Competition & Markets Authority

Retail banking market investigation

Summary of final report

9 August 2016

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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] An inquiry group of five independent members was appointed to conduct the investigation and publish this final report.[2] Alongside this final report, we have published an overview document summarising our approach, our key findings and package of remedies.[3]

2. In relation to personal customers, our terms of reference (ToR) include only the supply of PCAs, which includes overdrafts. In relation to SMEs, our ToR are broader; they include business current accounts (BCAs) and lending products, but they exclude insurance, merchant acquiring, hedging and foreign exchange.

3. We are 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 UK or a part of the UK. If we decide that there is such a feature or a combination of features, then there is an adverse effect on competition (AEC). 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 resulting detrimental effect on customers.[4] This final report sets out our decisions on these questions.

4. In parallel, the same members also conducted a review of the undertakings that were put in place following the 2002 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). Alongside this final report we have published our final decisions on both reviews.[5]

5. The result of the recent UK referendum on whether to leave the European Union (EU) and subsequent events may have an impact on the economic

[1] Retail banking market investigation ToR.
[2] The members appointed are Alasdair Smith (Chair); Philip Marsden (Deputy Chair), Tom Hoehn, Jill May and Ed Smith.
[3] Overview.
[4] Enterprise Act 2002 (EA02), section 134.
[5] See the NI Order review case page and the SME Undertakings review case page.

outlook and the regulatory framework that applies to retail banking in the UK. However, there is considerable uncertainty in this regard. At the time of this report, the UK had not triggered the formal process of leaving the EU under Article 50 of the Treaty on European Union.

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, the Independent Commission on Banking (ICB) chaired by Sir John Vickers in 2011, and the Parliamentary Commission on Banking Standards (PCBS) in 2013. Recommendations from these reviews have been far-reaching including: the establishment of what became the Payment Systems Regulator (PSR); the introduction of a current account switching service (CASS); the 'ring-fencing' of the retail banking businesses of the banks from the riskier parts of banks' businesses due to be implemented in 2019; the imposition of 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).

7. In light of these reviews and the market studies into PCAs and SME banking which led to this investigation, we investigated three broad areas in which we had concerns that retail banking may not be working well for customers:

   (a) whether there is a weak customer response due to lack of engagement and/or barriers to searching and switching reducing the incentives on banks to compete on price and/or quality and/or to innovate;

   (b) whether there are barriers to entry and expansion constraining the ability of banks to enter or expand; and

   (c) whether the level of concentration is having an adverse effect on customers.

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

9. During the crisis, the UK government took large holdings in Royal Bank of Scotland Group (RBSG) and Lloyds Banking Group (LBG) to restore financial stability. Following Lloyds TSB's acquisition of HBOS in 2009, which created LBG, the European Commission ruled that the UK government's financial assistance to LBG constituted state aid and required a divestment which

recreated TSB in 2013. Williams & Glyn is anticipated to be separated from RBSG following a similar decision by the European Commission.

10. 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.

11. In addition, partly in response to tighter capital requirements, there has been a general contraction in lending activity in particular by the larger banks to SMEs. This has 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 (BBB) and, together with the Bank of England (BoE), the Funding for Lending Scheme (FLS) to incentivise banks and building societies to increase their lending to SMEs.

12. In addition to significant regulatory changes which are ongoing, there has been continued technical innovation in retail banking. Internet banking has doubled since 2007 with over half of customers banking online and around a third of customers using mobile banking applications.

13. The development of ‘bank in a box’ technology and the wider digitalisation of banking have 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, in particular on the use of branches and how customers engage with their accounts.

Industry background

14. Retail banking is of fundamental importance to consumers and businesses and to the UK economy as a whole. There are around 70 million active PCAs in the UK and PCAs generated revenues of approximately £8.7 billion in 2014. 97% of adults have a PCA and 5.6 million PCAs were opened in the UK in 2015.

15. Following the financial crisis there has been a rise in the number of SMEs. In 2014 there were over 5 million SMEs accounting for 99.9% of all UK businesses. There are around 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 2015 was £96 billion with a further £9 billion of invoice finance loans and £25 billion of new asset finance loans. Just under 20% of all SMEs have a loan.

16. The five largest banks in GB are LBG, RBSG, HSBC Group (HSBCG), Barclays and Santander UK plc (Santander) (part of the Spanish banking group Banco Santander SA). 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 (Danske) (Northern Bank Limited, trading as Danske Bank), whose parent bank is Danish.

17. 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 others focus on digital-only distribution channels. They include Clydesdale Bank and Yorkshire Bank (part of the same banking group), 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 Bank), Metro Bank (Metro), Virgin Money, Aldermore Bank (Aldermore), the Post Office, and Tesco Bank.

18. 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.

Regulation of banks

19. Banks and building societies are regulated under both UK and European legislation. The European laws relevant to this report will continue to apply for the time being and many of them have been (or will soon be) transposed into UK law and would not be automatically repealed on the UK leaving the EU.

20. The Financial Services Act 2012 (FS Act) introduced a new regulatory framework for financial services in the UK. Under this framework, the BoE is responsible for financial and monetary policy and for 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 FCA, which replaced the Financial Services Authority on 1 April 2013, 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.

21. 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.

22. The UK has adopted regulations to implement the first EU Payment Services Directive, which came into force in November 2009. These regulations aim to improve competition in the provision of payment services and make cross-border payments easier. The UK government plans to implement the second Payment Services Directive by January 2018 (and this is still the case following the recent EU referendum). This will update the current framework on payment services, extending its scope to payment services providers that were previously unregulated, and improving the transparency and security of payment services. The updated rules extend the requirements on banks to provide certain information to their customers including on charges and interest as well as rules to enable customers to allow third party providers to access their accounts.

23. The UK has also adopted regulations to implement the EU Payment Accounts Directive, which will come into force in September 2016. Several aspects of the regulations are already broadly in place including CASS and the requirement on banks to provide basic bank accounts. The UK regulations will also require that consumers have access, free of charge, to an independent price comparison website (PCW).

24. In January 2016, regulations under the Small Business, Enterprise and Employment Act 2015 (SBEE Act) came into force. They require certain designated banks to provide information about SMEs to designated credit reference agencies (CRAs) and a duty on such CRAs to provide information about SMEs to lenders. In addition, designated banks will be under a duty to forward details of SMEs they decline for finance to designated platforms to help SMEs link to alternative lending opportunities (subject to consent from the SME).

25. UK banks are also subject to various other regulations such as anti-money laundering (AML) and data protection legislation.

Market definition

26. We identified the following product markets to frame 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.

27. For each of the above product markets, we found that GB and NI should be considered as separate geographic markets. 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.

28. However, we found that customers use different banks and brands in NI compared with the rest of the UK. We found no such differences in relation to Wales. In relation to Scotland, while there were some differences in market share in Scotland compared with England and Wales, these were not sufficient to suggest that Scotland should be viewed as a separate geographic market to England and Wales.

29. Whilst we identified business deposit accounts as a separate product market, we did not receive any evidence to suggest that we should investigate the market for such products.

New entry

30. There has been new entry into retail banking in recent years. Aldermore entered in 2009 providing SME lending. Metro was the first new high street bank in more than 100 years when it received its banking licence in March 2010 and offers both PCAs and SME banking including BCAs. Several other new entrants in PCAs have their roots in ancillary financial or retail services such as Tesco Bank (which entered in 2014), the Post Office (which entered in 2013/14), Virgin Money (which entered in 2014), and Marks & Spencer Bank (M&S Bank, part of HSBCG) (which entered in 2012). Santander entered the UK PCA and SME banking markets through its acquisition of Abbey National plc in 2004, followed by its acquisitions of Bradford & Bingley Building Society in 2008 and Alliance & Leicester Building Society in 2009. Handelsbanken (PCA and SME) has also significantly extended its UK operations, almost doubling its branch network between 2011 and 2015.

31. There are also a number of banks that have recently been authorised or are in the process of being authorised including Atom Bank (Atom) (authorised in June 2015, digital PCA and SME), Starling Bank (digital PCA), CivilisedBank (SME) and OakNorth (authorised in March 2015 SME banking but not BCAs). In addition to traditional bank lending, alternative finance has been growing

rapidly in recent years. Despite the rapid growth, alternative finance currently accounts for a small share of SME lending (less than 2%).

Financial performance of retail banks

32. We considered possible methods that might 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 concluded that there were inherent difficulties with such an exercise which would mean that such an analysis would not be sufficiently reliable to inform our assessment of competition.

33. In particular, none of the larger banks in the UK treat their PCA or SME businesses as separate and were not therefore able to produce separate profit and loss accounts or balance sheets for these 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. We also considered that there were particular issues in estimating a benchmark return on equity (ROE) for standalone PCA and SME products and in making an assessment of profitability over time given the impact of the financial crisis and the consequent market restructurings.

34. We therefore analysed available 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 financial performance of UK retail banking. These all pre-dated the UK referendum result and several banks' recent half-year results. These reports indicated that banks were 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 continued to limit profits.

35. While the total reported income of the larger UK banks' retail divisions remained relatively stable between 2012 and 2014, reported profit in general showed an upward trend largely driven by reducing impairments. Reported average ROE of the five largest banks' retail divisions increased from 7.5% in 2012 to 11.8% in 2014 again primarily due to lower impairments. The evidence we reviewed did not suggest that ROE were 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 average ROE or average net interest margins than smaller banks.

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; most PCAs 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 generally offer a range of PCAs targeted at particular customer groups and/or offering different services and pricing structures. Just under two-thirds of active PCAs in 2015 were ‘standard’ accounts under which customers do not pay regular fees for using the account’s core transaction services. Such accounts are frequently termed ‘free-if-in-credit’ (FIIC) accounts. However, customers do not receive interest on their credit balances (interest forgone) and, like other accounts, pay directly for other services, such as fees and interest for overdraft usage (unarranged and arranged) and foreign transaction fees. Standard accounts have been declining as a proportion of new accounts.

38. A number of banks have more recently introduced so-called ‘reward’ 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 offset by the cash benefits received if the eligibility requirements of the account are met. These accounts are primarily targeted at more affluent customers with higher credit balances. In 2015, over a third of new accounts opened were reward accounts compared to only 8% in 2011 and reward accounts accounted in 2015 for just over 16% of active PCAs compared to 6% in 2011.

