

Manchester, Wednesday 18th November 2015

Re: Response to CMA Retail Banking Market Investigation: Provisional Findings Report

Dear,

The CMA rightly acknowledges the considerable recent effort that has been directed to investigating retail banking competition in the UK, beginning with the Cruickshank Report published in 2000. This and subsequent reports have repeatedly made the diagnosis that the UK retail banking market is insufficiently competitive, leading to remedies intended to enhance competition. Given that past recommendations have done relatively little to resolve the apparent lack of competition it is disappointing that the current CMA investigation shows signs of more-or-less repeating the same findings and diagnosis to 'make the market work better'. We therefore agree with criticism from industry, business and political leaders¹ of the Provisional Findings Report and would encourage a re-framing of the problem.

The fact that the retail banking market has become less, not more, competitive over time, in spite of efforts to do the opposite, suggest that it is time to think about the sector in a different way. Our research carried at the Alliance Manchester Business School² leads us to conclude that previous policy has contributed to the development of a sector that lacks diversity and where most players have a similar business model. We argue that understanding this business model provides greater insights into the dysfunctionality of retail banking as well as suggesting a new focus for policy.

In particular we would like to challenge the common argument that a lack of competition and customer inertia are at the heart of the issue. Rather, we see these are symptoms of the business model that we can observe in retail banking. Some key features are outlined below, followed by a discussion of the implications for rethinking reform of the sector.

1. The model of banking is driven by selling financial products to customers, to help cover the costs of branches. Lower interest rates reduce the profitability of simple personal current accounts because of lower spreads. While 'selling' is not in itself a problem, the pressure to cross-sell unsuitable products to existing customers is evident in the enormous scale of mis-selling. Though PPI is the largest and most high profile example of mis-selling, it was by no means the first: the recurring episodes of mis-selling financial products by many banks should alert us to underlying problems with the business model.

¹ <http://www.ft.com/cms/s/0/0b530f88-78b9-11e5-a95a-27d368e1ddf7.html#axzz3rTb5aZPZ>

² Full paper 'It's the business model... Reframing the problems of UK retail banking' available from the authors.

2. The customer offer is also characterised by opacity. As is now widely acknowledged, cross-subsidies between product types and customers is prevalent with the result that customers would have difficulty understanding the cost of their bank accounts and other products provided by their bank. The free-if-in-credit current account is, of course, not free at all because customers pay through reduced rates of interest received on deposits. Products and services marketed to customers are usually opaque and overly complex in an attempt to (successfully) confuse customers when making judgements about the terms and costs of the particular offerings. Marketing campaigns make use of common practices including targeting potential new customers through teaser rates that have little or no benefits in the longer term: recent changes to the terms and conditions of Santander's 1-2-3 account are a prime example of this.
3. As with the Cruickshank report published in 2000, the provisional findings over-estimate the potential impact "crowd funding" and "digital wallets" may have on competitive conditions in retail banking (point 15). In particular, digital wallets are unlikely to replace current accounts, but instead will compete with the like of Visa, Master Card etc.

The argument that these fundamental problems could be solved by customers becoming more active in switching their accounts between providers ignores some important characteristics of the retail banking market.

- Retail banking is a mature and saturated market with most participants offering a limited, but largely similar range of core products and services.
- Innovation is limited, and mainly focused on the marketing of financial products, rather than offering customers improved or lower cost services.
- Retail banking is best thought about as a utility on which all citizens and economic actors are dependent. On this basis, retail banks have a social responsibility to provide appropriate products and services transparently and efficiently to ensure social and economic participation.
- Most UK banks are shareholder-owned, creating a homogeneous business sector, particularly compared with other countries like Germany which have greater diversity of ownership and legal forms. Shareholder ownership creates pressures for returns, partly driven by high return on equity produced in the pre-2008 period. Shareholder value-driven banking tends to focus on cost reduction (particularly branch closure) and raising fee income from selling products. As long as the UK banking sector is dominated by such pressures, complexity, opacity and selling will remain important features.

Though in principle new entrants could introduce diversity and choice for customers, this will only be the case if customers can choose between banks with different business models. To date, new entrants have either been very small or operate under the same pressures and conditions as the incumbents and therefore offer little real choice. In such a market, customer inertia and the limited amount of switching is not so much a failure of competition but a failed realisation that retail banking is a mature sector and a utility in which the dominance of a shareholder value driven business model sets demands on business performance while offering little choice. A more ambitious review of the banking sector might explore the scope for new banking models based on different ownership (such as



The University of Manchester
Alliance Manchester Business School

Alliance Manchester Business School
The University of Manchester
Booth Street East
Manchester
M15 6PB

+44 (0) 161 275 2919

mutuals, co-operatives and social enterprises) with regional and local links and better able to build relationships with both private and business customers.

Overall, there is a need for wider debate about the future of UK retail banking focusing on the business models to understand how organisations create and capture value. Customer complaints are at a high level but banks, while often failing to deliver a good service to customers, continue to make substantial returns on their retail banking operation. This suggests the need for some rebalancing of shareholder and customer/ community interests. These could most effectively be addressed through encouraging and supporting a greater diversity of business models in banking.

We hope that our analysis is useful for your enquiry and would, of course, be happy to provide further details.

Yours sincerely,

Julie Froud

Professor of Financial

Innovation

Daniel Tischer

Lecturer in Financialisation

& Business

Karel Williams

Professor of Accounting and

Political Economy