

# Retail banking market investigation

## Updated issues statement

**21 May 2015**

This is one of a series of consultative documents which will be published during the course of the investigation for consultation. The updated issues statement, and further working papers, do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in September 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to respond to this consultation should send their comments to [retailbanking@cma.gsi.gov.uk](mailto:retailbanking@cma.gsi.gov.uk) **by midday on Thursday 11 June 2015.**

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The Competition and Markets Authority has excluded from this published version of the updated issues statement information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive wording is also indicated in square brackets.

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## Introduction

1. On 12 November 2014, we published a statement of issues for our market investigation and this document provides an updated summary on the progress of the investigation. It summarises our current thinking based on the evidence received and the analysis undertaken to date.
2. In publishing this document and working papers we are inviting comments from interested parties on those issues that we consider are likely to represent the focus of our investigation as we progress to provisional findings. We also provide an indication of those issues in relation to which, subject to evidence we might receive, we have less concern and those areas where we are still undertaking analysis and/or where further evidence from parties would be particularly helpful.
3. We are publishing a number of working papers containing our detailed analysis on a number of issues. Appendix A lists the working papers that are currently planned or have already been published. We are aiming to publish all the papers listed in Appendix A and referenced in this statement by mid-July and may publish a small number of additional papers prior to provisional findings.
4. This statement follows the same broad structure as the statement of issues and considers in turn each of the theories of harm we previously identified. We cross-refer to relevant working papers as appropriate throughout this statement. Where appropriate, in this statement and in our other papers, we have summarised our analysis to date separately for personal current accounts (PCAs) and small and medium-sized enterprise (SME)<sup>1</sup> banking, distinguishing within SME banking products as relevant.
5. At this stage in our investigation we have not reached any provisional conclusions and our views as set out in this statement and other papers may change in light of our ongoing analysis as well as comments and further evidence we receive in response. If parties consider that there are any inaccuracies or gaps in our understanding or evidence base, we invite them to provide us with further necessary evidence. Whilst this document and papers will inform our hearings with a number of parties in June and July, we expect written submissions in response to this statement and the working papers to be the principal means by which all parties should respond.

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<sup>1</sup> Our terms of reference define SMEs as businesses with annual sales revenue not exceeding £25 million.

6. All parties are invited to respond to this statement and working papers in writing, either by email to [retailbanking@cma.gsi.gov.uk](mailto:retailbanking@cma.gsi.gov.uk) or by post to:

Project Manager  
Retail banking market investigation  
Competition and Markets Authority  
Victoria House  
Southampton Row  
London  
WC1B 4AD

**by 12pm on Thursday 11 June 2015.**

7. We aim to publish submissions we receive in response to this statement and our papers. We therefore request that when submitting any response, parties provide a non-confidential version at the same time to avoid unnecessary delay in publication. If any party has concerns about publication it should raise these at the time of submitting its response.
8. The remainder of this statement covers:
- progress to date of the investigation;
  - sector characteristics;
  - PCAs;
  - SME retail banking products;
  - overview of initial analysis on market definition and market outcomes;
  - theories of harm:
    - Theory of harm 1: Customer behaviour and banks' response;
    - Theory of harm 2: Concentration giving rise to unilateral market power;
    - Theory of harm 3: Barriers to entry and expansion; and
  - next steps.

## Progress to date of the investigation

9. Over the past six months of the investigation, we have engaged with a wide range of parties. We have visited 11 banks<sup>2</sup> across the UK and had meetings with others. We have also consulted with, obtained evidence and/or received submissions from a range of interested parties including banks, government, regulatory, consumer and industry bodies, potential new entrants, consumers including SMEs, price comparison websites, IT providers and academics.
10. A significant focus of our investigation to date has been on gathering and analysing data and other forms of evidence from the banks as well as other relevant parties. Throughout the investigation we have consulted<sup>3</sup> on our proposed methodologies on profitability, pricing analysis, switching, the design of our PCA consumer survey<sup>4</sup> and our surveys of SMEs, and international research.
11. Non-confidential versions of submissions we have received are on our webpages,<sup>5</sup> and further material relating to the investigation will be published there. We will continue to publish updates as our investigation proceeds to provisional findings.