39. 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 11% of active PCAs in 2015. Like standard accounts, packaged accounts have been declining as a proportion of new accounts.

40. Larger banks are required to offer basic bank accounts which, while otherwise similar to other accounts, typically do not provide a cheque book or overdraft facility. They accounted for approximately 7% of main PCAs in 2014.

41. 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 accounted for approximately 3% of main PCAs in 2014.

42. For all types of accounts, the total average revenue per PCA to the bank in 2014 was approximately £177 per year including interest forgone. There is considerable variation in bank revenue across main PCAs with 10% of accounts in our sample generating average revenue of around £15 per year and the highest 10% generating over £700 in revenue per year in the last quarter of 2014.

43. Main or primary banking customers hold a PCA into which they pay their main income and from which the majority of payments are made. These customers generally have more transactions on their account, have higher credit balances and have other personal banking products with the bank and therefore generate the most revenues for banks.

44. Around half of the revenue that banks earn from supplying PCAs comes from interest the bank earns by lending out customers' credit balances (value of funds) rather than from direct charges. Approximately a third of bank revenues comes from overdraft charges. Banks derive higher revenues from customers on higher incomes with high credit balances, with revenues from customers with no overdrafts and low credit balances being the lowest.

45. We also found that, based on each bank's assessment of profitability, their PCA or personal banking businesses are profitable. Packaged accounts tend to be the most profitable type of PCA as they generally require a monthly fee that exceeds the cost to the bank of the additional benefits provided and are more likely to be held by main banking customers. Basic bank accounts and non-adult PCAs (youth, graduate and student) tend to be less profitable than standard or reward accounts because of lower credit balances and/or no access or interest-free access to overdraft facilities.

PCA market structure

46. The PCA markets in both GB and NI are concentrated, whether concentration is measured by volume of main PCAs or, for the UK, by net revenue. Concentration levels have increased since the financial crisis following Santander's acquisitions of Bradford & Bingley and Alliance & Leicester building societies and LBG's acquisition of HBOS (notwithstanding its subsequent divestment of TSB). Although new entrants and smaller banks are gaining market share this has been slow and, excluding the impact of mergers

and acquisitions, the four largest banks in GB account for over 70% of main PCAs and collectively have lost less than 5% market share since 2005.

47. In NI, the four traditional clearing banks (RBSG/Ulster, Danske, AIB and BoI) have lost market share to former and continuing building societies such as Santander, Nationwide and LBG/Halifax.

Pricing, quality and innovation in PCAs

48. The range of services provided by a PCA means that price comparisons between PCAs are not straightforward. Because the prices paid by customers will depend on their usage, including overdraft usage, we calculated prices across a sample of PCA customers taking into account their different usage of banking services.

49. Many banks offer a number of different PCAs, and we found that, at most banking groups, there are substantial differences in the prices of the different products they offer. Banks with higher market shares offer some of the cheapest products as well as the most expensive products, but only a small proportion of their customers in 2014 were on the cheaper products.

50. Approximately 45% of customers use overdrafts. Overdraft users pay substantially more for their PCAs than non-overdraft users and the average price increases with the number of days in overdraft.

51. We analysed the relationship between average prices and market share, and the relationship between average prices and length of time that accounts are held with the bank. In GB, we found that recent entrants and smaller banks tend to offer lower average prices than banks with high market shares. We also found that banks whose customers have been with them for longer on average tend to have higher prices on average.

52. In NI, we similarly found that banks whose customers have been with the bank for longer on average, tend to have higher prices on average, but our analysis did not show a clear relationship between market shares and average prices. However, there were some limitations to the data for NI as a result of which we attach less weight to the comparison for NI than to that for GB.

53. The existence of large variations in prices across banks might indicate that customers of worse-performing banks would be better off switching away from their existing bank. However, it might also be reflective of differences in service quality, with customers making a trade-off between price and quality in choosing their account. We therefore interpret the results of the pricing and quality analysis together.

54. We found that a substantial proportion of customers are paying above-average prices for below-average service quality which suggests these customers would be better off switching product. We also found that there was a significant proportion of customers who are paying above-average prices who are not very satisfied with their account, who could again benefit from switching.

55. While we found that some banks offering lower average prices and/or better quality services have been gaining market share, this was at a slow pace.

56. In a well-functioning market we would expect to see customers responding to variations in prices and quality of service. We estimated gains from switching by focusing only on financial gains, and assuming customers switched to the cheapest products for their usage. It is a static assessment, in the sense that we assume no changes in customer behaviour or provider prices, therefore the gains from switching should not be interpreted as the gains that all customers could achieve in the market through switching.

57. Our estimate of the gains from switching found that many PCA customers could make substantial financial gains from switching. In GB for customers on standard or reward accounts we found that around 90% would gain financially from switching to a cheaper product.

58. The average gain from switching for these customers to one of the five cheapest products is around £92 per year. For customers on packaged accounts, 50% of customers could gain by switching and the average gain tends to be higher at just under £170 per year. However, our analysis of gains from switching for customers on packaged accounts is more caveated, as our assumptions on the value of the benefits offered by packaged accounts may not reflect the true value to all customers of such benefits and not all customers will regard the different benefits available as interchangeable.

59. For GB customers on standard or reward accounts, the average gains are highest for those customers who use overdrafts and increase with the number of days in overdraft. Overdraft users have potentially the most to gain from switching, with GB customers in overdraft for 8 to 14 days a month gaining approximately £180 per year. GB customers who use unarranged overdrafts for eight or more days a month and do not use any arranged overdrafts could gain by switching between £540 and 564 per year. These estimated gains for overdraft users assume that such customers are offered the same size overdraft by their new bank, which may not be the case as banks have different policies and a customer's financial circumstances may change affecting eligibility.

60. The lowest gains are for GB customers on standard or reward accounts who do not use overdrafts, or are very light users of arranged overdrafts.

61. Our analysis in NI is less robust as our customer data sets are less complete. We found that in NI, around 90% of customers could make annual savings of on average £66 per year, ranging from £43 on average for customers who do not use an overdraft to £124 on average for overdraft users. As for GB, we found that gains from switching generally increase with overdraft usage. We did not find similar trends as in GB of gains from switching increasing with credit balance for customers who do not use an overdraft, nor did we find that customers with one of the larger NI banks gain more from switching.

62. Innovation can be a useful indicator of the level of competition in a market. 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.

63. There have been a number of innovations in the PCA market in recent years with respect to products (such as the introduction of reward accounts), service (as part of the wider digitalisation of retail banking); and new business models (for example by firms with only an online presence). 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.

Customer engagement in PCA markets

64. As described above, despite variations between banks in prices and quality and the gains from switching, market shares have remained broadly stable with those banks offering the lower average prices and/or higher service quality only gaining market share slowly. This suggests that PCA customers are not responding to variations in price and quality and that the scale of this lack of responsiveness is significant given the gains from switching that many customers can make. We therefore focused on understanding the level of customer engagement and the reasons behind this.

Levels of customer engagement

65. We concluded that customer engagement is low:

(a) Over a third of respondents to our survey had been with their main PCA provider for more than 20 years.

(b) Over a half of respondents had been with their main PCA provider for more than ten years.

(c) Only 3% of PCA customers had switched PCAs to a different bank in the last year. Over the past three years only 8% had switched.

(d) Over three-quarters of PCA customers had neither searched nor switched in the last year.

66. We compared PCA switching rates to rates in other sectors and found that switching rates in the last three years were materially lower for PCAs than for example in savings products (13%) and in energy (over 30%). Internal switching rates – switching PCA products within the same bank – are also very low (2.5%) and nearly three-quarters of internal switchers did not search prior to switching.

Characteristics of engaged customers

67. We analysed whether any particular customer groups are more or less likely to search, switch or hold active PCAs with more than one provider ('multi-bank'). Looking at customers who searched, switched or multi-banked we found that such customers are more likely to have higher income, higher balances and higher education levels than those who did not. Internet banking and/or having confidence in the use of the internet also increases the probability of searching and switching. Customers who hold financial products at other banks are also more likely to search and switch PCAs.

68. We found that customers who use unarranged overdraft facilities are less likely to switch than customers who only use an arranged overdraft facility. Heavier overdraft users are less likely to switch than lighter overdraft users, and the heaviest unarranged overdraft users are least likely to switch compared to other customer groups including non-overdraft users. This is despite overdraft users having much greater potential gains from switching with the gains from switching increasing the heavier the usage, especially heavier unarranged usage. However, lighter overdraft users were more likely to switch than non-overdraft users, although the differences were small and we have assumed that these customers would be offered the same size overdraft after they switch, which may not be the case.

Barriers to engagement, searching and switching

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

70. We considered the process by which consumers engage and make choices in this market. Digitalisation has facilitated customer engagement with their accounts and if properly harnessed has the potential to reduce customer searching and switching costs. However, we found the following:

    (a) Unlike other financial services products such as motor insurance, PCAs have no contract end date, which means that customers are not required periodically to consider if their PCA is best for them. Life events such as moving house had no significant effect on searching or switching.

    (b) Many customers see no reason to engage as they are satisfied with their bank. Over half and more than a further third of respondents to our survey said they are 'very satisfied' and 'fairly satisfied' respectively. This is despite differences in the prices and quality of service offered by different banks and substantial potential gains from switching. 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) Many customers believe that there is not much to be gained from switching. PCAs are relatively low-cost products, particularly for those who remain in credit and many customers see little differentiation between banks. We found that over a half of customers did not incur any direct charges in the last quarter of 2014 for using their PCA and the most common source of charges were overdraft charges. Around three-quarters of customers who incurred charges paid less than £10 in the three-month period we analysed.

    (d) There are barriers to accessing and assessing information on PCA charges and service quality because:

        (i) In order to identify the best account for them, customers need to combine information on the different account charges, eligibility criteria and rewards, and complex overdraft charging structures, with a detailed knowledge of their own account usage.

(ii) Information on account usage is currently only generally available through monthly bank statements. 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 positive development, it is not straightforward to use, its current application is not fully effective and its usage remains very low.

(iii) In addition to being complex, banks' pricing structures lack transparency and PCWs currently play a limited role.

(iv) Quality of service information is currently very limited despite 80% of respondents to our survey stating that quality of staff and service and handling problems are essential or very important features of a PCA.

