Provisional decision on market investigation reference

EEF response to CMA consultation

EEF, the manufacturers' organisation, is the representative voice of UK manufacturing, with offices in London, Brussels, every English region and Wales, representing 20,000 companies of all sizes across every engineering, manufacturing, technology and the wider industrial sector.

SUMMARY

EEF welcomes the opportunity to respond to this consultation on a potential market investigation reference. Comments contained in this response refer only to the Business Current Account market and banking services for SMEs. The key points include:

- We agree with the analysis presented on the desirable characteristics of a competitive SME banking sector and with the evidence pointing to weaknesses in the current structure in the UK.
- In light of the concerns highlighted, the scale and long-standing nature of these concerns we also agree that there is sufficient justification to move to a market investigation.
- The arguments for addressing the shortcomings in the market which are contributing to restricted competition through 'undertakings in lieu of reference' are inconclusive at this stage. This includes the proposals brought forward by the banks.
- All options to address distortions in the SME banking sector – behavioural and structural – should be considered.

Do you consider that the CMA's analysis of the suspected features of concern in the SME banking sector is correct?

We agree with the CMA analysis of the structure of the SME banking sector and concerns in relation to the availability of finance as presented in the latest market study.

The study outlined the right characteristics of a well-functioning banking market for SMEs against which the UK banking sector should be measured. We agree with the analysis presented and support the conclusions that currently the operation of UK retail banks for SMEs does not exhibit these characteristics. The supporting evidence presented in the review reinforces the long standing view that the business current account market is concentrated in the UK; a BCA remains a major factor in businesses' choice of other finance product provider; switching between banks remains very modest and satisfaction levels are low and stable.

We also note that SMEs constitute a large community of businesses and the impact of these issues on different sizes of SMEs is also variable. Anecdotal evidence from manufacturers in recent years indicates that larger SMEs appear better equipped to access finance from providers other than the one with which they hold their BCA, however, for those larger SMEs that are dissatisfied with their main bank the switching process is more complex and protracted and cannot be streamlined through the new switching service.

The emergence of new providers outside of the banking sector is a welcome development and EEF has supported initiatives to encourage further choice of finance provider but their impact will take time to be felt and these new entrants should not be seen as complete substitutes for a more competitive SME banking sector.

In addition to the analysis presented in the market study, evidence submitted by EEF to the CMA on the scope of this market study in 2013 highlighted the following financing issues for SMEs, these included;

- challenges accessing finance were among the reasons for low levels of business investment among some SMEs;
- relationships between banks and businesses had not fully recovered following the financial crisis leading to companies being discouraged from accessing finance; and
- the cost of finance for SMEs remained elevated despite falls in Bank Rate.

These market factors remain relevant for small businesses, in particular. More recent survey evidence from SME manufacturers[1] shows that for a fifth of manufacturers with a turnover of less than £5 million and for one in eight manufacturers with a turnover of between £5 - £9 million the most significant barrier to higher levels of business investment in the next two years is a lack of external finance.

For some SMEs this may be a consequence of unsuccessful applications for new finance, although this would appear to be changing with anecdotal reports of improved credit availability compared with the immediate period following the financial crisis. However, there are still signs that companies are being put off seeking new lines of credit. For example the SME Finance Monitor shows that almost one in ten SMEs (excluding permanent non-borrowers) have an unmet need for finance and a key reason behind this is discouragement – either directly by their bank or due to an assumption that the application would not be successful. The narrow choice of mainstream lenders could lead to this discouragement becoming more entrenched.

While not central to the market study's considerations of the operation of the sector it may also be worth noting that banks can also be a channel for the delivery of the other support

[1] EEF (2014) Investment Monitor 2014: An uncertain return

products, such as those managed by UK Export Finance. A trend towards disengagement may also impact, indirectly, the effectiveness of these schemes across SMEs.

