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CMA Retail Banking Market Investigation: Provisional decision on remedies

Response from the New Economics Foundation

About the New Economics Foundation (NEF)

NEF is an independent and non-partisan research institution which applies economic analysis to the improvement of social, economic and environmental outcomes. We have established a reputation as a leading civil society voice on financial reform issues and in particular on the need to diversify the UK's banking sector. NEF has been engaged with these issues for many years and has published numerous research reports relevant to the remit of this investigation which we will refer to throughout this response.

In this submission we provide some comments on the case that the CMA has made against structural separation, drawing on the findings of our research, and then respond to the key elements of the provisional decision on remedies. We would welcome the opportunity to discuss these comments with representatives of the CMA.

Comments on the case against structural remedies

In reference to the proposals from some respondents to bring more competitors into the market by breaking up the big banks, the report states that, "it is not the size of the banks or the number of banks that is the problem… Improving competition through further divestitures is an idea that is superficially attractive, but would be sensible only if we had strong evidence that it would make the retail banking market work better".[1] It also echoes the earlier conclusion that structural remedies "might simply create two smaller banks, each with a high proportion of inactive customers paying relatively high prices"[2].

Whilst we agree that breaking up larger banks into smaller but similar banks would in itself have limited impact on customer engagement, we disagree with the conclusion that the key lever for change is customer behaviour rather than the structure of the market. Genuine competition and choice requires a diversity of providers for consumers to choose from, rather than simply a larger number of major players following the same business model. With the market dominated by a small number of large, universal, shareholder-owned banks who all behave in similar ways (and who have been hit by repeated scandals), it is hardly surprising that today there is weak customer engagement and switching activity.

[1] CMA – Provisional decision on remedies p.2
[2] CMA – Notice of Possible Remedies p.43

In considering structural remedies it is therefore important to consider diversity in business models and ownership structures and its effect on competition, choice and customer engagement. In our view, of particular importance is the question of whether the market includes viable alternatives to commercial banks with the main objective of maximising shareholder value. Empirical evidence suggests that locally focused banks, particularly those owned by or on behalf of their customers (known generically as 'stakeholder banks'), perform better than large national or international banks in meeting the banking needs of customers, and in particular SMEs. [3] [4] [5] [6] [7]

NEF's 2013 report 'Stakeholder Banks' identified four main types of these banks globally; co-operative banks, credit unions, public savings banks and CDFIs (Community Development Finance Institutions). Stakeholder banks are often profit-making but not profit-maximising, and do not face the same pressure to enhance short-term 'shareholder value'. Such banks tend to display a greater focus on the needs of customers, including more competitive products, better service, and longer term lending; and often have an explicit aim to provide for customers who are under-served by commercial banks.

Local stakeholder banks can maintain intimate knowledge of local people and the local economy, and evidence suggests that they are better than commercial banks at seeking and assimilating the 'soft' information needed to holistically assess the prospects of small firms. Often described as 'relationship banking', this approach ameliorates the information asymmetry which makes SME lending unattractive to larger banks, where the drive for process efficiency and control leads to centralised systems of credit scoring that become blind to regional, local and firm specific conditions.[8] This may help to explain their higher provision of lending to SMEs, with stakeholder banks across Europe routinely commanding market shares of SME lending that are disproportionately larger than their size. Across Europe, stakeholder banks on average lend 66% of their assets to individuals and businesses in the real economy, compared with only 37% for large shareholder-owned banks.[9]

Moreover, geographically-limited stakeholder banks only invest in their local area, creating and retaining wealth regionally rather than reinforcing existing geographic lending imbalances.[10] This contributes to increased competition and choice in geographic areas

[3] See New Economics Foundation (2012) Stakeholder banks

[4] Cole, R., Goldberg, L. & White, L. (2004). Cookie-cutter versus character: The micro structure of small business lending by large and small banks. The Journal of Financial and Quantitative Analysis, 39(2): 227-251.

[5] Clarke, S. (2012). Street Cred: local banks and strong local economies. London: Civitas.