71. Customers still perceive significant barriers to switching accounts despite the introduction of CASS. CASS has eased account switching as it provides a useful guarantee. However, our survey found that over half of customers considered that switching was a 'hassle' and over 40% feared that something 'may go wrong'. Research by the FCA published in 2015 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 customers were confident that CASS would complete their switch without error.

72. In addition, there are particular concerns for overdraft users. Around 4.5% of active PCAs used an overdraft in 2014 with around a quarter of PCA customers using an unarranged overdraft. Despite overdraft users tending to have the most to gain from switching, we found that:

(a) Overdraft charges are particularly difficult to compare across banks, due to both the complexity and multiplicity of the charging structures and the difficulties in understanding their own usage. In particular, customers exceeding their pre-arranged credit limit can incur substantial charges but there is no easy way for a customer to find and compare the charges or credit limits an alternative PCA might offer them.

(b) Overdraft users generally have limited awareness of and engagement with their overdraft usage. For example, over half of overdraft users we surveyed underestimated their usage by two or more months in a year and over a third were not aware that they had gone into overdraft. Moreover, around half of unarranged overdraft users did not believe they had gone into unarranged overdraft.

(c) There are additional barriers to switching for overdraft users due to uncertainty surrounding the acceptance and timing of any overdraft approval when opening a new account. In addition, a new bank may not be willing to offer the same level of overdraft facility as a customer's bank, for example because the new bank will not have access to the customer's transaction data but will need to rely on information from the customer and from CRAs.

73. We also found that unarranged overdraft users are likely to find it hardest to effectively engage with the market. Around half of unarranged overdraft users were not aware that they had gone into an unarranged overdraft. Low engagement by unarranged overdraft users is of particular concern because unarranged overdraft usage is not pre-agreed with the bank and in many cases may be inadvertent. Such usage also involves a significant increase in charges. Some customers may therefore not want to use unarranged overdrafts and would avoid doing so if they had greater awareness of their overdraft usage.

Banks' incentives to compete in PCAs

74. The behaviour of customers can play a central role in providing competitive constraints on providers. This happens if customers are engaged and willing to search for and implicitly threaten to switch to another provider, which offers them a better deal. Conversely, a lack of customer engagement in the market reduces banks' incentives to compete.

75. The evidence we gathered indicates that competition between banks is focused on acquiring the primary banking relationship and targeting more affluent customers. Consistent with this, several banks have launched new PCAs with conditions that encourage affluent customers to move their primary banking relationship to these brands.

76. There are an increasing number of initiatives in product development by banks, with the introduction of reward accounts and the introduction of one-off switching incentives, typically in the form of cash payments. Such accounts enable banks to target new to market customers and switchers. Our pricing analysis shows that some of the new reward accounts are relatively cheap compared to standard accounts.

77. Competition to attract new customers is an important aspect of banks' overall competitive behaviour. However, there has been much less active competition on other aspects such as arranged and unarranged overdraft charges and there is no evidence of banks specifically targeting overdraft users despite a significant proportion of PCA revenues deriving from overdraft usage. Many

recent changes to overdraft fees have been driven by regulation rather than the banks. This more limited competition on arranged and unarranged overdraft charges is consistent with our analysis of the levels of engagement, searching and switching by overdraft users.

78. We have considered the impact of the FIIC price model on customer engagement. We have not found that the FIIC price model itself reduces customer engagement. FIIC accounts work well for many customers as it means that such customers are not charged directly for everyday banking transactions. In addition we have found:

(a) Switching rates: evidence from other countries that do not operate a FIIC pricing model does not point to switching being higher under alternative pricing models. Similarly, the BCA market, which does not operate a FIIC pricing model, has similar rates of switching.

(b) Facilitate switching: FIIC pricing may make it easier for some customers to multi-bank and to try alternative accounts before switching.

(c) Customer engagement: whilst our survey suggests that non FIIC accounts have tended to attract more engaged customers, the differences are small and are likely to reflect that customers on reward accounts, which are relatively new accounts, are likely to consist of recent switchers.

(d) Transparency of costs of PCAs: there is a lack of transparency around the cost of PCAs and this makes it difficult for a consumer to compare PCAs and select the best one for them. However, alternative pricing models to FIIC are not necessarily more transparent than FIIC accounts. For example, pricing structures for BCAs that are not generally FIIC accounts are also complex making it difficult for SMEs to compare. Similarly reward accounts are also difficult to compare to assess best value. The underlying reason is the overall complexity of charges and any rewards including interest, and the lack of tools available to consumers to combine the charges and any rewards with their account usage, rather than the FIIC pricing model as such.

(e) Overdraft charges: banks’ incentives to set high overdraft charges arise because of the low customer engagement and barriers to searching and switching for overdraft users on all types of accounts and not just FIIC accounts.

79. We also analysed whether the FIIC pricing model means that some customers are cross-subsiding others and/or contributing more to banks’ revenues. All types of customers across different income groups and credit balances contribute to banks’ revenues once interest forgone is taken into

account, although there is considerable variation between customers in the revenue generated as described in paragraphs 42 to 44 above. Taking into account direct charges and interest forgone, the cost to the customer of a PCA increases with credit balance and the number of days overdrawn. We did not find that it is the customers on the lowest income who pay most for their PCAs.

80. We found that arranged overdraft users tend to have higher incomes and higher education than non-overdraft users and those who use unarranged overdrafts. We also did not find that heavier overdraft users have lower incomes than lighter overdraft users on average.

81. Setting aside basic bank accounts, which are likely to be used by the most financially vulnerable and which are likely to be cross-subsidised by other customers, we found that the costs of PCAs (including interest forgone) are highest for customers in the highest income deciles and this is particularly the case for FIIC accounts. Conversely customers with no overdraft and low credit balances pay the lowest costs.

82. We also did not find that the FIIC model limits banks' abilities to adopt alternative pricing structures to differentiate themselves. Many banks, including new entrants and smaller banks, are adopting alternative pricing models including reward accounts. These alternative pricing models have been relatively successful in attracting new customers. The main barrier to customers engaging with such accounts is not the FIIC model itself but the complexity for customers in comparing and assessing best value and the barriers to switching.

Findings in relation to customer engagement in the provision of PCAs

83. The overall level of PCA customer engagement, while having increased in recent years in particular due to the increasing digitalisation of banking, remains low. This is demonstrated by the low levels of searching and switching and the existence of substantial gains if customers were to switch PCAs. We have also found specific concerns regarding the low level of engagement of and difficulties in searching and switching for overdraft users.

84. 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. This in turn weakens banks' incentives to compete to gain new customers and retain existing customers. There is in particular a lack of competitive pressure on overdraft charges especially unarranged overdraft charges. Overall, we have therefore found that competition in PCA markets is not working well.

85. We consider further the overall impact of this low customer engagement on barriers to entry and expansion (together with our analysis of other potential barriers to entry and expansion) and the market power of the banks before summarising our findings on the features giving rise to AECs and the remedies we are putting in place to address these.

Competition in SME banking

Introduction

86. Banking services including BCAs are an indispensable service for the vast majority of SMEs. How an SME uses its bank and what it needs 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.

87. Over 97% of SMEs in the UK had turnover of less than £2 million. 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, nearly half of SMEs are over ten years old and over a quarter are over 20 years old.

88. There is little variation between types of BCA. 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 basis. Larger SMEs may negotiate bespoke pricing terms for their BCAs. 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.

89. Alongside transactional services, banks generally 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 deposit accounts. How and what advisory and support services are provided by most banks to SMEs will vary with the size of the SME. The smallest SMEs will generally have access to a call centre whereas larger SMEs will generally have a personal relationship manager.

90. For many SMEs, banks are also an important source of finance. SMEs need finance 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.

91. In 2014, 48% of SMEs had credit cards and 43% had overdraft facilities. However, only 18% of SMEs had held a loan and very few SMEs with turnover below £2 million had taken out commercial mortgages, invoice finance or asset finance. While smaller SMEs represent over 97% of SMEs, they accounted for around three-quarters of new loans by volume and less than half by value.

92. We collected data on banks' UK revenues to understand the profitability of their SME operations and, where possible, the profitability of individual products and customers. BCAs (or wider SME banking, depending on banks' own assessments of profitability) are profitable. The volume and type of transactional activity is particularly important to the profitability of BCAs. 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. Charities, clubs and societies on the other hand are the least profitable SMEs for banks as they usually get 'free' transactional banking, are likely to have lower credit balances and are more likely to use cheques, which are more costly for banks to process.

93. Average net revenue including the value of funds per active BCA in 2014 was £736. As with PCAs, nearly a half of net revenue is from the value of funds deposited and just over a third from overdraft charges. There has been a decline in net revenues from BCAs since 2012 driven by a reduction in revenues from overdraft charges and from transaction charges and other receipts. Unlike PCAs, there has been an increase in the net value of funds.

94. Whilst BCA revenues have declined, total revenues from interest and charges on general purpose loans have increased since 2011. This has been driven by interest charges and other receipts. However, invoice finance revenue and net revenue from business deposits has declined.

Structure of SME banking markets

95. In 2015, the markets for BCAs in GB and NI were concentrated, with the NI market more so. The combined market shares of active BCAs of the four largest providers in GB (RBSG, LBG, Barclays and HSBCG) and in NI (RBSG, Danske, BoI and AIB) were 83% and 86% respectively in 2015. Their combined shares have declined by only 1 percentage point in GB and 2 percentage points in NI between 2012 and 2015.

96. We have considered separately the different SME lending products. We found that levels of concentration in general-purpose business lending (including commercial mortgages) are high in both GB and NI. Similarly, the markets in GB and NI for general-purpose business loans to SMEs with turnover of less than £2 million are more concentrated than for larger SMEs.

97. The equivalent data for invoice finance is incomplete because figures for a significant number of finance providers are not available. However, given the larger number of providers and the 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 SME business loan market are lower than for general-purpose business loans.

Pricing, quality and innovation in SME banking

98. BCA charges are complex and vary significantly between SMEs depending on usage, whether the SME is able to negotiate fees, whether it benefits from so-called 'free' core transactions and whether it pays a per-transaction or a monthly fee. This complexity makes comparisons of BCA pricing challenging. In order to make comparisons across banks, we applied banks' current BCA charging tariffs to representative SME customer profiles for SMEs with SMEs with annual turnover less than £2 million.