Thirdly, reports from EEF members continue to show that while there has been some improvement over the past two years the cost of finance remains elevated. EEF's most recent survey on credit conditions reports a positive balance (7%) of companies see an increase in the overall cost of credit in the past two months.

Do you consider that the CMA's provisional analysis with respect to the exercise of its discretion to refer SME banking is correct?

We agree that the size and persistence of the competition problem within SME banking merit further investigation of possible solutions to the level of concentration currently evident in the market.

In the first instance the potential negative consequences of a lack of choice, finance availability or information about appropriate finance solutions could have a wide reach across SMEs. The numbers affected are likely to be more significant than those unable to attract alternative of more niche sources of funding, such as growth capital. The economic effects of this must be considered in light of efforts to accelerate business investment growth in the UK.

Secondly, the question of competition has been under review in the UK for more than a decade with no sign of any substantive change within the market. More recent initiatives such as the switching service, the divestments from Lloyds and some new entrants into the market are positive but we note that these new players still account for only a small proportion of SME banking relationships and do not offer a challenger bank of scale that the Vickers Commission recommended in 2011. The limited number of new entrants and their pace of expansion would not indicate that the barriers to entry and expansion identified in the market study are being systematically eroded. This point in particular would raise questions about the suitability of UILs in addressing the underlying weakness in the market.

However, the study does point to a range of potential remedies – both structural and behavioural – that could be further explored. These should be seen as complementary to those proposed by the Independent Commission on Banking Standards.

Do you consider that the features which the CMA has identified that may prevent, restrict or distort competition, are capable of being effectively and comprehensively remedied by UILs (undertakings in lieu of an MIR) given by the banks?

Actions taken since the financial crisis by the banks have attempted to improve the relationship between banks and businesses and have sought to introduce greater levels of churn in the BCA (and PCA) market with more switching by the smallest companies.

Efforts to increase transparency by banks would be welcome, but we see two reasons why this would not be sufficient to change the banking landscape for SMEs. The first is that only four banks can come forward to support the proposal, limiting the impact on new entrants or those seeking to expand. Secondly, commitments made jointly by the banks following the financial crisis have had inconclusive outcomes – the banks agreed actions to improve service levels to SMEs and carried these forward on their own terms with no clear metrics or accountability measures on successful outcomes.

Their proposals only address some weaknesses in the SME banking market, i.e. delivering appropriate products to informed customers, rather than attacking all the shortcomings

Do you have any views on the CMA's provisional analysis regarding proposals for possible UILs being offered in principle by the four largest UK retail banks in relation to SME banking, particularly on the appropriate-ness, effectiveness and deliverability of such UILs?

As noted above, the proposals put forward should be seen as a welcome contribution to the possible suite of solutions to the concentration levels seen in the SME banking sector. However, the evidence on the likely effectiveness of these proposals is inconclusive. The market study correctly references the complexity of demand and supply issues in improving competition in this market and while improving information on products and services and better reporting on performance could begin to make a difference for SMEs the absence of a fuller exploration of structural and regulatory factors would argue against the implementation of these UIL and a further delay to a phase 2 market investigation.

Do you consider that a potential solution to any competition concerns identified may need to consider alterations to the structure of the markets in addition to (or in place of) remedies focused on increasing customer engagement?

Given that relatively little progress has been made following previous competition reviews in this market, it would not seem appropriate to rule out any actions prior to investigation.

We would, however, acknowledge that structural changes involving further divestments by the main banks may simply result in smaller, mirror images of the existing banks, without additional actions to improve transparency and comparability of products. This should be explored in the investigation. In addition, for all options to be fully explored, consideration should also be given to the competition impact of new regulatory requirements.

Additionally, we should also point out that 'structural solution' is not necessarily short-hand for further divestments. Indeed, more direct government involvement in establishing new competitors should also be considered. EEF has previously proposed that the government's Business Bank be used as a vehicle for creating a strong challenger[2].

FOR FURTHER INFORMATION CONTACT:

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[2] EEF (2012) Finance for Growth: Increasing Competition in SME Banking