## Sector characteristics

12. In our statement of issues we noted a number of key characteristics that we considered would be important in assessing the nature of competition in the sector. Most of these characteristics are directly linked to one or more of our theories of harm and are considered in more detail below in our section on market definition and market outcomes, and as appropriate in our discussion under each of the theories of harm. In this section we consider the following sector characteristics: regulation, future developments/innovation, and the macroeconomic background to our investigation.
13. Our working paper on the regulatory background to the retail banking industry,<sup>6</sup> published on 1 May 2015, sets out in detail the roles of the principal banking regulators, the authorisation processes to provide banking services, the capital and liquidity requirements for banks as well as a number of other relevant national, EU and international regulations and initiatives. The paper also considers a number of changes including new capital adequacy

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<sup>2</sup> In this document the term 'banks' is, for convenience, used to refer to both banks and building societies.

<sup>3</sup> [Retail banking market investigation case page](#).

<sup>4</sup> Quantitative and qualitative research conducted by GfK NOP which is being published alongside this statement.

<sup>5</sup> [Retail banking market investigation case page](#).

<sup>6</sup> [Regulatory framework applicable to the retail banking industry in the UK](#).

requirements, implementation of the recommendations of the Independent Commission on Banking (ICB) for the ring-fencing of retail banking functions, the Small Business, Enterprise and Employment Act 2015 and the implementation of EU legislation such as the Payment Accounts Directive (PAD). In addition, the Financial Conduct Authority (FCA) has recently undertaken a number of market reviews, including into the effectiveness of the current account switch service (CASS) and the potential benefits of account number portability. The Payment Systems Regulator (PSR) is currently reviewing the ownership and competitiveness of the current payment systems infrastructure as well as the supply of indirect access to payment systems.

14. In addition to developments in regulation, there have been a number of technological developments in the sector ranging from the development of off-the-shelf modular pay-per-use IT platforms for start-up banks to the expansion of digital banking services to customers. The former is relevant to our assessment of barriers to entry and expansion and is considered in more detail in our working paper on barriers to entry and expansion: regulation, IT systems and payment systems, to be published shortly. In addition, there has been a significant amount of innovation and development in alternative payment providers to the banks (for example, PayPal is now a well-established alternative and Zapp is scheduled to launch later this year<sup>7</sup>), as well as in alternative lending such as crowdfunding and peer-to-peer lending. We are gathering evidence to understand the implications of these developments to our competition assessment and our initial views are set out in paragraphs 39 to 45 below. We have also commissioned Deloitte LLP (Deloitte) to undertake research into ongoing and future innovations in the UK retail banking market and the possible implications for competition, by reference to international comparisons. We will publish its report in due course.
15. We recognise that our market investigation is being carried out against a backdrop of highly unusual macroeconomic conditions following the global financial crisis in 2007/08 and the subsequent economic downturn. These pose a series of challenges for our analysis, and a number of questions which we will wish to address in reaching conclusions on competitive effects. For example, the profitability of core retail banking services is likely to have been affected by the macroeconomic conditions. Similarly, there is a challenge for our analysis in determining what impact a return to more 'normal' macroeconomic conditions might have in the future.
16. We have identified the following as particularly relevant to our assessment:

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<sup>7</sup> See [Zapp](#).

