



**Federation of Small Businesses**  
*The UK's Leading Business Organisation*

**17<sup>th</sup> September 2014**

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Retail Banking Team  
Competition and Markets Authority  
Victoria House  
Southampton Row  
London WC1B 4AD

Dear Sir/Madam,

**Provisional decision to make a MIR in relation to the provision of PCAs and the provision of banking services to SMEs in the UK**

The Federation of Small Businesses (FSB) welcomes the opportunity to respond to the above named consultation paper.

The FSB is the UK's leading business organisation. It exists to protect and promote the interests of the self-employed and all those who run their own business. The FSB is non-party political, and with 200,000 members, it is also the largest organisation representing small and medium sized businesses in the UK. Small businesses make up over 99 per cent of all businesses in the UK, and make a huge contribution to the UK economy. They contribute 51 per cent of the GDP and employ over 59 per cent of the private sector workforce.

The FSB supports proposals to investigate the SME banking market. There are long-standing issues stemming from the SME banking market being highly concentrated. The issues of low availability and uptake of credit by small firms can be addressed with greater competition from new entrants who provide SME specific products and services.

We trust that you will find our comments helpful and that they will be taken into consideration.

Yours sincerely

Mike Cherry  
Chairman of the Policy Committee  
Federation of Small Businesses



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**FSB response  
to the CMA  
consultation  
on the  
provisional  
decision to  
make a market  
investigation  
reference in  
relation to the  
provision of  
banking  
services to  
SMEs in the  
UK**

**September 2014**



## General comment

The FSB welcomes the Competition & Markets Authority's consultation paper questioning whether a market investigation of the SME banking market is necessary.

1. Getting the financial system right is fundamental to ensuring a sustained recovery for the United Kingdom (UK) economy. The consistently high level of concentration of large bank provision in the micro, small, and medium enterprise (SME) retail banking market remains a structural weakness in the finance market. As a general rule, markets are less competitive when they are more concentrated, have barriers to entry, and the incumbents have significant levels of sunk costs. Small firms face detriment from reduced affordability, choice and accessibility of financial products and services, consumer protection on complex financial products, and not benefiting to the full extent from new technology and the innovation it can bring
2. The financial market has long-standing and embedded features of concern on both the supply-side and demand-side. These features need to be addressed to support a sustainable market structure that encourages entry and equally importantly, enables exit without detriment to small firms. The steps that are, and have been, taken to address some of the market issues are welcome yet to be proven effective in increasing competition in the market. Given the long-standing recognition of the issues in this market, the FSB believes a market investigation is required to once and for all identify and drive the implementation of remedies that deliver a dynamic finance market for small firms.

### **Q1 Do you consider that the CMA's analysis of the suspected features of concern in the market for PCAs is correct? (3.6)**

The FSB has no comment on this.

### **Q2 Do you consider that the CMA's provisional analysis with respect to the exercise of its discretion to refer the PCA market is correct? (4)**

The FSB has no comment on this.

### **Q3 Do you consider that the CMA's analysis of the suspected features of concern in the SME banking sector is correct (3.3)**

- *Persistent levels of concentration and relatively stable market shares among providers of both BCAs and general purpose business loans*
- *A market structure characterised by close linkages both between PCAs and BCAs, and between BCAs and general purpose business loans, limiting the scope and speed for newer or smaller providers to expand and develop their business models*
- *Continuing high barriers to entry and expansion in the supply of BCAs and general purpose business loans to SMEs, particularly the inability of smaller or newer providers to develop their businesses outside of niche, specialist areas (see the SME report Chapter 5). Such barriers include:*
  - *the difficulties faced by new or smaller banks to acquire sufficient numbers of profitable customers to establish a credible SME banking business, partly in consequence of low levels of shopping around and switching by SME customers as referred to below*
  - *the continuing need (despite a very significant increase in online and mobile banking) for an extensive local branch network to acquire new customers and distribute products effectively*
  - *limited access to key inputs by smaller or newer banks, particularly some evidence of concerns about access to payment systems at commercially attractive rates (also being considered by the Payment Systems Regulator), and to information on the creditworthiness of SMEs*