[6] European Association of Cooperative Banks. (2010). Latest key figures on the sector [webpage]. Retrieved from http://www.eacb.eu/en/cooperative_banks/key_figures/last_key_figures.html

[7] Credit Union Central of Canada. (2012). Exploring the relationship between credit unions and the small business sector: facts, figures and future prospects. System brief. Retrieved from http://www.cucentral.ca//_layouts/download.aspx?SourceUrl=http://www.cucentral.ca/Publications1/SYSTEMBrief_Small_Business_June_2012v1.pdf

[8] Berger, A., Miller, N., Petersen, M., Rajan, R. & Stein, J. (2002). Does function follow organizational form? Evidence from the lending practices of large and small banks. Journal of Financial Economics, 76(2): 237-269.

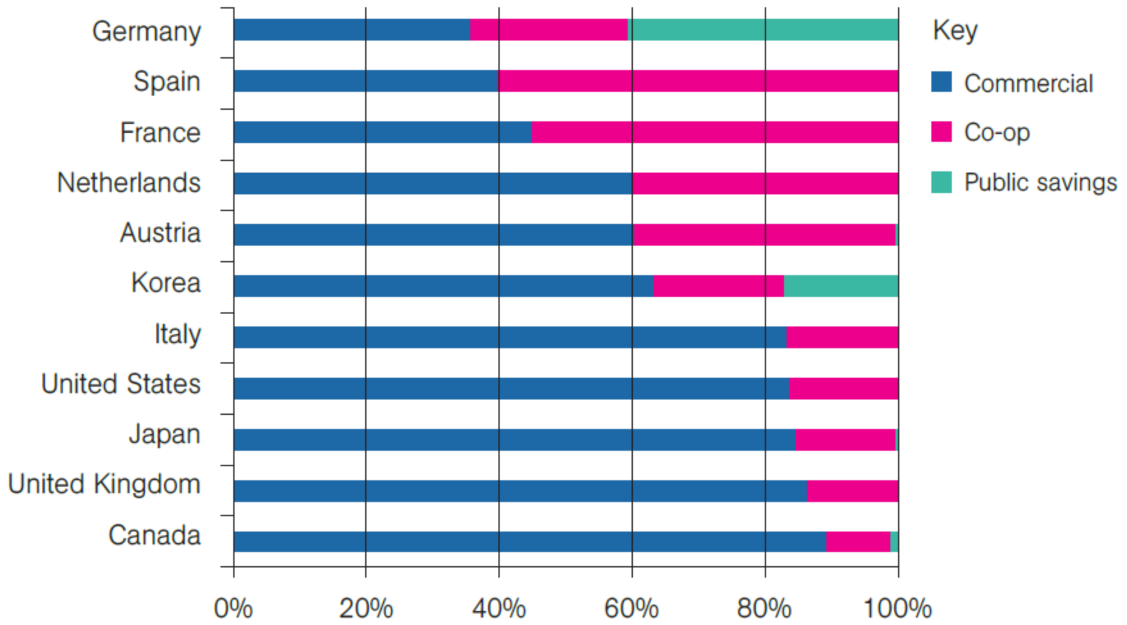
[9] See New Economics Foundation (2015) Reforming RBS: Local banking for the public good

[10] Usai, S., & Vannini, M. (2005). Banking Structure and Regional Economic Growth: Lessons from Italy. Annals of Regional Science, 39(4), 691-714; Hakenes, H., Schmidt, R., & Xie, R. (2009). Public Banks and Regional Development: Evidence from German savings banks.

which are poorly served by commercial banks – particularly relevant to the current UK context as commercial banks are rapidly withdrawing from rural areas.

As figure 1 shows, the UK is highly unusual in lacking any significant presence of this form of bank. Instead, the UK has among the most concentrated banking sector in the developed world, and is uniquely dependent on commercial shareholder-owned banks.

Figure 1: Banks' market shares of deposits by ownership type



We believe that this lack of diversity in business models and ownership within the UK retail banking market is a key factor behind the lack of competition and customer engagement that has been identified by the CMA. As long as diversity in the market remains limited, remedies that facilitate switching and promote transparency will do little to affect customers' underlying motives to engage or to switch in the first place – even where they are subject to poor service quality or value for money. If this is the case across the entire market, systemic abuse is more likely to occur as banks are perceived as being "all as bad as each other" leaving customers with little incentive to switch, as evidenced by the negligible impact that the repeated banking scandals have had on incumbent banks' market shares.