- (a) Very low central bank interest rates over a prolonged period. The Bank of England official rate has been held at 0.5% since March 2009: such near-zero interest rates have led to very low savings rates on instant access savings accounts, reducing the opportunity cost to personal and SME customers of holding deposits in low- or zero-interest current accounts. We will take this into account in considering the evolution of banks' pricing structures, and the evidence on where banks currently earn revenues.
- (b) The financial crisis impacted banks in many ways. It resulted in significant government intervention in the banking sector to restore financial stability<sup>8</sup> including the taking of large government holdings in Royal Bank of Scotland Group (RBSG) and Lloyds Banking Group (LBG). Facing high levels of impairments and falling share prices, banks have also sought to strengthen their capital base and to reduce their reliance on external wholesale funding. This has increased the importance of current account balances as a source of funding.
- (c) As banks have sought to rebuild their balance sheets, partly in response to tightening regulatory capital requirements, there has been a general contraction of lending activity by the major banks, particularly to the SME sector after the financial crisis. The contraction may have facilitated entry/expansion by new lending providers, including both new banks such as Aldermore and Shawbrook, and/or non-bank institutions such as peer-to-peer lenders.
- (d) The government has made a series of interventions with the aim of stimulating business lending, including the Funding for Lending Scheme (FLS), and the creation of the British Business Bank.

## **Personal current accounts**

- 17. This section summarises our initial findings on the structure of the market for PCAs. The section is supplemented by Appendix B which describes the nature of personal current accounts and provides further detail of our initial findings on the PCA market.
- 18. Our initial analysis on the structure of the markets for PCAs shows the following:
  - (a) Based on data we obtained from the banks, there were more than 80 million PCAs in the UK in 2014. More than 50 million of these accounts

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<sup>8</sup> See our working paper on the [regulatory background](#) for further details on many of these issues.



had average incoming monthly payments of more than £500.<sup>9</sup> The number of new PCAs opened annually in the UK has remained broadly constant at approximately 6 million a year, representing approximately 7.5% of all PCAs in 2014. The majority of these were standard (including interest-paying) PCAs in 2014.<sup>10</sup>

- (b) UK market shares for main PCAs have been relatively stable between 2011 and 2014.<sup>11</sup> Santander and Metro Bank (Metro) have seen the greatest increases in market share and Nationwide Building Society (Nationwide) and TSB have seen slight increases in market share. Other smaller banks' shares have been relatively stable. Over the last ten years, Santander, Nationwide and The Co-operative Bank (Co-op) have gained market share while HSBC Group (HSBCG), RBSG and Clydesdale Bank (Clydesdale) have lost market share (this excludes the effect of mergers and demergers).
- (c) The combined UK market shares of the four largest banks have been decreasing since 2011, and in 2014 accounted for more than 70% of UK main PCAs.
- (d) The PCA markets for main, active<sup>12</sup> and new PCAs remain concentrated<sup>13</sup> in each of England and Wales, Scotland and Northern Ireland.<sup>14</sup> Scotland is more concentrated than the other nations for main and active PCAs. There has been a slight decrease in concentration levels between 2013 and 2014.

19. As noted above, further detail on PCAs including data on market shares and concentration in England and Wales, Scotland and Northern Ireland is contained in Appendix B.

## **SME retail banking products**

20. Our terms of reference encompass a wide range of SME retail banking products. The CMA market study focused on the provision of business current accounts (BCAs) (including overdrafts) and general purpose business loans. Our investigation also covers other products such as deposit accounts, credit

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<sup>9</sup> We characterise such accounts as main accounts.

<sup>10</sup> See further Appendix B for details of different types of PCA.

<sup>11</sup> Except for the effects of mergers and divestments including LBG's acquisition of Halifax Bank of Scotland (HBOS) in 2009 and the recent divestment of TSB.

<sup>12</sup> An active account is one with at least one customer-generated transaction in the previous 12 months.

<sup>13</sup> We have used the Herfindahl-Hirschman Index (HHI) to measure concentration. See our [Guidelines for market investigations: their role, procedures, assessment and remedies \(CC3\)](#), Annex A.

<sup>14</sup> Appendix B, Figure 12 contains concentration levels across different parts of the UK including Wales as well as regions within England. In paragraph 24 below we set out our initial thinking on market definition including geographic market definition.

and charge cards, commercial mortgages, asset finance and invoice finance. Our initial analyses have focused on BCAs (including overdrafts) and general purpose loans, and the details of our initial findings are included in Appendix B. Work is ongoing in relation to other SME retail banking products.