— regulatory barriers arising from the methodology used to assess capital requirements imposed on banks

- Demand-side issues, with SMEs not easily able to access, assess and act on information to ensure that they get the best deal, manifested in low levels of shopping around and switching activity (4% annually for BCA customers despite the introduction of CASS). This particularly reflects limitations in transparency and the comparability of information on the offers of different providers and SME customers' 'inertia' (ie reluctance to shop around between banks and to switch banks) (see the SME report, Chapters 6 to 8). Survey evidence of SME customers suggests that the reluctance to shop around or switch at least partly reflects a widespread belief that better alternatives are not available and that there are significant frictions in the switching process.

3.1 The FSB considers the features of concern identified are correct. We recognise there are issues on both the supply-side and the demand-side that need to be addressed to support a competitive, dynamic finance market. The FSB believes that a successful market would lead to a more efficient allocation of capital, thereby encouraging start-ups and small firms to invest in their businesses, for example to grow exports or expand to new premises, or to improve their durability in the market by upgrading information technology.

3.2 The persistent levels of concentration mean that ~80% of the Great Britain SME banking market is with four big banks. In Northern Ireland (NI), there is a high dependency on banks because the demand-side is relatively unsophisticated with limited use of alternative finance. Perceptions remain that there is a high degree of homogeneity in service levels and the products that are available, and there is a small range of credit providers for small firms. The relatively stable market shares indicate this situation is unlikely to change without intervention.

3.3 Four banks hold the substantive proportion of the market and subsequently set the tone for the market. Business Banking Insight (BBI) results<sup>1</sup> showed that large banks performed on a similar basis, with small firm customer satisfaction levels between 55%-60%, depending on size of firm. The unfortunate recurrence of the mis-selling of products such as, mortgages and derivatives, has damaged small firm trust in the banking market.

3.4 In the UK, irrespective of initiatives such as the Funding for Lending scheme, of the small firms that did apply to banks for finance, 50% failed to get credit.<sup>2</sup> In Wales, small firms have suffered a greater decline in bank credit financing than in any other region of the UK.<sup>3</sup> In Northern Ireland, the banks have strict capital requirements, with small firms considering that banks have gone too far in their assessment of risk, and the supply of bank credit is constrained.<sup>4</sup>

3.5 The close linkages between personal current accounts (PCA) and business current accounts (BCA), between BCA and general purpose business loans and often the 'bundled' nature of banking services are all factors that mean small firms keep all their business with one finance provider (the 'gateway' effect noted in the Banking Market Study). This can lead to the small firm not considering alternative finance providers, benefiting from IT innovations, or being aware of different funding options. Small firms are not

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<sup>1</sup> July 2014

<sup>2</sup> Q3 2014 survey - Voice of Small Business

<sup>3</sup> 'Access to Finance Review: Stage 2', Bristol Business School, November 2013 by D Jones-Evans, cited in 'The financial crisis, small businesses and relationship banking in Wales', FSB Wales Round Table seminar series No. 1, by Hans Degryse – Katholieke Universiteit Leuven, Belgium and CEPR, Kent Matthews – Cardiff Business School, Cardiff University, Tianshu Zhao – Stirling Management School, University of Stirling

<sup>4</sup> 'Review of access to finance for NI businesses', Northern Ireland Economic Advisory Group, March 2013



always offered or made aware of terms and conditions, and financial products and services that could better suit the aspirations of the business at that point in time.

Together with the perceptions that search and switching costs are high against the benefit of switching provider, a situation further compounded by the perception noted earlier that there is a high degree of homogeneity in the market, these factors mean switching levels are low. Only 6% of small firms switched or were in the process of switching in 2013.<sup>5</sup> The Payments Council's current account switch service (CASS) is a welcome development but small firms continue to experience a complex and resource intense process where the supply-side has not changed the level of support for customers choosing to switch. The ease and inclination for SME retail banking customers to switch between financial providers is an important step towards improving competition in the market.