99. We found substantial variations in BCA monthly charges between banks. In GB, the difference between the highest and lowest monthly costs was over 100% for the majority of the customer profiles. For five of the profiles, the highest monthly cost was over three times as large as the lowest monthly cost. Similar variations were found in NI and monthly prices are generally higher than those in GB. However, we did not find evidence of a clear association between price and market share in GB or NI.

100. We have not undertaken a similar analysis of SME loan pricing. There is wide variation in types of lending and loan pricing is opaque, complex and tends to be more tailored reflecting the nature of the SME, and the term and size of the loan. Any pricing analysis would therefore be highly data intensive and complex, and the inferences that we could draw from it would be limited.

101. To compare the quality of SME banking services across banks, we considered indicators such as customer satisfaction scores and net promoter scores and also measures of satisfaction with relationship managers. We found that many new entrants in the provision of BCAs in GB typically had higher satisfaction and net promoter scores compared with the larger longer-

established banks, which all had similar satisfaction scores. In NI, results were less clear cut. As with price, however we did not find a clear association between quality and market share in GB or NI.

102. We observed that some 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 slow pace.

103. We also assessed the levels of innovation in SME banking. We found that there has been little product innovation and innovation has tended to focus on the digitalisation of banking and reducing customer reliance on branches. These innovations have lagged behind the levels observed for PCAs. For example, some banks do not offer mobile banking to SMEs and/or offer less functionality than they offer to PCA customers. This may be explained, at least in part, by the size of the respective markets.

SME engagement in BCA markets

104. The levels of concentration and stability in market shares despite variations in price and quality between banks and the limited levels of new entry and innovation suggest that SMEs are not responding to variations in price and quality and that competition is not effective. We therefore focused on understanding the level of SME engagement with BCAs and the reasons behind this.

Levels of engagement in BCAs

105. 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 a BCA; and third, more established SMEs whose needs for other banking products and services, including in particular lending, may increase and the banking relationship may become stronger.

106. In relation to BCAs, we found little evidence that SMEs search or consider switching:

(a) Over half of start-up SMEs in GB went to their owner's PCA provider for their first BCA and a third did so without searching at all.

(b) Over half of all start-up SMEs did not compare providers and nearly a further quarter 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.

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

107. While satisfaction with their provider was the main reason given by SMEs for not considering switching BCA, over a third of SMEs dissatisfied with their bank also did not consider switching and this was consistent with our qualitative research on SME behaviour. In addition, the low levels of searching and the differences in price and quality between providers suggest that many SMEs may not be making an informed decision to remain with their BCA provider.

108. We therefore investigated whether there are other factors that act as barriers to searching and switching.

109. We examined SMEs' attitudes to banking and found that there are a number of factors that may reduce searching and switching. There is a lack of triggers that would prompt them to consider their BCA, and BCAs are relatively 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 among SMEs that potential gains from switching are not high and that there is limited differentiation between banks. This perception is not borne out by our BCA pricing analysis which found significant differences between the highest and lowest monthly costs of a BCA for almost all our customer profiles. Whilst our estimates should be interpreted carefully, our BCA pricing analysis suggests that, in GB, SMEs could save around £80 per year on average by switching to the bank that was cheapest based on their transaction behaviour. In NI the equivalent figure is around £112 per year.

110. We found that while price information is available, it is difficult for SMEs to compare charges across banks. This is because of the complexity of tariff structures, the variability in usage and the lack of publicly available comparable information on the quality of banks' services. The equivalent of Midata in PCAs does not exist for SMEs and there is a lack of effective price

comparison tools, making comparison time consuming and difficult. Websites such as Better Business Finance (BBF) and Business Banking Insight (BBI) focus on specific aspects of SME banking – for example, service quality. Finance platforms that currently operate in the market (including Bizfitech, Funding Options and Funding Xchange) provide information on alternative sources of finance to the large banks, but offer limited comparisons of other services such as BCAs. This lack of effective comparison tools is likely to particularly affect smaller SMEs without specialist financial capability.

111. There are also barriers to switching BCAs.

(a) The account opening process can be lengthy and onerous, particularly because of banks' informational requirements for undertaking AML compliance.

(b) Awareness of CASS is low among SMEs, despite most being eligible. Of those who switched in 2014, only 10% switched through CASS. 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.

(c) 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 switching process.

(d) For some customers, access to lending may deter them from switching for fear that doing so would make it less likely that they would be able to access ongoing lending or future lending.

Banks' incentives to compete in BCAs

112. 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) PCA providers have advantages in acquiring start-up SMEs, with over half of SMEs in GB opening a BCA with their owner's PCA provider. Only one small prospective entrant is planning to provide BCAs but not PCAs. At the end of the 'free' banking period, the most important factors driving choice of BCA provider for start-up SMEs were branch location and the bank being the SME owner's personal bank.

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

113. We looked at how banks compete for SMEs at the end of their ‘free’ banking period and for more established SMEs and found the following:

(a) While there are some offers of ‘free’ banking periods as inducements to BCA switchers, this is becoming less common in particular by newer entrants and smaller banks.

(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 sell other products. Where relationship managers have customer acquisition targets, these tend to be geared towards the largest SMEs (turnover above £5 million).

(c) Banks tend to negotiate with larger SMEs, but not smaller SMEs. However, while important for banks in terms of revenues, larger SMEs represent less than 5% of all SMEs.

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

SME engagement in SME lending

114. As SMEs grow they are more likely to seek additional products from their bank or other providers. Most SME lending by value is taken by larger SMEs 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%).

115. We considered, as in PCAs and BCAs, the level of engagement and whether there were barriers to searching in SME lending that prevented SMEs from identifying the best lending products for their needs. Our surveys of SMEs found that:

(a) around 90% of SMEs went to their main bank for overdrafts, general-purpose business loans and credit cards; over two-thirds went to their main BCA bank for invoice discounting and factoring and more than three-quarters for commercial mortgages; and

(b) over half of SMEs considered only one provider when seeking lending.

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

(a) Relationship with main bank: 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 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. We found that a quarter of SMEs did not consider other providers because of the 'hassle' or time associated with applying for finance. Time spent searching and completing applications – including gathering necessary documentation – varies significantly and so does the time it takes for banks to subsequently make a decision.

(c) Barriers to searching: it is difficult for SMEs to compare prices, eligibility and other terms across banks. Prices are opaque and lending products are complex. Banks do not publish indicative tables of interest rates, management fees or eligibility 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. We have also identified that there is a potential risk to SMEs' credit ratings from searching.

Banks' incentives to compete in SME lending

117. The nature of customer engagement in the market will affect banks' behaviour. Some banks have sought 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 are mainly focused on retaining existing BCA 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 is mostly targeted at larger SMEs which are best able to negotiate and with a view to acquiring the main banking relationship. Evidence of pricing initiatives and discounts aimed at attracting new customers is limited.

Findings on SME engagement in BCAs and SME lending

118. Overall we therefore find that competition for both BCAs and SME lending is not working well for customers. A combination of factors mean there is weak customer response to price and quality weakening the constraints on banks from customer switching or the threat of switching, or in the case of SME lending going to an alternative lender. As a result banks have limited incentives to compete in BCAs or SME lending on price and quality. With greater customer engagement banks will have stronger incentives to compete.

119. We found that in particular smaller SMEs that no longer benefit from a 'free' banking period are most likely to be affected by the reduced competitive constraints on banks in BCAs from this weak customer response. We also found that smaller SMEs, in particular those that are less able to negotiate better prices and terms, are also most likely to be adversely affected by the reduced competitive constraints on banks in SME lending.

Barriers to entry and expansion

120. 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. As set out above, there is weak customer response by PCA customers and SMEs in relation to BCAs and SME lending, as well as, in relation to SMEs, strong product linkages and information advantages. New entrants and smaller banks seeking to enter or expand therefore have to invest heavily in order to attract customers away from the incumbent banks over and above the inherent costs of entry and expansion. Even then, it will take some time before they are able to acquire a sufficient volume of customers to recover their costs of entry and expansion and/or to have a sufficient presence in the market commensurate with their initial investment. The high cost of customer acquisition arising from this weak customer response, including strong product linkages, is a barrier to entry and expansion in PCAs, BCAs and SME lending.

121. We considered a number of further potential barriers to entry and expansion. Previous reviews have found the authorisation process for banks, the cost of IT and access to branches as barriers to entry or expansion in retail banking. We no longer find this to be the case. A revised authorisation process has enabled a more flexible approach enabling banks to become authorised with restrictions before committing to large potentially irreversible upfront investments. While economies of scale and scope still exist in retail banking markets, technological developments have reduced the cost and risk of upfront investment in IT systems and enabled the development of alternative

business models that do not rely on branches as a distribution channel. If a branch is part of a new entrant's business strategy, we did not find that it has any cost disadvantages or other difficulties compared to incumbent banks.

122. We also looked at AML regulations and did not find that these were a barrier to entry and expansion but as described above banks' differing requirements for compliance can make it more difficult for customers, in particular SMEs, to search and switch accounts. We also looked at whether accessing funds to set up as a bank or intermediaries as a distribution channel were problems for new entrants and did not find that this was the case.

123. Access to payment systems has long been identified as an issue because the payment systems are owned by the four largest UK banks and many other banks access the payments systems through one of the four banks. The PSR, which has only been fully operational since April 2015, has a primary objective of ensuring that payment systems operate in a pro-competitive way. It has an extensive work programme looking at the issues we identified and we consider that it is best placed to take forward and address these long-standing issues.

124. In July 2015, the government made changes to reduce the bank levy over time. The bank levy had been imposed, following the financial crisis, on the larger banks to ensure that they made a greater tax contribution reflecting the risks they posed to the financial system and the wider UK economy. Also in July 2015, the government introduced the corporation tax surcharge on a wider group of banks. A number of smaller banks raised significant concerns with these changes.

125. We did not find that the changes are currently deterring entry and expansion or causing exit from retail banking. The bank tax regime continues to favour smaller banks including new entrants. However, the recent changes to the bank tax regime have reduced the previous tax advantage that new entrants and smaller banks had over those banks subject to the bank levy. Moreover, there are aspects of the design of the corporation tax surcharge that may lead to differential effects across retail banks and that might impact on competition between banks in the future. We therefore welcome HM Treasury's (HMT) commitment to keeping the impact of the bank tax regime on smaller banks and new entrants under review.