21. Our initial analyses on the structure of BCAs and general purpose business loans have found that:
- (a) The total number of SMEs with one or more BCA has remained broadly static between 2010 and 2014 at approximately 3.5 million. The number of start-up SMEs using a BCA has fallen slightly over the last few years despite the rise in the number of new SMEs.
  - (b) The total size of the UK BCA market has remained broadly constant between 2012 and 2014. Within this period, about 12% of accounts were opened and closed each year (compared with 8% for PCAs)<sup>15</sup> – this reflects the rate of SME start-up and closure as well as switching. Santander, Metro and Handelsbanken have had the highest rate of net account openings as a proportion of their total accounts during this four-year period.
  - (c) UK market shares for BCAs have remained broadly stable between 2010 and 2014. The position is broadly the same across England and Wales, Northern Ireland and Scotland. Some banks such as RBSG and LBG have higher market shares in the provision of general purpose business loans compared with their share of active BCAs whilst for other banks, such as HSBCG, Santander and the Co-op, the reverse is the case.
  - (d) In 2014, the four largest banks had a combined UK market share of active and new BCAs of [80–85]%. This combined market share has fallen by approximately three percentage points between 2012 and 2014. There is, however, some variation between each of the four largest banks with some increasing their market shares.
  - (e) There is some variation in UK BCA market shares by size of SME. For example, Barclays has a greater share of start-up BCAs whilst HSBCG has a lower share of start-up BCAs compared with its total market shares. Similarly, Santander has a much larger market share in relation to start-ups and SMEs with turnover under £2 million, compared with its market share for other SMEs.

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<sup>15</sup> The figures refer to account openings and closures excluding internal transfers.

- (f) The UK markets for BCAs remain concentrated in 2014 and are more concentrated than for PCAs. Scotland is more concentrated than the markets in England and Wales, and in Northern Ireland. Concentration levels have been relatively stable, although there have been slight decreases in concentration levels since 2012.
  - (g) As for BCAs, UK market shares in general purpose business loans have remained broadly stable between 2012 and 2014. The four largest banks in 2014 had a combined share of over 85% of the number of outstanding loans. This has remained broadly constant since 2012 although, as with PCAs and BCAs, there is variability between the four largest banks.
  - (h) The UK market for general purpose business loans is more concentrated than for BCAs. The market is slightly less concentrated when measured by value of loans (with the four largest banks having a combined share of [75–80]% in 2014).
  - (i) As for BCAs, there is some variation in market share by size of SME but also depending on whether the market is measured by number or by value of loans within size of SME. For example, one of the larger bank's share of loans to SMEs with turnover above £2 million is almost three times greater than its share of loans to smaller SMEs.
22. Further details on BCAs and general purpose business loans is contained in Appendix B including more detailed data on England and Wales, Scotland and Northern Ireland and by size of SME.

## **Overview of initial analysis on market definition and market outcomes**

23. In this section we provide an overview of outcomes we have observed based on the evidence we have received to date. Outcomes relating to profits, prices, quality of service and levels of innovation form part of our overall assessment of the market and can be useful in analysing the extent and nature of competition in the market. In addition, an assessment of outcomes may help determine the extent to which customers may be harmed by any feature we may find giving rise to an adverse effect on competition. Before looking at outcomes we explain our current thinking on market definition.

### ***Market definition***

24. Market definition provides a framework for our assessment of the effects on competition of features of a market. It is therefore a useful tool but not an end in itself. Several parties have highlighted that there are local dimensions to

competition which may be particularly relevant to our analysis under theories of harm 2 and 3. For example, we discuss below in paragraphs 127 to 133 the importance of local branches to customer acquisition for new entrants. In addition there may be a regional dimension to market definition, for example in relation to SME lending. These issues are being considered as part of our assessment of competition irrespective of our approach to market definition in particular geographic market definition. Our current thinking on market definition is as follows:

- (a) **PCA product market:** for personal customers, the terms of reference are limited to PCAs. As described in Appendix B, PCAs provide a number of different services. Alternative products (such as instant access savings accounts, digital wallets<sup>16</sup> and some forms of loans) can substitute for certain elements of a PCA but none of them can fully substitute for all the features of a PCA. We do not consider that any of them exercise a sufficient constraint on PCAs to be included in the same market. Our current view is therefore that the relevant market in this investigation is for PCAs and no wider. However, such alternative products will be relevant to our competition assessment. We also do not intend to define separate markets for different types of PCA or service elements within PCAs (such as overdrafts) – we will consider relevant differences as part of our competitive assessment.
- (b) **SME retail banking product market:** the terms of reference cover the following main SME retail banking products: BCAs including overdrafts; business deposit accounts (including both short- and long-term deposits); general purpose business loans; and other types of loans (including asset finance and invoice finance). Previous inquiries<sup>17</sup> have tended to identify each of these as separate product markets and we do not currently see a reason to depart from this. We are considering including alternative finance products (for example, peer-to-peer lending and invoice financing) as part of the market for general purpose business loans or the market for other types of loan as appropriate.
- (c) **Geographic market definition:** for PCAs, BCAs and general purpose business loans, previous inquiries have tended to focus on three separate geographical areas within the UK: England and Wales, Scotland and

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<sup>16</sup> A digital wallet is an online account/identity in which customers can aggregate their personal payment details and which they can use to make purchases. Examples are PayPal and Amazon Payments in the UK and Google Wallet and Apple Pay in the USA.

<sup>17</sup> Competition Commission (2002), *A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*.

Northern Ireland. We do not currently see a reason to depart from this.<sup>18</sup> We are considering the extent to which more recent market changes might suggest wider geographic markets combining Scotland and England and Wales for all the relevant product markets. However, our current view, based on the evidence reviewed to date, is that Northern Ireland remains a separate geographic market to the rest of the UK in relation to PCAs, BCAs and general purpose loans at least.<sup>19</sup>

### ***Profitability***

25. In the methodology paper published on 27 March 2015 for our proposed assessment of market-wide profitability, we highlighted a number of difficulties with such an analysis. We received extensive responses from interested parties, many of which confirmed our concerns on the feasibility of undertaking a market-wide profitability assessment of the type proposed in the methodology paper. We also undertook further work including analysis of the financial information provided by the five largest banks.<sup>20</sup>
26. There are a number of factors specific to the assessment of profitability in the PCA and SME retail banking markets which made the originally proposed analysis particularly problematic. These include the appropriate allocation of common and shared costs, equity capital, and revenues, the estimation of a benchmark return on equity for stand-alone PCA and SME banking products, and the impact of the financial crisis and the market restructuring that followed. The particularly large number of allocation adjustments and assumptions necessary would have had a cumulative effect making any objective judgement difficult. We have therefore decided not to undertake the market-wide profitability analysis as originally proposed.
27. We will, however, use the financial information already provided by the banks, together with publicly available information, and information to be gathered in a further data request, to inform our overall understanding of the financial performance of the banks at both the PCA and SME banking level, as well as at a more aggregate level, for example retail banking. We also aim to add to the analysis of theory of harm 2, assessing the possible impact of concentration, by producing a set of revenue and margin comparators across the larger and smaller banks, and across the UK nations. We plan to carry out this

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<sup>18</sup> The Welsh Government has proposed that Wales should be regarded as a distinct geographic market to the rest of the UK. We are reviewing the evidence submitted.

<sup>19</sup> Our analysis to date has looked wherever possible at England and Wales, Scotland and Northern Ireland separately.

<sup>20</sup> LBG, RBSG, HSBCG, Barclays and Santander.

analysis for the five-year period 2010 to 2014 which is the period over which we planned to carry out the market-wide profitability analysis.