3.6 The payments structure is complex and the FCA has rightly identified issues with access to UK payment systems, the terms offered for access, and the industry's pace of innovation. Clearing banks play a central role within the payment structure and it is costly for challenger banks to access the system. The FSB welcomes the introduction of the Payment Systems Regulator as a means to address some of these issues. Any interventions need to align with or support remedies to address the other barriers to entry of challenger banks and alternative finance providers.

3.7 Credit data platforms have historically been developed and are maintained by larger banks and credit reference agencies (CRA). The cost or lack of access to credit data, due to closed user groups, is a barrier to new entrants. The Bank of England's proposal to develop a credit register that is available to all prospective lenders is therefore welcomed by the FSB.

3.8 The lack of transparency on credit data causes an asymmetry of information and an imbalance of power between the credit provider and the small firm. This reduces the small firm's ability to challenge the lending decision, in particular at the lower end of the credit market where personal credit ratings are a major factor in companies' ability to borrow. In addition, small firms need to be informed to make sound financial decisions and to improve their ability to access credit. Finance providers and Credit Reference Agencies lack transparency on how the credit score is calculated. Small firms need guidance to understand their credit score and to take steps to improve it, and to challenge it where the assessment is inaccurate.

3.9

**Q4 Do you consider that the CMA's provisional analysis with respect to the exercise of its discretion to refer SME banking is correct**

4.1 The FSB believes the CMA is correct in its analysis on SME banking. A CMA market investigation is necessary to:

- (a) Enable the engagement and participation of the numerous stakeholders involved in the SME banking market across the nations;
- (b) Take account of the experience and models of banking and alternative finance markets in other countries, such as the United States, Germany, and Switzerland, drawing on lessons from those markets as appropriate;
- (c) Identify remedies that take a cohesive and co-ordinated approach to addressing specific and / or long-standing SME finance market issues on both the supply-side and demand-side;

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<sup>5</sup> FSB 'Voice of Small Business' Survey Panel – August 2013



- (d) Ensure compliance with remedies within prerequisite quality requirements and timeframes; and
- (e) Assess success of remedies and take action to address outstanding and / or evolving issues.

4.2 The SME banking market has suffered from long-standing issues, as initially raised in 2000<sup>6</sup> in the Cruickshank report. To date, the variety of reforms and initiatives to improve the market, such as Funding for Lending and referral for declined applications, have not addressed the underlying market features of concern. FSB research has shown that 66% of small firms received no support or referral from their bank when their application for credit was declined.<sup>7</sup> Despite falling average interest rates and the reported increase in credit available for small firms, 47% of firms believed that credit was unaffordable.<sup>8</sup>

4.3 It is reported there are about 500,000 new small firms every year requiring a BCA.<sup>9</sup> From this pool of customers, finance providers have not grown the SME credit market and 85%<sup>10</sup> of small firms are not inspired or motivated by the finance sector to fulfil the potential of their business through credit based investment and growth. Of the small firms who applied for finance, 50%<sup>11</sup> were turned down.

4.4 The current initiatives undertaken by the FCA, and future work by the Payments Systems Regulator (PSR), to encourage new entrants are welcome and will be part of the solution to improve the supply-side of the market. However, the authorisation of new entrants and reduction in capital requirements do not address other fundamental issues such as information asymmetries for non-bank financial providers, retail bank overcharging,<sup>12</sup> and transparency of credit profiling. In addition, it will be some time before the success or otherwise of the regulators' initiatives are known. Reliance should not be placed solely on these initiatives which to be effective need to not only achieve an increase of new entrants but also ensure the new entrants:

- (a) Are increased to a level that is significant enough to dilute the feature of concentration and alter market share;
- (b) Address the supply-side issues of the market; and
- (c) Provide SME relevant, financial products and services.