126. We identified three areas of particular concern in respect of barriers to entry and expansion: capital requirements; the costs of funds for lending; and information asymmetries between banks.

Capital requirements

127. The capital requirements 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. The amount of capital a bank has to hold depends on the structure of a bank's asset book, its risk profile, whether it is classed as a systemic bank, and its business decisions. Also the dual system of calculating the amount of capital a bank has to hold against different types of lending, results in some banks, primarily new entrants and smaller banks, having to hold much higher amounts of capital for the same lending than incumbent banks, for many types of lending.

128. The difference is particularly acute in the case of residential mortgages, especially low loan-to-value mortgages. Residential mortgages are a large and profitable part of the activities of many banks and we found that new, and some smaller, banks are at a competitive disadvantage in residential mortgages as a result of the differential in the amount of capital they are required to hold compared to many incumbent banks.

129. Two members of the inquiry group are of the view that the evidence is sufficient to support a finding that the capital requirements regime for mortgages has sufficiently large effects on the costs and returns of banks to be a barrier to entry and/or expansion in retail banking more generally, including the supply of PCAs and of SME banking services. The majority of the inquiry group, however, consider that further evidence would be needed in order to be confident about the materiality of the competitive disadvantage and the impact on outcomes in order to support a finding that the differential in capital requirements in residential mortgages is a barrier to entry and/or expansion in PCAs, and/or SME banking (or indeed in other retail banking markets).

130. We decided that it would not be appropriate to undertake further analysis on this issue. We do not have powers to change the capital requirements regime and the regime as a whole is the subject of a number of significant developments for reform at international level. Moreover and importantly, the PRA, BoE and HMT, which have primary responsibility in this area, have confirmed that they are considering the issues we have identified as a matter of priority to ensure that the competition impacts are given due weight. In light of this and the importance of the capital requirements regime to the safety and soundness of the UK banking system, it would not be appropriate to create regulatory uncertainty in this area by seeking to pre-empt the ongoing work of the PRA, BoE and HMT.

Costs of funding for lending

131. The high cost of customer acquisition means that it is expensive and time consuming for new entrants and smaller banks to attract retail deposits which are then used by banks to fund their lending activities. Incumbent banks on the other hand benefit from access to an existing stable book of lower cost retail deposits. The larger the customer base and the more diversified the product portfolio, due to product linkages, generally the greater the costs of funding advantage for an incumbent bank.

132. We also find that incumbent banks enjoy some cost advantages in wholesale funding. This advantage is most readily quantifiable for those banks that are viewed by investors as 'too big to fail' (TBTF). Such banks are viewed by investors as lower risk and therefore benefit from lower wholesale funding costs. Other factors may compound the wholesale cost advantage from TBTF over and above the firm-level differentials to be expected in a well-functioning market.

133. Since the financial crisis, regulators in the UK and internationally have been seeking to address TBTF as it raises not only competition issues but also prudential concerns. The measures taken to date have reduced the impact of TBTF and the 'ring fencing' of the larger banks' retail businesses from the riskier parts of their businesses from 2019 will further address this.

Information advantages

134. 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. This is common in many retail industries and with increased digitalisation, the use of such data is likely to increase. However, we have not found strong evidence that such informational advantages are acting as a barrier to entry or expansion.

135. In relation to SME lending however, an SME's BCA provider will benefit from better information about the financial history on their existing SME customers than alternative providers. This gives an SME's BCA provider an advantage in pricing and assessing default 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 such 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 financial and transactional data is a barrier to entry and expansion to SME lending.

Overall conclusions on barriers to entry and expansion

136. We therefore find that the high cost of customer acquisition including product linkages and, in relation to SME lending, the informational advantages of the BCA provider, make it difficult for new entrants and smaller banks to expand and are a barrier to entry and expansion. Combined with economies of scale and scope in retail banking, this means that incumbent banks have first mover advantages and are able to spread their costs over an established customer base. They also have lower costs of funds for lending as they have access to stable and lower cost retail deposits from their established customer base and, particularly for the largest incumbent banks, wholesale funding advantages. These incumbency advantages are particularly strong for incumbent banks with larger customer bases.

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

137. 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 investigated.

138. As described above, we found that retail banking markets are concentrated, excluding the impact of mergers and acquisitions, the larger banks in both GB and NI in aggregate have lost market shares, but this reduction has been small.

139. In general, the combination of persistent concentration in a market and barriers to entry and expansion may indicate competition problems and lead to worse outcomes for customers.

140. We analysed prices and service quality in both the PCA and BCA markets in GB and NI. Our comparisons of BCA prices is more limited but overall we did not find any evidence of a clear relationship between BCA market shares and prices. Neither did we find a relationship between market shares and service quality for PCAs. The lack of a corresponding relationship between price or quality and market shares was also the case in relation to NI for both PCAs and BCAs.

141. However, in relation to PCAs in GB, we found that banks with larger market shares have a tendency to charge higher average prices than banks with

lower market shares. This might suggest that larger banks have more market power and we considered carefully whether this was the case.

142. As described above, the majority of PCA customers are not responsive to price or quality. Banks therefore do not need to work hard enough to gain and retain customers. This gives banks a source of unilateral market power over their existing insensitive customers. However, the extent to which PCA customers are insensitive to price varies. Some customers are more price sensitive, actively look for better deals and respond to price and quality differences by switching.

143. The evidence suggests that the proportion of active and inactive customers and product mix are important factors explaining why we find that banks with larger market shares tend to charge higher PCA prices on average. The larger banks offer lower priced accounts to new customers and switchers, but because they have relatively larger proportions of customers on more expensive accounts than the newer and smaller banks, the prices of banks with high market shares are, on average, higher.

144. The difference in the proportion of active and inactive customers at larger banks as compared to smaller banks may have been the result of them having weaker incentives to compete for active customers, including concerns about engaging their own customers to switch. We note in particular, the role that entrants and banks seeking to expand have had in the introduction of lower priced accounts. Overall, however, we find insufficient evidence to support a finding that the current concentrated market structure is itself having adverse effects on competition and detrimental effects on outcomes in PCAs or in SME retail banking.

Our findings on competition in the provision of PCAs, BCAs and SME lending

145. 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.

146. However the weak customer response to price and quality we have found in the PCA, BCA and SME lending markets means that the discipline imposed by customers on banks through switching and the threat of switching is not as strong as it should be. It also leads to banks having unilateral market power over their existing customer base. As a result banks’ incentives to compete on price and/or quality and/or to innovate are reduced.

147. Further, as a result of the weak customer response including product linkages in respect of BCAs and SME lending, customer acquisition costs are high,

which makes it difficult for new entrants and small banks to expand, and is a barrier to entry and expansion. This barrier to entry and expansion, combined with the economies of scale and scope in retail banking markets, gives incumbent banks first mover advantages as they have an established base of customers over which to spread their costs. Such banks also have lower costs of funds for lending in particular due to access to an established book of lower cost retail deposits. These incumbency advantages are particularly strong for longer-established banks with larger existing customer bases. In relation to BCAs and SME lending such incumbency advantages are also particularly strong for banks with an existing PCA or BCA customer base given the product linkages between PCAs and BCAs and BCAs and SME lending respectively and, in relation to SME lending, the information asymmetries between an SME's BCA provider and other providers of lending products.

148. An overall consequence of this is that larger longer-established banks are able to maintain high and stable market shares.

149. We have therefore 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 NI is leading to AECs.

150. We have also found that the 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.

151. We have also found that the combination of barriers to searching, strong 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.

152. Certain customer groups are particularly affected by the AECs we have 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.

(b) Overdraft users, as charging structures for overdrafts are particularly complex and lack transparency. They also have greater difficulty in switching and have limited awareness of and engagement with their overdraft usage. Heavier overdraft users are particularly unlikely to switch and unarranged overdraft users incur unplanned charges and may not even be aware that they have started to incur such charges.

(c) SMEs that no longer benefit from a 'free' banking period.

(d) Smaller SMEs, in particular those less able to negotiate better terms and prices on lending.

153. While we have identified three separate AECs in each of GB and NI in relation to PCAs, BCAs and SME lending respectively these AECs are linked. Larger 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. The GB and NI markets are also linked and we have the same features in both. Given this, the detriment to customers from each AEC we have identified will therefore arise not only within each market in which we have identified the AEC but also in the markets of the other AECs.

Our remedies package

154. As the weak customer response plays such a central role in our diagnosis of the competition problems in the retail banking markets, measures to engage, empower and inform personal and business customers are at the heart of our remedies package.

155. This weak customer response does not have a single cause. There is therefore not a single 'magic bullet' that puts everything right. We are proposing a package of remedies the strength of which lies in the fact that the whole package is more than the sum of its parts.

156. As described in paragraph 6 above, there has been a succession of investigations of retail banking markets over the years, resulting in a series of interventions, some of them quite recent. Where it makes sense to do so, we aim to build upon and strengthen existing initiatives rather than replace them.

157. The pace of technological change in retail banking is speeding up – mobile banking tools have been rapidly adopted, and a growing financial technology ('FinTech') sector is developing and applying new tools. Application programming interfaces (APIs) will allow publicly available data and customers' own data to be shared with trusted third parties, and 'open standard' APIs can be particularly powerful (with necessary safeguards for security and privacy) in opening up new customer information and advice services.

158. The overall shape of our remedies package is also influenced by the insights of 'behavioural economics' which tell us that the differences between effective

and ineffective interventions may be quite subtle. We have drawn on our own and others' customer research in developing our proposals, and in a number of areas we recommend the use of customer research including randomised controlled trials (RCTs) to refine the design of remedies and ensure they are as effective as possible in changing customer behaviour.

159. Before setting out our remedies, we explain why we are not taking forward certain remedies which have been the subject of longstanding debate and concern in retail banking.