28. We have also collected information on how the banks assess customer and product profitability. The purpose was to assess the extent to which different customer groups or sets of products make different levels of contribution to banks' profit margins, whether larger banks use BCAs and PCAs as gateway products to cross-sell other retail banking products and whether any differential level of margin contribution and/or cross-selling acts as a barrier to entry or expansion. Our analysis has focused on the banks' own internal documents, in particular business and marketing plans and other strategy documents relating to their PCA and SME retail banking businesses in the UK. This initial analysis has been focused on LBG, HSBCG, RBSG, Barclays and Santander. These banks assess customer and product performance differently and they do not all assess customer or product profitability in the normal course of business.
29. Our initial analysis of the evidence provided by the banks appears to suggest that:
  - (a) The retail banking products provided to SMEs and personal customers, including BCAs and PCAs, are profitable when considered separately from the banks' overall retail banking propositions.<sup>21</sup>
  - (b) There are a number of ways in which the manner in which a customer uses their BCA or PCA impacts upon the returns that they generate for their BCA or PCA provider. These include:
    - The level of credit balances held in BCAs and PCAs. This is a key driver of net interest income.
    - The volume and type of transactional activity undertaken by the customer. This is particularly the case for BCAs, as the banks typically charge transactional fees (in addition to a monthly fee for usage of the account).
    - Overdraft usage is a key driver of the profitability of BCAs and PCAs.

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<sup>21</sup> Our analysis of customer and product profitability has focused on understanding how and to what extent the banks assess the profitability of customers and products, and not on conducting a detailed financial analysis of customer and product profitability. Therefore, our assessment of the profitability of the banks' retail banking products has been based on financial data provided by the banks and reflects accounting profits and not economic profits.

(c) Characteristics of BCA and PCA customers which impact upon the returns that they generate for their BCA or PCA provider include:

- the size of the SME or the affluence of the individual;
- the customer's length of tenure with their current BCA or PCA provider;
- the life stage of the SME or individual;
- the type of PCA held by the customer; and
- whether a PCA customer is a primary or secondary banking customer.<sup>22</sup>

30. We intend to conduct further analysis of the evidence provided by the banks, to gain a more comprehensive and well-developed understanding of these issues.

### ***PCA and BCA pricing analysis***

31. We are analysing the prices of PCAs and BCAs. Details of the two types of analysis we are undertaking are set out in Appendix C. Whilst each bank's prices are uniform across the UK, a comparison of current account prices is not straightforward because different PCA and BCA products have different pricing structures. Consequently, which product is cheaper will depend on customer characteristics (for example, whether the customer has a credit balance or is overdrawn). In addition, as described in Appendix B, most banks have several different current account products and some banking groups have different brands with different product offerings, for example for PCAs Lloyds, Bank of Scotland (BoS) and Halifax within LBG, and HSBC, First Direct and Marks and Spencer Bank (M&S Bank) within HSBCG; and for BCAs RBS, NatWest and Ulster Bank (Ulster) within RBSG.

32. While banks have fewer different BCA offerings compared with PCA products, they usually offer customers a choice of BCA tariff and the tariff may vary depending on, for example, the type of SME. A further complication in comparing prices is that it is common for both BCA and PCA providers to make special offers to new customers, for example a one-off reward for switching or a period of 'free banking' for BCAs.

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<sup>22</sup> We understand that a bank deems a customer to be a primary banking customer if they hold their main transactional account (ie the account in which they hold their income and from which the majority of their payments are made) and therefore, their main banking relationship with them, and that all other customers are deemed to be secondary banking customers, as they hold their main banking relationship elsewhere.