4.5 Previous reviews of the market have not adequately considered international comparisons on how a plurality of banking types can benefit competition and contestability in the UK market. Features of other models and types of finance provision such as tiered banking licences and off-the-shelf bank set-up approaches could inform remedies to address UK issues. Diversity within other banking models for example, Germany<sup>13</sup> is proven to provide financial stability, local coverage, and to retain customer choice across products and services. Lessons could be drawn too, for example the growth community

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<sup>6</sup> Cited - House of Commons Treasury Committee 'Competition and choice in retail banking', 9th Report of Session 2010–11 Vol I <http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf>

<sup>7</sup> Q3 2014 survey – Voice of Small Business

<sup>8</sup> Q3 2014 survey - Voice of Small Business

<sup>9</sup> p52, annex A, point 13, 'CMA consultation: personal current accounts and banking services to SME – provisional decision on MIR', 18 July 2014

<sup>10</sup> Q3 2014 survey - Voice of Small Business

<sup>11</sup> Q3 2014 survey - Voice of Small Business

<sup>12</sup> The FSB believes the issue of personal and SME customers being overcharged by up to £3-5 billion a year for banking services has not been proven to be resolved

<sup>13</sup> The German tri-pillar model is formed of private banks, co-operative banks, and public banks





development finance institutions the USA, in growing non-bank alternatives and thereby increase competitive pressures in the market.

**Q5 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 given by the banks (3.3 3.6)**

5.1 The FSB believes the CMA assessment is correct and the market for business finance is affected by features both on the supply-side and the demand-side. For example, in Northern Ireland, banks are having to transition from lending on the property backed basis to the ability to repay while small firms are experiencing low growth and high levels of uncertainty resulting in low demand<sup>14</sup>.

5.2 The UILs are not capable of effectively and comprehensively remedying the features of concern. The supply-side features of concern, of market concentration and stable market shares, personal current accounts linked to business current accounts and business current accounts linked to business loans, and barriers to entry and expansion are not directly addressed by the UILs.

5.3 The UILs focus predominantly on influencing the demand-side behaviour of small firms through a website to improve the awareness of small firms on the availability and range of BCA and standard SME business loans, a loan portal to make it easier for small firms to contact a loan provider, standardised procedures for small firms to open a BCA, and a standardised customer due diligence data pack. These UILs are welcome as they could raise awareness and reduce some of the administrative burden on small firms engaging with banks. In particular, the UILs on BCA annual summaries and a customer communication programme are consistent with the requirements set out in the principles of the FCA handbook. However, in isolation of cohesive complementary remedies across both the supply-side and demand-side, the FSB believes UILs are unlikely to be effective. In addition, the UILs do not address other known demand-side issues, for example, a lack of transparency and guidance on credit scoring (personal credit scores carry a significant weight in the lending decision, a factor especially relevant for sole traders and micro firms) and risk factors. The lack of information reduces the ability of small firms to improve their risk rating and understand their credit options, causing a barrier to obtaining credit.

5.4 The Business Banking Insight survey (BBI) increases transparency on the quality of small firms' banking experiences. This information can be used by small firms when assessing which finance provider to approach for funding. The indication of support for the BBI by the large banks is welcome, but the BBI needs further development before it establishes itself as a 'go to' information point in the market.

**Q6 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 appropriateness, effectiveness and deliverability of such UILs (4.58 – 4.71)**

6.1 The FSB believes the CMA is correct in its analysis on the UILs. Whilst the FSB would welcome their implementation to increase transparency to small firms, the UILs are not appropriate, effective, or deliverable to the extent required to address the features of concern. In part, this is because the UILs:

- (a) Focus on addressing only some of the known issues in the banking market, predominantly the lack of information provided to small business customers and the administrative and time burden associated with engaging with banks. These UILs may be appropriate to address specific issues but the UILs do not address other long-standing known issues or features of

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<sup>14</sup> 'Review of access to finance for NI businesses', Northern Ireland Economic Advisory Group, March 2013



concern identified in the Banking Market Study. A market investigation is needed to better understand the inter-relationship and causal effect of known issues and to identify new or emerging issues across the finance market to encompass banks and alternative finance providers.

- (b) Have not been supported with evidence on effectiveness of for example, informing small firms on the best option for their business, changing the behaviour of small firms, or increasing the number of new entrants to the SME banking market. It is not clear whether the UILs could be extended to effectively address other long-standing known issues and features of concern.
- (c) Have not set out how agreement across the UK banking sector, or as a minimum to include all the large banks, would be put in place. The issues in the banking sector span England, Northern Ireland, Scotland, and Wales. Cohesive and complementary action across the UK will be necessary to improve outcomes for small firms because small firms do business across all nations and each nation has issues and structures that will require a nuanced response to remedy them. In addition, the FSB believes that to address the financial issues of small firms, the remedies need to extend beyond the banking system to include alternative non-bank finance providers.

