data.
Note: See Figure 12.1.

11.45 Our information on BCA market shares is less complete than on PCAs.[547] General trends appear more variable than for PCAs among the larger banks, but the pattern is broadly similar. In aggregate, the four largest banks experienced declining market share[548] while smaller banks, with the exception of Clydesdale,[549] have increased their market share.

11.46 The evidence in this area is therefore broadly consistent with smaller banks making better price/quality offers to customers than larger banks.

[547] Figure 6.1 shows available data summarised from different sources.
[548] Figure 6.1 suggests that RBSG, Lloyds TSB and HSBCG experienced declining market share between 2005 and 2014, though HSBCG experienced increasing market share since 2010 and Barclays experienced generally increasing market share between 2005 and 2014.
[549] Figure 6.1 suggests that Santander and Co-op increased their market share. Handlesbanken, which is not included in Figure 6.1, has also increased its market share.

Other evidence

11.47 We also considered the following other evidence:

(a) recent mergers and divestments;

(b) review of the literature on the link between market structure and outcomes;

(c) overall profitability; and

(d) comparison of individual markets with different levels of concentration.

Recent mergers and divestments

11.48 Appendix 11.1 sets out evidence on recent mergers and divestments: Santander's acquisition of Alliance & Leicester in 2008; LBG's acquisition of HBOS in early 2009; and its subsequent divestment of TSB in 2014. It is difficult to draw inferences because we do not know what would have happened in the absence of the merger/divestment, especially as both mergers were proposed at the time of the 2008 financial crisis and the divestment of TSB is relatively recent. However, we did not find strong evidence of a reduction in competition following LBG's acquisition of HBOS.

Literature review

11.49 We have reviewed the empirical literature on the link between concentration and outcomes (see Appendix 11.2). Most, but not all, of the reviewed papers suggest that the structure of banking markets is important and that more concentrated market structures are associated with worse outcomes for consumers, such as lower interest rates on deposits and higher rates on loans and overdrafts. However, there are some limitations to the empirical literature: first, few of the studies focus on UK banking markets; secondly, the majority of the studies focus on banking markets as a whole, with only a few focusing specifically on the PCA and SME banking markets.

Overall profitability

11.50 Based on banks' reported profits, we noted that reported financial performance for 2012 to 2014 showed improving profits and returns, stable or increasing net interest margin, declining cost-income ratio, declining impairments and declining share of non-interest income in total income.[550]

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[550] See paragraphs 2.66–2.68.

However, we were not able to undertake a comparison of the return on equity earned in PCA and SME banking with the relevant cost of equity, either for larger or smaller banks.[551]

Markets with different levels of concentration

11.51 As set out above, the BCA markets in both GB and NI are more concentrated than the PCA markets.[552] It is not possible directly to compare BCA and PCA prices and quality due to differences in the services provided; and we were not able to make a full assessment of market profitability in BCAs or PCAs (see paragraph 11.50). However, we found that one bank ([✂]) measured its performance using a range of different indicators, one of which is profit before tax. Profit before tax data showed its BCA profits were consistently higher than its PCA profits as a percentage of revenue.[553] We considered that this evidence was of limited value as it related to only one bank and there were other differences between BCA and PCA markets, for example greater barriers to switching BCAs, which might explain any profitability differences between them.

11.52 The level of concentration in BCAs is higher in NI than in GB (see Table 11.1).[554] We noted that the prices of banks with more BCAs in NI than in GB tended to be higher (see Figure 6.7). Given the limitations to our comparison of BCA prices (see paragraph 11.38), we did not attach much weight to this point.

Summary of evidence

11.53 We have reviewed a range of relevant evidence. In relation to PCA prices and quality, we saw some tendency of banks with larger market share to have higher prices; we do not observe a similar tendency in relation to BCAs, though the BCA pricing data is less comprehensive and subject to more uncertainties. We saw a general tendency for smaller banks over the medium to longer term to grow more rapidly than larger banks, which is consistent with smaller banks making better average price/quality offers to customers than larger banks. As regards other evidence, we did not find strong evidence of a reduction in competition following LBG's acquisition of HBOS but our review of the economic literature suggested more

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[551] See paragraph 2.53.
[552] The evidence regarding concentration in SME deposits and loans in GB versus NI is less clear, see Section 6.
[553] Comparison of profit before tax as % of total income for BCAs (see Appendix 6.3, Table 1) against PCAs (see Appendix 5.3, Table 1).
[554] The level of PCA concentration in GB and NI is similar (see Table 11.1).

concentrated market structures tended to be associated with worse outcomes for consumers.