(a) **Divestiture**: Some parties argue that the main reason why there is too little competition in UK retail banking is because the market is dominated by a small number of big banks, and that the way to put that right is to bring more competitors into the market by 'breaking up the big banks'. As summarised in paragraphs 137 to 144 above, we have looked carefully at this, but have come to the view that market concentration may be having an effect on competitive behaviour but the evidence is neither strong nor conclusive that this is leading to worse outcomes for customers. In addition the separation of TSB from LBG and the upcoming separation of Williams & Glyn from RBSG have demonstrated that such divestitures can be prolonged and expensive exercises and are highly disruptive for those customers affected. Improving competition through further divestitures is superficially attractive, but would be sensible only if we had strong evidence that it would be an effective and proportionate remedy to the AECs we have found. We have not found that the evidence supports such an intervention.

(b) **FIIC**: Other parties have suggested that competition problems arise because of the prevalence of FIIC current accounts for personal customers. For the reasons set out in paragraphs 78 to 82 above, the real issue is not the FIIC price model as such, but a wider problem in that it is difficult for customers to work out whether their current account provider is offering them the best value or whether they would be better off with a different provider.

160. Our focus is on improving competition in retail banking to the benefit of personal and business customers by addressing the AECs we have found. Our remedies will drive innovation and improve products and services, disrupting the status quo. If the measures we are introducing lead, as we intend and expect, to increased competition, this will stimulate entry by new competitors and expansion by smaller competitors, putting pressure on the market position of the larger banks. Similarly, we have already seen a move away by customers from FIIC accounts and would expect this to increase with our remedies in place.

161. Our integrated package of remedies is illustrated below, and consists of four elements:

(a) Three cross-cutting **foundation measures** that will underpin increased competition in our reference markets. They have the object of increasing customer engagement and making it easier for personal and business customers to compare the prices and service quality of different providers and of encouraging the development of new services.

(b) Additional measures to make **current account switching** work better, including building on and improving the existing CASS.

(c) A set of measures aimed at **PCA overdraft** users, a group of customers who suffer particularly from the competition failures in the PCA market.

(d) A set of measures targeted at the specific problems in **SME banking**, making it easier for SMEs to compare different providers and reducing the hold that incumbent banks have in the market for BCAs and SME loans.

Overview of the remedy package

Foundation measures		
	Open Banking standard Service quality information Customer prompts	
Current account switching measures	PCA overdraft measures	Additional banking measures for small businesses
Better governance of guaranteed switching service Extended redirection of payments following switching Customer access to transactions history Customer awareness and confidence	Overdraft alerts with grace periods Monthly maximum charge (MMC) Improved account opening and switching process	Competition to develop SME comparison tools Loan rate transparency Loan price and eligibility indicator Standard information requirements for BCA opening Sharing of SME information 'Soft' searches Role of professional advisers

162. We will use our legal powers to impose some of the measures by order, while other measures will be implemented by our accepting legally binding undertakings from Bacs Payment Schemes Limited (Bacs), which operates CASS. Our remedies will not apply to private banks meeting relevant criteria and a number of our remedies apply only to the largest providers, while others only apply above a de minimis threshold.

163. For some of our remedies (including those where the final design will be subject to a programme of RCTs), we will collaborate with the FCA, and work closely with government departments, including HMT and the Department for Business, Energy & Industrial Strategy (BEIS), on the implementation of our decisions.

Foundation measures

164. The foundation of our remedy package is provided by three cross-cutting measures whose objective is to promote customer engagement and help customers make reliable and easy comparisons between banks based on their products' prices and features, quality of service and customers' own transaction history.

165. These measures aim to empower SMEs and personal customers to take greater control of their banking arrangements, reduce the costs to customers of shopping around, and encourage the development of a dynamic intermediary sector including providers of digital comparison tools and other FinTech advisory services.

166. Of all the measures we have considered as part of this investigation, the timely development and implementation of an open API banking standard has the greatest potential to transform competition in retail banking markets. We believe that it will significantly increase competition between banks, by making it much easier for both personal customers and SMEs to compare what is offered by different banks and by paving the way to the development of new business models offering innovative services to customers.

167. APIs are the key to the digital services that are used on computers and smartphones. They enable users to share information, for example on location or preferences. They are the technological drivers behind digital applications like Facebook, Google Maps and Uber. In banking, APIs can be used to share, in a secure environment, information such as the location of bank branches, prices and terms of banking products. APIs may also be used, with the customer's informed consent, to share securely their transaction history to enable access to tailored current account comparisons and other services.

168. We are requiring the largest retail banks[6] in both GB and NI to develop and adopt an API banking standard so as to share information to a specified timetable and we are requiring it to be an open standard so as to enable it to be widely accessible. This will enable intermediaries to access information

[6] RBSG, LBG, Barclays, HSBCG, Santander, Nationwide, Danske, BoI and AIBG.

about bank services, prices and service quality. Customers who are satisfied about privacy and security safeguards, and are willing to give consent, will be able to share their own transaction data with trusted intermediaries, which can then offer advice tailored to the individual customer. This will make it easier for customers to identify the best products for their needs.

169. Open APIs are central to our package of remedies. We will ensure that the programme of work to introduce open APIs is effectively managed and does not get bogged down in debates between market participants by creating a new entity, funded by the banks but led by an independent trustee, to ensure the timely delivery of this core remedy. We will also ensure that the views and interests of other major stakeholders, for example smaller banks and FinTechs, are fully represented.

170. We have considered very carefully the importance of data security and redress for customers. Customer confidence in the security of their information and, if a breach does occur, the availability of appropriate and speedy redress, are likely to matter at least as much to customers as the opportunities and benefit from using new technology. The security measures, as well as provisions in upcoming payment services legislation, provide a blueprint for how these issues can be dealt with effectively, though further detailed work on this issue will be necessary during the implementation of this remedy.

171. To ensure that sufficient time is available to work through the important issues associated with customers' data security and redress, the release of information under this remedy will take place in stages. We are requiring the banks to release the least sensitive information – for example about prices, terms and conditions and branch location – by the end of March 2017. We expect that all aspects of an open banking standard for sharing transaction data would be up and running by early 2018 at the latest.

172. Our second foundation measure will ensure that banks' customers get much better information on service quality than they currently have.

173. We are requiring banks to display prominently a number of core indicators of service quality. Our preferred measures of quality are based on customer willingness to recommend their bank to friends, family or colleagues. Data will be collected twice a year on a standardised basis, so that customers can easily compare across banks.

174. We are also requiring banks to collect and publish a wider range of additional quality measures that they will make available, alongside the core indicators, through open APIs to intermediaries which can use them in new kinds of

advisory and comparison services. The FCA is best placed to work with banks to develop and test which specific additional measures of service quality would be most useful, and then to put these measures in place, and we are making a recommendation to that effect.

175. Our third foundation measure deals with the lack of customer engagement that is in part caused by the ‘evergreen’ nature of current accounts that have no contract end date. Unlike other products, most customers hold a bank account for many years without ever being prompted to make a conscious choice about whether to continue or switch provider. Our remedy is therefore that personal and business customers should receive occasional reminders (‘prompts’), at suitable times, to encourage them to consider their current banking arrangements and shop around for alternative banking services. Some prompts might be triggered by specific events affecting the customer such as the closure of a local branch; others might be periodic, such as a reminder included in an annual statement.

176. We have identified a number of possible prompts and have also reviewed helpful suggestions from interested parties. Rather than trying to ‘pick a winner’, based on our current state of knowledge, the design and timing of such prompts needs to be based on further, careful research if they are to be as effective as possible. We are therefore recommending that the FCA should undertake a programme of RCTs to identify which prompts are likely to be most effective in changing customer behaviour. We are also recommending to the FCA that, subject to the results of the RCTs, it should implement, monitor and (when necessary) update such prompts. To facilitate this process banks will be required to cooperate with the FCA in this research programme. We will also be requiring BCA providers to send prompts to those SMEs not covered by the FCA’s powers.

177. As we discuss further below in paragraph 193, we are also requiring banks to provide prompts to help customers control the charges they pay to their existing bank, especially unarranged overdraft fees.

Current account switching measures

178. Even when a bank customer recognises that they could gain from switching banks, they might not do so if they lack confidence in the switching process.

179. We have found that both personal and business customers fear that switching current accounts is burdensome and time-consuming, and worry that something might go wrong. The risk of something going wrong is of particular concern to SMEs.

180. CASS has already made a positive difference to the switching process and is generally working well, but many customers either do not know about or do not have confidence in CASS. We are therefore requiring:

(a) the governance of CASS to be strengthened, and have it overseen by a regulator;

(b) customer awareness of and confidence in CASS to be increased; and

(c) improvements to specific aspects of the switching process, with a longer period of redirection of transactions from the old to the new account.

181. We are also guaranteeing the provision of transaction history on the old account once an account is closed.

182. Reforming the way in which CASS is governed will provide those managing the service with stronger incentives to operate and develop the service in the interests of customers; seeking new ways to improve the process over time. This in turn will increase customer confidence in the switching process and reduce barriers to switching.

183. We are requiring undertakings from Bacs, which currently operates CASS, to strengthen CASS's corporate governance by including an independent chair in its management committee (MC) and involving representatives of consumer groups and intermediaries in its decision-making. CASS's main decisions and performance against agreed awareness and switching targets will also be made transparent. To support this, we are recommending to HMT that the PSR or the FCA should have regulatory oversight of CASS.

184. CASS provides an efficient and secure service to both personal and business customers who want to change banks, and it deserves to have a higher profile and a higher degree of customer confidence than it currently has. We are therefore requiring undertakings from Bacs to work with the banks to support a long-term promotional campaign to raise the profile of and confidence in CASS. This work should be particularly focused on those groups who at the moment have the greatest concerns about switching, who are least inclined to switch, and/or would gain most from switching. These include SMEs, overdraft users, customers with high credit balances, the young, and the financially disadvantaged.

185. Bacs will also be required to extend the current 36-month redirection period so as to provide further assurance to customers that their payments will not go missing after they switch banks, and by doing so, increase their confidence in CASS. For customers who continue to need it, payments will be redirected

to their new account indefinitely as long as a payment has been redirected into their account in the last 13 months.

186. A more fundamental change to the switching process would be the introduction of Account Number Portability (ANP). ANP would mean that a customer would effectively take their account number (and maybe their sort code) with them when they switch banks. This could make the switching process easier from the customer's point of view and could give customers more confidence that payments would not go astray.