**Q7 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?**

7.1 The structure of the market needs to be considered alongside behavioural remedies. Reasons for this include:

- (a) Structural changes to reduce market concentration by divestment will have limited impact where the divested entities are traditional banks that provide low levels of SME specific banking products and services.
- (b) Small firms have less protection than individual consumers and are not always aware of the risks in advance of purchasing a product or a service, in particular a complex financial derivative product.
- (c) Whilst the banking structure does not need to be dismantled, the market place does need to better accommodate new entrant and alternative non-bank finance providers and a broader range of distribution channels. In particular, the market structure should encourage entry and enable exit of banking and finance providers with minimal disruption to the market.

7.2 The through-market structure could be improved by encouraging more, smaller finance providers that understand the opportunities and risks associated with the local business environment and maintain relationships with local small firms. New entrants could be supported through:

- (a) Off-the-shelf approaches - commonly used in the United States for bank start-ups and incorporated into Metro Bank.
- (b) A utility style banking platform - to enable banks to set up quickly and reduce costs. These could include basic functions such as accounting/general ledger, data access and integration, and lending, payment and trust solutions.





- (c) A social purpose protection – to retain diversity in the market. Regulators could adapt equity and debt thresholds so small banks/community development financial institutions are able to make a low profit when lending to customers who would not otherwise get credit or on better terms than customary across the market.

### 7.3 To increase the customer base of new entrants:

- (a) Specific consideration is required on the importance of branches and Personal Current Accounts in getting and retaining a customer base. New entrants who do not have a presence through a branch network and who do not also offer Personal Current Accounts are likely to be at a competitive disadvantage. Small firms need and expect convenient banking services. With most small businesses being sole traders,<sup>15</sup> access to a Personal Current Account is equally as important as a Business Current Account. It is not uncommon for sole traders to use their Personal Current Account for business purposes. Levels of switching to another bank remain consistently low and it is unlikely a small firm will switch to a new entrant who offers less access than the incumbent bank.
- (b) Small firms need confidence in the security and longevity of new finance providers. FSB research shows 73% of SME are aware of alternative finance.<sup>16</sup> In particular, Peer to Peer lenders (P2P) want to be regulated to promote the safety of the industry and to instil trust with small firms. The FSB is concerned that alternative finance providers should not be placed at a competitive disadvantage to the traditional high street banks. Regulatory requirements and costs should be proportionate to the risk the financial providers pose to small firms and the stability of the market. (c) The British Business Bank (BBB) needs to be supported and promoted. The BBB has a critical role in identifying gaps in the finance market and enabling small firms to access the finance they need. New entrants can extend their coverage with BBB assistance and access more small firm customers.
- (c) The development and utilisation of a referral system by banks that have declined an application. Bank referrals would stimulate growth in the non-bank finance market and increase competition in the marketplace for small businesses finance. The referral system would increase small firm awareness of the range of finance providers and improve their ability to access the finance that is appropriate for their business.
- (d) The support of the larger banks for the Business Banking Insight would sign-post small firms to information on the quality of the banking experience of firms like theirs and raise awareness of the range of banks who undertake SME business.

7.4 The lack of credit data is a barrier to entry. In conjunction with the work of the FCA, a comprehensive business register would give new entrants and established finance providers access to the same data; supporting a level playing field. One register would ensure data was consistent in content, quality, and currency. Finance providers use different criteria to assess credit status and Credit Reference Agencies use data from different sources. The use of a single register, available to new entrants, would enable more consistent risk assessment that could increase competition on lending, product innovation, and targeted customer support.