11.54 Overall, we consider that the evidence is consistent with incumbency advantages deriving from the weak customer response we discussed in Sections 7 to 10. We consider that it provides limited support for the level of current concentration having additional adverse effects over and above that of incumbency, as implied by the two mechanisms set out in paragraph 11.14 above. While we observe some tendency of banks with larger PCA market shares to have higher average PCA prices, this may well reflect their longer time in the market and higher proportion of inactive customers paying relatively high prices (see Figure 5.7), ie their incumbency advantage.

Provisional conclusions

11.55 We identified that as a result of barriers to search and/or switching, low levels of customer engagement and linkages between PCA, BCA and SME loans markets, incumbent banks in these markets hold market power over their existing customers.

11.56 Longer-established banks have a larger base of existing customers including more inactive customers. There is evidence that such longer-established banks, with larger market shares, are able on average to charge higher prices and/or provide lower quality, than newer banks with lower market shares. Although the longer-established banks have been losing market share, the same issues (lack of customer engagement and the existence of search/switching barriers) mean that this loss has occurred very slowly. The four large longer-established banks in GB still have the largest shares of both PCA and BCA markets.[555]

11.57 We found the structure of the PCA and BCA markets to be concentrated, and we observed some tendency in the PCA market for larger banks to have higher prices.[556] However, as set out in paragraph 11.54, we considered the tendency of larger PCA banks to have higher PCA prices was also explained by their incumbency advantage. Hence, we provisionally find there is insufficient evidence to support a finding that the current concentrated market structure is itself having adverse effects on competition and detrimental effects on customer outcomes.

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[555] They also have the largest shares of general purpose business loans (we do not have accurate figures for all business loans). The four longer-established banks in NI hold four of the top six positions in PCAs and the top four positions in SMEs.

[556] We did not see similar evidence in relation to the SME markets (though we also note that our evidence base for SMEs is more limited than for PCAs.

11.58 To sum up, we provisionally find that longer-established banks, with larger market shares, are able on average to charge higher prices and/or provide lower quality, than newer banks with lower market shares. We consider that this is due to weak customer response and to their having a larger base of established customers.

11.59 We have reached this provisional view on the basis of the current evidence and current levels of concentration, including the recent divestment of TSB from LBG.

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

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

12. Provisional findings

12.1 On 6 November 2014, the CMA board in exercise of its power under sections 131 and 133 of EA02 made a reference to the chair of the CMA for an investigation into the supply of retail banking services to PCA customers and SMEs in the UK.

AEC provisional findings

12.2 We have provisionally found, pursuant to section 134(1) of EA02, that there are features of the relevant markets, which alone or in combination, prevent, restrict or distort competition in the supply of PCAs in the UK and in the supply of certain retail banking services to SMEs in the UK such that there are AECs within the meaning of section 134(2) of EA02.

Personal current accounts

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

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

(b) **Barriers to switching PCAs**: customers perceive that switching accounts is burdensome and there is still a fear that something will go wrong. Awareness of and confidence in the CASS switching service is still low. There are additional barriers to switching for overdraft users because of uncertainty surrounding the acceptance and timing of an overdraft approval.

(c) **Low levels of customer engagement**: few customers search for better offers and the number of customers switching PCAs, in part or in full, remains very low. A lack of triggers for customers to engage in the market, the low cost of PCAs for many customers, reported satisfaction despite low levels of searching and a belief by many customers that there is little to be gained from searching and/or switching, together with features (a) and (b) contribute to continued low levels of customer

engagement. Overdraft users, despite being those who would potentially gain most from switching, generally show limited awareness of and engagement with their overdraft usage and have a lower tendency to switch.

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

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

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

12.6 While competition between banks to attract new customers has increased, in particular for the primary banking relationship, and increasing digitalisation in banking is reducing the barriers to customer engagement, we have found that many customers are not benefiting from this competition. In particular, the competitive pressures on overdraft charges are low. Overdraft charging structures are complex and overdraft users are less likely to switch banks, even though these users are likely to gain the most financially from switching. Some overdraft users also face additional barriers to switching due to the uncertainty surrounding the acceptance and timing of an overdraft approval. Other groups of customers who find it more difficult to search and/or switch PCAs are also likely to be adversely affected. This tends to be customers who are less financially sophisticated and/or less confident in the use of the internet.