187. ANP could be implemented in a variety of ways, all of which involve substantial changes to the payments systems used by banks. Estimates of the costs of ANP vary between £2 billion and £10 billion, depending on how radical the changes would be. ANP could also increase customer confidence in switching and the PSR might want to consider ANP at a future date. However, open APIs have the potential to fundamentally change customer experience in banking and reduce the role of bank account numbers, we therefore decided that making CASS work better is a quicker and more proportionate approach.

188. We are also requiring that customers of all current account providers will be able to get a copy of their transaction history after account closure (free of charge or for a reasonable fee). This is particularly important for SMEs, for which loss of access to their previous transaction history following a switch of banks can make it harder (or at least it is perceived by SMEs that it can make it harder) to secure business loans.

189. Some customers want to have accounts at more than one bank at a time. Such 'multi-banking' is good for competition – it allows customers of one bank to try out the services of another. Customers can arrange this for themselves or they can use the partial switching service that most banks now offer, which redirects some payments from one account to another. Although we are not introducing a specific remedy on partial switching, Bacs is considering ways of developing and promoting this service, and we encourage them to pursue this.

190. We have considered another measure to improve the CASS switching process – requiring the transfer of continuous payment authorities (CPAs) on debit cards when switching through CASS. In light of the likely cost and complexity of this measure compared to its relatively modest benefits, we are not taking this forward.

PCA overdraft measures

191. Our foundation remedies and current account switching measures will enhance competition and deliver benefits for all types of PCA and SME banking customers.

192. However, as described above in paragraphs 72 to 73, PCA overdraft users have particular difficulties in engaging with the market, searching and switching. We also found that the effects of the problems we have identified are particularly acute for overdraft users, especially unarranged overdraft users who have the most to gain from switching. Our further measures targeted at overdraft users will increase competition and improve outcomes for such customers.

193. The primary objective of these additional measures is to increase customers' awareness of their overdraft usage and help them manage it. This will help PCA customers save money by avoiding unnecessary overdraft charges, and, by increasing customer awareness of and responsiveness to overdraft fees and charges, should also put downward pressure on these charges. To this end, we are:

    (a) requiring banks to automatically enrol all their customers into an unarranged overdraft alert;

    (b) requiring banks to offer, and alert customers to the opportunity to benefit from, grace periods during which they can take action to avoid or reduce all charges resulting from unarranged overdraft use;

    (c) recommending to the FCA that it undertakes further work to identify, research, test and, as appropriate, implement measures to increase overdraft customers' engagement with their overdraft usage and charges. This will be facilitated by an Order to require banks to cooperate with the FCA in its research programme, including RCTs; and

    (d) to increase PCA customers' engagement with overdraft features, we are recommending that the FCA looks at ways for banks to engage customers more in considering overdraft features and their potential relevance and impact, during the PCA opening process.

194. To address concerns about the cumulative costs of overdraft charges for heavier unarranged overdraft users, we are requiring all PCA providers to set an MMC for use of an unarranged overdraft facility. The MMC, which will be set by each PCA provider, will specify the maximum amount that the provider will charge a customer during any given month due to unarranged overdraft

and will include all unarranged overdraft charges including debit interest and unpaid item fees.

195. The MMC remedy will benefit overdraft customers in two main ways.

196. First, it will improve transparency. The introduction of a common measure of this aspect of overdraft pricing will provide a point of comparison for customers wishing to choose a PCA. While other aspects of overdraft pricing will also be relevant, this intervention will help cut through some of the complexity of overdraft fees and charges, in particular for heavier unarranged overdraft users.

197. Second, it will provide some protection for the heavier unarranged overdraft users – a group that incurs the highest charges for using their PCA, but are least likely to switch to another provider. While the MMC will be set by individual banks themselves rather than centrally regulated, the increased visibility of this aspect of pricing and the associated need to have a competitive offering will constrain the level at which this is set by individual banks. Heavier overdraft users would therefore have some comfort as to their maximum monthly exposure to fees and charges, as opposed to the current situation where this exposure can be open-ended.

198. We considered setting a regulated upper limit on the MMC but have decided not to do so. MMCs set by the banks rather than a regulator will mean the banks themselves remain accountable for their overdraft charges, in what we expect to be a significantly more competitive environment. A regulated upper limit might validate a particular level of cap, incentivising some banks to set MMCs at the upper limit as opposed to competing down the level of MMC. It might also lead banks to become significantly more restrictive in allowing unarranged overdrafts, with the associated risk that some customers could lose access to this form of credit.

199. The success of our approach to the MMC will depend on the way in which this new aspect of overdraft pricing is communicated to customers. We will require banks to make the disclosure of MMCs no less prominent than the presentation of other information on overdraft fees and interest. We are recommending to the FCA that it carries out further work to assess the ongoing effectiveness of the MMC and consider whether measures (including the introduction of rules if appropriate) could be taken to further enhance its effectiveness.

200. We have also considered ways in which we could make it easier for PCA customers to find out whether the overdraft facilities they require would be available to them from another PCA provider. This is a complex area that

interacts with our other remedies, particularly in relation to improvements to the switching process and the development of open banking APIs. Therefore, rather than seeking to specify a particular solution, we are:

(a) seeking undertakings from Bacs to work with CASS participants to review the account switching process for overdraft customers; and

(b) recommending that, following the introduction of open APIs (see paragraphs 168 to 171 above), the FCA considers requiring PCA providers to offer online tools that indicate whether a prospective customer is likely to be eligible for an overdraft.

201. Taken together, we believe that these additional remedies will address the specific problems we identified in relation to PCA overdrafts and will reinforce the effectiveness of the package of remedies for these customers.

Additional SME banking remedies

202. Our foundation measures and current account switching remedies will address a number of our competition concerns in SME banking.

203. Given the specific nature of the competition problems identified in SME banking, additional targeted measures are needed in order to deal with all of the issues we have identified.

204. Our remedies will improve the information available to SMEs about loan and overdraft charges and eligibility, make it easier for SMEs to compare the products of different banks, and make it easier for SMEs to open a new BCA. When SMEs have better information about what the market offers and are able to move more freely between providers, they will be able to make better choices, and the banks will have to compete harder for their custom. We particularly want SMEs to have a real choice when they need finance, and not to feel that their existing bank is the only option.

205. We have looked at the availability of effective comparison tools for SMEs.

206. Although there are several comparison websites currently available on the market, as described in paragraph 110 above, they each individually offer only a part of the service required to compare SME banking products and providers effectively. We think that SMEs would be best served by tools that provide a ‘one-stop-shop’ that would enable them to quickly and reliably compare banks on price, service quality and lending criteria across the whole range of providers.

207. We have looked at a number of ways in which such services could be created. The independent charity Nesta is planning to launch a 'challenge prize' to identify possible solutions to the problem of limited access by SMEs to information on banking services. We consider that this offers the best prospect of effectively addressing this problem, as it is most likely to facilitate innovative and commercially sustainable solutions and should encourage new suppliers to enter the market without precluding an ongoing role for existing providers of comparison services. This approach will stimulate the development of comparison services and other advisory services for SME banking. By doing so, it will address the problems we found in this market by helping business customers to effectively and efficiently compare BCAs, lending products, and other banking products and services.

208. This is an innovative approach to implementing a CMA remedy and so we need to be confident that the Nesta proposal is taken forward to a successful conclusion. It needs both financial backing and technical support from the banks. We are therefore requiring the largest SME banking providers to provide product data[7] and samples of customer transaction data[8] to the developers of proposals for the Nesta challenge.

209. We are also requiring these banks to support and fund the organisation of the prize process and to contribute funding to the prize fund, with their respective contributions reflecting their market positions in the provision of BCAs and SME lending in the UK. To help ensure the Nesta challenge produces a result that addresses our concerns and meets the needs of the SME banking market, a CMA representative will be on the Nesta 'prize committee'.

210. Since the Nesta process will not be completed until at least 18 months after the publication of our final report, we want the existing bank-supported services such as the BBI to be kept going. We are therefore requiring, as a transitional measure, that the banks which currently fund the BBI continue supporting the survey that provides the material underlying the BBI. The BBI may have a long-term role as part of the outcome of the Nesta process, or as part of a solution to our proposal for banks to provide information on service quality (see paragraphs 172 to 174 discussed above), but we do not want to pre-judge either of these outcomes.

211. In addition, we think it is necessary to include a safeguard remedy that would only take effect in the event that the Nesta process failed to produce a satisfactory winner or the winner of the prize proved not to be operationally

[7] RBSG, LBG, Barclays, HSBCG, Santander, Danske, BoI and AIBG.
[8] RBSG, LBG, Barclays, HSBCG and Santander.

and/or commercially viable after the launch. This remedy will require the creation of an industry funded SME comparison tool.

212. We are also requiring that all lenders offering loans publish standard rates for unsecured loans and overdrafts of up to £25,000 in value and that this information is made available as open data to intermediaries. Further, we are requiring the largest SME lenders[9] to offer a tool on their websites so that business customers can get an indicative quote and know, provisionally, whether they would be eligible for the loan or overdraft they seek.

213. In addition, we are recommending to HMT that it works with CRAs and SME lenders to implement a mechanism for 'soft' searching, so that SMEs are confident that they can shop around for credit and obtain indicative price quotes without adversely affecting their credit rating.

214. Our remedies on SME lending are generally limited in scope to unsecured loans and overdrafts with a value of up to £25,000, so they do not directly address the barriers to lending for those SMEs that need secured or larger lending products. Secured and larger loans and overdrafts usually require specific credit assessment, will typically be negotiated through a relationship manager, and will have individually tailored terms. Price and quality comparison tools are therefore of limited assistance for such lending.

215. However, we do expect the market for larger loans to benefit from the increased engagement of SMEs and the increased competitive pressure on banks resulting from our overall remedy package. Also, the development of open APIs, the data-sharing initiatives stemming from the SBEE Act and industry-led initiatives should all help those SMEs seeking larger amounts of finance by facilitating sharing of information about SMEs with potential lenders.

216. We do not think that there is a case for us to launch further interventions in this area at this time. It is better to allow time for the market to absorb and respond to existing and proposed initiatives. We are therefore recommending that HMT undertakes a review of the efficacy and impact of these developments two years after the publication of our final report (ie by August 2018).