7.5 The payments structure is underpinned by the central role of banks in the payments mechanism and control of monetary transactions. Smaller banks are disadvantaged due to the costs and restrictions to

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<sup>15</sup> 68% of FSB membership – Q3 2014 survey – Voice of Small Business

<sup>16</sup> Q3 2014 survey - Voice of Small Business



'plug-in' to this system. Alternative models in other nations split the payment systems from users and banks, to be owned by either the central bank or another state department. The German payment system is owned and run through the German central bank as it is deemed critically important to the well running of the economy. The United States national payment system is co-owned between a non-profit organisation [run by the US Federal Reserve System] and a private organisation.

7.6 The level of consumer protection is too low for small firms when purchasing, or having been mis-sold, complex financial products such as tailored loans / embedded swaps. Many of these products were sold to small firms by commercial bank teams with small firms being unaware of expensive break costs until they tried to break, exit, or move. HM Treasury, the Department of Business Innovation & Skills, and the Financial Conduct Authority are currently not treating the mis-selling of embedded swaps as a regulatory matter. This leaves the small firm at a severe financial disadvantage; having to take legal action on a complex finance product against a bank to get redress. The market for complex financial products lacks:

- (a) Transparency of data;
- (b) Regulatory scrutiny of the suitability of information and advice provided to small firms pre and post sale;
- (c) Penalties for mis-selling; and
- (d) Clarity on how small firms can get timely redress.

7.7 Distribution channels will be influenced by cost, competition, innovation, and the expectations of customers. Local banking and financial services are an integral part of a competitive market that meets the needs of small firms. Small firms are likely to choose and remain with a bank that has a branch presence with business and personal services that are convenient to access, such as Personal Current Accounts. This is unlikely to change until web-based delivery is reliable and accessible. Currently broadband delivery and 3G/4G coverage is not comprehensive. As distribution channels adapt to the requirements of banking and finance providers and customers, the market will need to accommodate an increasingly diverse range of distribution channels, such as:

- (a) Neutral shared-use branches. The ability to use a local bank to conduct the business banking of other banks retains the social benefits and specific facilities of local banks within smaller and remote communities. Inter Bank Agency Agreements (IBAA) enable challenger banks and new entrants to extend their coverage to small firms who can more easily access another bank branch for cash and cheque deposit facilities, for example the Handelsbanken UK.
- (b) 24-hour online / mobile banking and user-support that increase customer self-management. Online and mobile banking will not suit all customers and cannot be posed as a solution on its own. Whilst some banks make concerted efforts to raise customer awareness of training and support for online and mobile banking, the issue remains that parts of the UK do not have consistent broadband network coverage to provide small businesses with reliable access to financial services and products.
- (c) The expansion, through commoditisation and simplification, of banking and financial products that are available from retail outlets. Additionally, the retail outlet could provide banking services such as deposit and cash withdrawal, and cheque scanning.
- (d) Post office substitution for bank branches. The rate of conversion is determined by the banks. It is not clear if this is co-ordinated across the banks to enable the post office to absorb the



change. The FSB suggests the rate of conversion needs to be measured and reviewed to ensure:

- i. Small firm Post Office franchises have capacity and capability to adjust to the change in customer footfall, service expectations, and changes in the information business customers require.
- ii. Small firm business banking customers retain the level of customer support they need and timely access to designated business banking services. Crucially, banks must provide small firms with the means to access timely services from post offices. There are delays where banks use paper based systems rather than, for example, barcodes. Banks must also provide small firms with clear information on the changes that is, the information should be highlighted and separate to other banking information. There are examples where information on Post Office substitution could be made clearer rather than being included within other banking information. Banks should inform small firms when the level of service will be less than they would have got within their own branch, in particularly where this will negatively impact on cash flow. The information must include for example, the restrictions on cash volumes (£1000 per transaction at open counter outlets) and 2 days delay in giving value for cheques and cash compared to using branches of the account holding bank.

7.8 The FSB suggests the CMA should consider:

- (a) The impact of the reduction in the level of service, and the increase in the footfall where banks are closing branches where the Post Office has only one site and other dispersal options are not available.
- (b) Whether tariffs levied by the agent bank should be passed on to the customer or absorbed by the bank, that is, whether or not the small firm would be charged the same tariff in the Post Office as in its own branch.

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### For further information

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