Business current accounts

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

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

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

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

(d) **Low levels of customer engagement**: as with PCAs, there are limited triggers for SMEs to engage once they have a BCA; BCAs are low cost relative to other business costs and many SMEs are satisfied with their BCA. In addition, many SMEs consider that there is little to be gained and potential disadvantages from searching and/or switching, in full or in part. Together with features (a) to (c) this leads to low levels of customer engagement more generally in particular as shown by the significant number of SMEs who do not search and by the low number of SMEs switching BCAs, in full or in part.

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

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

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

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

SME lending

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

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

(b) **Barriers to comparing lending products**: charges are opaque and lending terms including early repayment and penalty clauses can also be complex. There is a lack of effective comparison tools which may

particularly affect smaller SMEs that do not have specialist financial capability.

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

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

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

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

12.13 Longer-established banks benefit from having a larger existing customer base over which they have unilateral market power and, given the weak customer response, they are thus able to maintain high and stable market shares. We have also found that the main barrier to entry and expansion is the existence of incumbency advantages from having an established base of customers. These incumbency advantages are particularly strong for banks with an existing base of BCA customers given the strong product linkages between BCAs and SME lending, and the information asymmetries between an SME's BCA provider and other providers of lending products. This makes it more difficult for other lenders to expand organically in turn weakening the constraints that other lenders impose on incumbent providers.

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

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

Customer detriment

12.16 We have considered the nature and potential scale of the detriment to PCA customers and to SMEs arising from the AECs we have provisionally found.[557] We were not able to quantify the detriment from the reduced incentives to compete, partly due to the difficulties associated with assessing the profitability of PCA and SME banking, but more importantly because the dynamic benefits from increased competition are by nature difficult to quantify. If there were more switching, we would expect banks to have stronger incentives to compete on prices, quality and/or innovation. These wider dynamic benefits would create more pressure on banks to develop products that benefit customers, including more incentives on providers to develop PCAs, BCAs and SME loans with charges and services which are clearer to and valued by customers. We expect that this detriment could be substantial.

12.17 In relation to PCAs, we undertook analysis to estimate the direct harm to consumers arising from the lack of switching. Our switching analysis found that on average PCA customers could make financial gains of about £70 per year if they were to switch – with larger gains for overdraft users of £140 per year on average. This is a static analysis of consumer harm from lack of switching, which does not take into account changes in the incentives for

[557] For the purposes of section 134(4) of EA02.

banks to compete if there were more switching, nor does it take into account other aspects of banks' offering (such as service levels). Nonetheless, it gives an indication that PCA detriment could be substantial.

12.18 We did not carry out a similar analysis for BCAs and for SME loans as for PCAs to quantify the benefits from switching. For BCAs, our calculations, based on our BCA pricing analysis, suggests that SMEs could save approximately £70 per year on their BCA if they were to switch.[558] Due to the assumptions in the BCA pricing analysis, this is likely to be a conservative estimate – for instance it does not take into account any period of free banking that an SME would get if switching to another bank. It also does not reflect the savings from SMEs searching and obtaining finance from other providers.

[558] Our BCA pricing analysis covers monthly fees and transaction charges for SMEs up to £2 million turnover and excludes those on non-standard tariffs (eg switchers, start-ups, negotiated etc).

13. Review of 2002 SME banking undertakings

13.1 The SME banking undertakings were originally provided by nine banks (the banks)[559] in 2002 and 2003 to remedy the competition concerns outlined in the CC's 2002 report into SME banking.

13.2 The undertakings require the banks to comply with a number of provisions in relation to transparency, switching and portable credit data bundling. See Appendix 3.1 for further information.

13.3 The CMA has a statutory duty to keep such undertakings under review and to consider from time to time whether, by reason of any change of circumstances, any undertaking is no longer appropriate and whether either one or more of the relevant parties can be released from the undertaking or whether the undertaking needs to be varied or superseded by a new undertaking. As part of its consideration of whether to conduct a review, the CMA initially assesses whether there is a realistic prospect of the review finding that there has been a change of circumstances since the undertakings were first given.[560]

13.4 The CMA undertook an initial assessment of the undertakings alongside the 2013/14 market study into SME banking. The CMA found that in relation to:

(a) transparency: the undertakings have played a role in improving the transparency of prices, but concerns about transparency and comparability of prices remained, and therefore, there was not a realistic prospect of there being a relevant change of circumstances and these undertakings should continue in place to continue to provide a minimum, albeit incomplete, standard with respect to the transparency of prices;

(b) switching: there was a realistic prospect for believing that CASS substantially superseded the obligations with respect to the timing of the switching process and measurement of performance included in the undertakings, and therefore, there was a reasonable prospect that it represented a change of circumstances, which may mean that the undertakings, in so far as they related to SMEs with a turnover of below €2 million,[561] were no longer appropriate and should be reviewed;