217. We considered whether further action is needed to require banks to pass to CRAs further information on SMEs such as transaction data. Regulations under the SBEE Act came into force in June 2016, requiring providers to share SME data, through CRAs, with alternative providers. In addition, our

[9] RBSG, LBG, Barclays and HSBCG.

foundation measure to adopt an open API standard will enable SMEs to share their transaction information with intermediaries. Given this, we did not see a need for a further intervention in this area.

218. Even if SMEs consider switching to a different provider, they may be discouraged from doing so if they think that the process of opening a new business account is going to be difficult. We are therefore requiring BCA providers to adopt a core set of standard information and evidence requirements for opening a BCA. We expect this to be achieved through an industry working group co-ordinated by the British Bankers' Association (the BBA) which is currently ongoing. We are recommending that the FCA supports and facilitates the implementation of this remedy through participating in the proposed industry group as an observer.

219. Our overall package of remedies for SME banking will be more effective if more businesses understand the benefits of shopping around for their banking services. Professional advisers, particularly accountants, have an important role in helping SMEs make good business decisions, including decisions about their choice of provider. We are therefore recommending that BEIS works with the BBB and professional associations to explore ways in which their members can channel advice on choice of banks and sources of finance to SMEs.

An effective and proportionate solution

220. We have put together a set of remedies, which in our judgement will deliver a comprehensive and effective solution to the problems we have identified. Although each individual remedy helps personal and business customers improve their banking experience in some way, they should not be viewed in isolation but as part of a package. The integrated nature of our remedies also means that the impact of the overall package would be reduced if not all of the measures were put in place.

221. The elements of the package will work together to address the underlying problems in the following ways:

(a) Our foundation measures will work together to empower personal and business customers to make good choices when considering banking arrangements. Customers will be encouraged to shop around in the first place and will be prompted to consider switching, putting more pressure on banks to compete for custom. The prompt development of open data in banking, through which information can be shared securely, will harness the benefits of new technology and open up opportunities for new business models to shake up what is still a fairly traditional banking

industry. Open data and robust and comparable information about service quality will make it easier to access and assess information on banking products and providers.

(b) Our overdraft measures will help personal customers to understand the offer they are getting and better manage their use of overdrafts, which in turn will reduce their cost of banking.

(c) Once current account customers decide to act, our switching remedy package will make switching banks more straightforward and customers will have more awareness of and confidence in the process.

(d) By making it easier for SMEs to shop around and open a new BCA, we expect to reduce the reliance on business owners' existing PCA bank when selecting a BCA. Further, our SME remedies will increase transparency of prices and availability of lending products, and facilitate comparisons of current accounts, loans and overdrafts. This will mean that the majority of businesses will not need to turn directly to their existing bank for finance (as is the case now), but are more likely to consider other options. Our remedies combined with recent regulatory changes will also decrease the information advantages of existing credit providers, which should allow other lenders to price more competitively. As a consequence of these interventions, we expect established banks' incumbency advantages to be reduced substantially.

222. We have considered how best to implement, monitor and enforce compliance with our remedy package. We paid particular attention to ensuring the effectiveness and sustainability of the package we are implementing, and have consulted extensively with colleagues in regulators and government about how we can work together to implement these important measures.

223. We also see our remedy package as a proportionate response to the problems we have found. We have considered a wide range of alternative options and have avoided taking forward other measures that are less effective than our proposals, or that would impose unnecessary costs. We have also considered carefully which banks should be subject to which remedies. We have also sought, where possible, to build on existing industry, government and regulatory initiatives. This will avoid creating additional costs by 'reinventing the wheel' and will keep down the overall costs of implementing our package of remedies.

224. We believe that the beneficial effects of our remedies package will outweigh its costs by a substantial margin. The markets for PCAs and SME banking services are very important sectors of the economy in their own right –

generating combined revenues of over £14 billion in 2014 – and are of vital importance to the wider economy. Making these markets work better, by empowering customers and harnessing technological change, will deliver substantial benefits for small businesses and personal customers.

225. It is not possible to measure all of the dynamic benefits of future innovation and increased competition that we expect our remedies to stimulate. However, it is possible to make broad estimates of some of the direct, static benefits of our remedies, which we cautiously estimate will be at least in the region of £150 million to £250 million per year post implementation. We expect these benefits to persist and to accumulate to an amount in the order of at least £700 million to £1 billion within a period of around five years. In addition to these direct gains, we expect further very substantial dynamic benefits from our remedies through increased pressure on banks to improve their quality of service, to innovate and to compete on prices. This is in comparison to our estimate of the costs of implementing our remedies of around £75 million to £110 million. These will predominantly be one-off upfront costs.

226. Our package of remedies will therefore be both an effective and a proportionate solution to the competition problems we have found in PCA and SME banking markets in GB and NI.

Final decision on the AECs and remedies

227. Section 11 of this report sets out the AECs that we have found and Section 19 of this report sets out in full the remedies we will be taking forward to address the AECs that we have found.

228. We have aimed through our remedies package to build upon and strengthen existing initiatives and to reflect ongoing regulatory and importantly technological change. We believe that our remedies package will address the main causes of the poor customer outcomes we have found. The other issues that we have identified, in particular in the context of barriers to entry and expansion, are complex and longstanding.

229. The UK government and various regulators and authorities, both UK and international, have a lead and ongoing role to play in making the UK retail banking market more competitive. In all these areas, we urge the relevant authorities to give due weight to competition objectives. In this context we welcome what is happening on various fronts to address some of the issues we have identified:

(a) The PRA's work programme to improve the ability of smaller banks to transition to adopting their own internal risk models to calculate their risk weights by making the application process more proportionate. The PRA has confirmed in particular that it is making additional resources available to support banks to transition and is reviewing data requirements including the use of external data.

(b) BoE and PRA's commitments to supporting wider reform with a view to achieving a more proportionate approach to the prudential regulation of retail banks in the UK.

(c) HMT, BoE and the PRA's proactive identification of areas of regulation where a more proportionate approach could be adopted whilst still achieving relevant regulatory objectives and HMT's programme aimed at reducing the regulatory burden on banks and in particular smaller banks.

(d) The BoE and PRA's commitment to narrowing the differentials between capital requirements where there is discretion and, together with HMT and the European Commission, in the negotiation of the current proposed reforms to the calculation of risk weights and of capital risk floors as well as future reforms.

(e) The UK government's and BoE's ongoing work to strengthen bank resolution to address TBTF.

(f) The PSR's extensive work programme to improve access and the cost of access to payment systems.

(g) HMT's commitment to keeping under review the impact on smaller banks and on new entry of the bank tax regime in light of the specific issues we have highlighted. We also urge HMT to continue to monitor the impact of its fiscal policies on competition in retail banking more generally.

230. In addition, while we find that there is insufficient evidence to support a finding that the levels of concentration themselves have adverse effects on outcomes, this does not mean that an increase in concentration would not raise competition issues.

231. Our analysis is based on the current evidence and current levels of concentration, including the recent divestment of TSB from LBG. Any changes to the current level of concentration, either through merger and/or divestment, should be considered on their merits as to their impact on competition. The high levels of concentration in the market and the incumbency advantages stemming from the weak customer engagement that we have found are sufficient to justify a cautious approach to any future merger activity. The loss

of rivalry from any bank merger could raise competition concerns. 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.

232. Different considerations apply to concentration changes only involving smaller banks. We have found that because of the weak customer response it is difficult for new entrants and smaller banks to expand organically. Expansion by smaller incumbent banks through acquisition enabling such smaller banks to spread their fixed costs across a greater number of customers, may somewhat improve the competitive threat from such banks, although without increased customer engagement the main barrier to expansion would remain. Similarly, an effective demerger of Williams & Glyn from RBSG has the potential to provide a stimulus to competition, in particular if it is of sufficient scale. Consequently, mergers only involving smaller banks may have the potential to improve competition in the relevant markets.

233. Below we summarise our remedies which will be implemented by way of a CMA Order or by accepting undertakings, and separately our remedies where we are making recommendations. Given the scale and ambition of our remedies, it will take until the summer of 2018, for all elements of the package to come into force although some of the remedies will be in place within a year.

Summary of remedies by Orders and Undertakings

Remedy	*Responsibility*	*Order or Undertakings*	*Commencement date – by or between*
Development and adoption of an open API standard	Largest banks in GB and NI	Order	Q1 2017 and Q1 2018
Service quality metrics: core measures	All banks*	Order	Q3 2018
Prompts: cooperate with FCA research and trials	All banks*	Order	Q1 2017
Facilitating switching: CASS governance	Bacs	Undertakings	Q3 2017
Facilitating switching: CASS awareness and confidence	Bacs	Undertakings	Q3 2017
Facilitating switching: CASS redirection	Bacs	Undertakings	Q4 2017
Transaction history for customers	All banks*	Order	Q1 2018
Overdraft alerts with grace periods	All PCA providers*	Order	Q1 2018
Alerts: cooperate with FCA research and trials	All banks*	Order	Q1 2017
Monthly maximum charge	All PCA providers	Order	Q3 2017
Firm overdraft decision to customer prior to switching account provider	Bacs	Undertakings	Q3 2017
Development of a comparison services for SMEs	Largest banks in GB and NI	Order	Q1 2017
Publication of SME lending product prices	All SME lenders	Order	Q3 2017
Development of SME loan price and eligibility tool	Largest banks in GB	Order	Q1 2018
BCA opening procedures	All banks*	Order	Q1 2018

* Subject to a de minimis threshold.

Summary of remedies by recommendation

Who	*What*
FCA	Undertake a programme of research into customer prompts and to implement measures as appropriate
	Additional measures of providers' service performance
	Identify, research, test, and, as appropriate, implement measures to increase customers' engagement with their overdraft usage and charges
	Assess ongoing effectiveness of the MMC and consider whether other measures could be taken to further enhance its effectiveness
	Consider requiring PCA providers to offer online tools indicating customers' overdraft eligibility
	Investigate how to engage customers more in considering overdraft features during the PCA opening process
	Attend the BCA opening industry group as an observer
HMT	Give an authority powers to have regulatory oversight of CASS
	To work with CRAs and SME lenders to enable SMEs to undertake soft searches for loans
	Review commercial, technical and regulatory developments in the area of sharing SME data
BEIS	Work with the BBB and professional associations to explore ways in which their members can channel advice on identifying and choosing providers and sources of finance to SMEs