We therefore urge the CMA to re-examine the case for structural remedies by considering how diversity in business models and ownership structures could enhance competition, choice and customer engagement. NEF has argued that this could be achieved by using the majority public ownership of the Royal Bank of Scotland to restructure the bank into a network of 130 interconnected, mutually supporting local stakeholder banks – similar to the German Sparkassen.[11]

[11] New Economics Foundation (2015) Reforming RBS: Local banking for the public good

Comments on the provisional remedies

We note that the CMA's provisional remedies are mainly demand-side solutions that focus on increasing customer engagement, improving transparency and making better information available to customers. While these are welcome and may help assist customers once they have chosen to engage, we consider that they will do little to affect customers' underlying motives to engage or to switch in the first place so long as the market remains dominated by a small number of large, universal, shareholder-owned banks. Moreover, recent experience shows that demand-side responses to these issues are very weak, and rarely make a significant difference despite improved systems for engagement. For example:

- Switching levels remain extremely low. Only 3% of customers have switched accounts,[12] whilst switching volumes have fallen back almost to pre-CASS levels despite the introduction of CASS 2 years ago.[13]
- Financial incentives alone are too low to effectively encourage switching, even when taking into account switching rewards and foregone interest.[14]
- Customers generally switch because they are "pushed" to by a negative experience, rather than "pulled" by potential benefits. The top three given reasons for not switching are "Happy with current supplier" (51%), "No need/reason to change" (22%), and "Too much hassle/Can't be bothered" (20%).[15] This suggests that there is little perceived differentiation between market providers or the benefits that they offer.

In addition, the proposals fail to address a number of structural determinants which also contribute towards the lack of competition in the UK retail banking sector, including:

- The implicit taxpayer subsidy that large 'too big to fail' incumbent banks benefit from which reduces their cost of capital, placing them at a competitive advantage. This derives from the fact that large banks are able to borrow at lower interest rates than they would otherwise be able to due to the fact that there is an implicit (and now in some cases explicit) understanding that the government will step in and bail out bond holders if a large bank defaults on its debt payments. Using the methodology devised by the Bank of England's Chief Economist Andy Haldane we estimated that this subsidy amounted to £5.8 billion in 2015.[16]
- The competitive advantages arising from the calculation of risk weights in the capital requirements regulatory regime. Incumbent banks with lending history of 5 years or more can use internal ratings-based approach (IRB) for risk weighting, whilst new banks and building societies are limited to using the standardised approach (SA). In the CMA's addendum to the provisional findings the capital requirements regulatory regime it found that for every £1 of capital, large banks using the internal ratings-based approach can do 10 times more low LTV mortgage lending than a small bank or building society using the standardised approach. This puts smaller new entrants at a distinct competitive disadvantage.

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[12] CMA – Summary of Provisional Findings, section 48.c, p.14

[13] According to official BACS switching figures, there were 985,000 switches Oct 12 – Sept 13 (pre CASS) and 1,036,045 switches Oct 14 – Sept 15 (2nd year of CASS), representing only a 5% increase since the introduction of CASS. See http://www.bacs.co.uk/bacs/corporate/resources/pages/factsandfigures.aspx

[14] See GfK NOP – Personal Current Account Investigation for the CMA (2015) section 4.8

[15] See GfK NOP – Personal Current Account Investigation for the CMA (2015) Figure 43, p. 56

[16] New Economics Foundation (2016) Our Friends in the City

Conclusion

In conclusion, we consider that the provisional remedies are welcome and may help assist customers once they have chosen to engage, but they provide little incentive for those customers to engage in the first place. Furthermore, such demand-side remedies do little to address the structural impediments to genuine competition in the retail banking market identified above.

In contrast, experience from other countries suggests that an enhanced share of the market for stakeholder banks could be more effective in creating genuine customer engagement, competition and choice. Such interventions can only be achieved through structural remedies, and we therefore recommend that this warrants immediate re-examination by the CMA.