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[559] The nine banks were AIB Group (UK) plc (known as First Trust Bank) (AIB); Bank of Ireland (BoI); Barclays Bank plc (Barclays); Clydesdale Bank PLC (Clydesdale); HBOS plc (now part of Lloyds Banking Group (LBG)); HSBC Bank plc (HSBCG); Lloyds TSB Bank plc (now part of LBG); Northern Bank Limited (trading as Danske Bank); and The Royal Bank of Scotland Group plc (which also includes Ulster Bank Ltd in NI) (RBSG). The nine banks became eight following the acquisition of HBOS plc by Lloyds TSB plc in 2009.
[560] See *CMA11*, paragraph 3.10.
[561] At the time of the initial assessment, CASS covered those SMEs with an annual turnover that did not exceed €2 million (or sterling equivalent) and employed fewer than ten people (referred to as 'microbusinesses'. In March

(c) bundling: the CMA identified specific concerns with respect to compliance with these undertakings (and continued close linkages between BCAs, loans and deposit accounts, with BCAs continuing to act as a 'gateway' for those products), and therefore did not identify a realistic prospect of a change of circumstances; and

(d) portable credit histories: a number of banks had indicated that requests for portable credit histories had been very low. The government's proposals to legislate to mandate the sharing of credit information was, subject to implementation, highly likely to create a realistic prospect of there being a change of circumstances.[562]

13.5 Following consultation,[563] the CMA decided to undertake a formal review of the undertakings in their entirety alongside the retail banking market investigation.

13.6 We intend to publish our provisional decision on whether there have been any change of circumstances since the undertakings were first given and, if appropriate, a notice of intention to release, vary or supersede the undertakings in February 2016. The provisional decision will take into account all representations made by parties to date and any further submissions that we receive prior to making the provisional decision, including any responses to our Remedies Notice, where parties consider that any of our proposed remedies represent a change of circumstances if implemented.

2015, the eligibility criteria was extended to include SMEs with a turnover of up to £6.5 million (ie 99% of UK SMEs).

[562] See 2013/14 market study into SME banking, Chapter 11.

[563] The CMA received responses to its consultation from Barclays, HSBCG, LBG, and RBSG. Each of the respondents considered that a review should be an administrative priority for the CMA. In doing so, some respondents also referred to other aspects of the SME banking undertakings (eg the publication of tariffs and the provision of portable credit histories), in addition to obligations regarding the switching process, which they considered should be reviewed.

14. Review of 2008 Northern Ireland PCA banking order

14.1 The NI Order was originally put in place in 2008 following an investigation by the CC into the PCA banking market in NI. The NI Order was varied in 2011 following a review by the CC, which found that there had been a change of circumstances as a result of the coming into force of the Consumer Credit Directive (CCD) and the Payment Services Directive (PSD).[564]

14.2 The NI Order requires any bank that offers PCA banking services in NI to 10,000 or more customers (or 5,000 or more customers if the bank is part of a larger group, which has 10,000 or more customers) ('the banks') to comply with a number of information and switching requirements. See Appendix 3.1 for further information.

14.3 The CMA has a statutory duty to keep under review orders made under section 161 of EA02 by virtue of section 162 of EA02. The CMA shall from time to time consider whether by reason of any change of circumstances an order is no longer appropriate and needs to be varied or revoked.

14.4 Following consultation in May 2015,[565] the CMA decided to open a review of the NI Order alongside the review of the 2002 SME Undertakings and the retail banking market investigation, which covers retail banking services to PCA customers in the UK, including NI.

14.5 We intend to publish our provisional decision on whether there has been any change of circumstances since the NI Order was varied in 2011 and, if appropriate, a notice of intention to revoke or vary the NI Order in February 2016. The provisional decision will take into account all representations made by parties to date and any further submissions that we receive prior to making the provisional decision, including any responses to our Remedies Notice, where parties consider that any of our proposed remedies represent a change of circumstances if implemented.

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[564] The CCD established a common set of rules for consumer credit providers on the form, content and manner of provision of pre-contractual and ongoing information on consumer credit agreements, including some types of overdrafts. The PSD established a common set of rules for payment services providers on the form, content and manner of provision of pre-contractual and ongoing information on payment services to consumers. Therefore, a number of provisions in the order were deleted or amended, as they were no longer relevant or exceeded the requirements of the CCD or PSD.
[565] The CMA received 11 responses to its consultation, all of which welcomed the CMA opening a review of the order.