33. Our analyses are still at an early stage, in particular in relation to BCAs. In addition any pricing analysis needs to take into account differences in quality of service not just in price. We are collecting information on quality measures to obtain a fuller picture and to assess whether lower prices are associated with lower quality (which may make price comparisons hard to interpret).
34. Our initial analysis of published PCA tariffs is based on six illustrative profiles (see Appendix C, Annex 1). It shows wide variation in prices across banks, and mixed evidence on whether larger banks' prices are higher or lower than smaller banks prices. We intend to carry out further analysis of PCA published tariffs using transactions data obtained from the relevant banks. Our equivalent analysis of BCA average monthly charges is ongoing.
35. Our analysis of aggregate trends in PCA net revenue suggests that net revenue per PCA has declined over the period 2011 to 2014. The primary reasons for the decline appear to be declining revenue from monthly account and overdraft fees, increasing interest payments on credit balances and lower net value of funds from credit balances. The value of funds from PCA credit balances remain the largest source of PCA net revenue across all the banks.
36. Analysis of aggregate trends for BCA net revenue suggests similarly that net revenue per BCA has been declining over time, with declines in transaction charges, arranged overdraft fees and the value of funds. As with PCAs, the value of funds from BCA credit balances remain the largest source of aggregate BCA net revenue.
37. We will be publishing working papers on our PCA and BCA pricing analyses and on revenues and margins in due course.

### ***Quality of service and complaints***

38. Alongside our analysis of profits and prices, quality is an important dimension of competition in banking markets. We have started to analyse banks' quality and levels of service comparing the larger banks with smaller banks. We have obtained information from the banks on how they measure quality, for example complaints data from the Financial Ombudsman Service and the FCA and industry-wide customer satisfaction data.

### ***Levels of innovation***

39. The existence and impact of innovation is another aspect we are actively reviewing. Innovation can be an important indicator of a well-functioning market, driving diversity of choice, cost efficiencies and enhanced service levels. Conversely, if there is a lack of innovation it is important to understand



whether this reflects a lack of competitive incentives, or the existence of high barriers to innovation and whether these raise barriers to entry and expansion and hence impede competition.

40. Innovation can take many different forms, including new/enhanced: distribution channels, products/services, business models or operational processes leading to cost efficiencies. The types and forms of innovation observed will be affected by the specifics of the individual market, including demand-side and supply-side factors, such as the scope for technological development and customer behaviour (eg adoption rates).
41. In the PCA market, for example, the use of internet banking is now commonplace and, with the increased take-up of smartphones and tablets, the use of mobile banking is similarly increasing at a rapid pace.<sup>23</sup> Other forms of non-traditional banking also emerge.<sup>24</sup> Despite these changes, traditional channels still appear important with some banks innovating in their branch offering/design (eg Barclays (partnering with Asda) and Metro). There are also innovations in product development, such as Santander's 123 account, the Club Lloyds account and Barclays' Blue Rewards account.
42. Alongside this, customers are seeing new technology-focused financial services such as money management/financial aggregation services (eg Moneydashboard) or government initiatives such as midata<sup>25</sup> and an open standard for application programming interfaces (APIs) in banking which is aimed at making it easier to develop new financial tools.<sup>26</sup> How payments are made is likewise changing: for example, mobile payments through Paym<sup>27</sup> and services such as Barclays' Pingit<sup>28</sup> are on the rise; contactless card use is increasing; and alternative payment options (such as digital wallets) are emerging.

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<sup>23</sup> Our PCA survey published alongside this statement found that 66% of respondents used internet banking and 37% of respondents used a tablet/smartphone app for their main bank account, rising to 84% and 59% respectively for 18–44 year olds. Data from Accenture's UK Current Account Customer Surveys in the period 2010–2014 shows monthly mobile UK banking usage levels of 8% in 2010 rising to 27% by 2014 – see BBA/Accenture (March 2015), [Digital Disruption: UK Banking Report](#).

<sup>24</sup> For example, video and webchat banking, or introducing innovation to widen the use of cheque imaging (the Small Business, Enterprise and Employment Act 2015) will move one of the few remaining forms of branch-focused transactions online. Our PCA survey found that among respondents who had visited a branch in the last year, 85% had paid in money/cheques during this period.

<sup>25</sup> The [midata project](#), part of the UK government's consumer empowerment strategy, is aimed at providing consumers access to their transaction data in electronic, portable and safe way so that they are able to make more informed choices. [GoCompare](#) was the first price comparison website to launch with midata capability in March 2015.

<sup>26</sup> Further details on the API initiative can be found on GOV.UK: [Data sharing and open data in banking: call for evidence](#).

<sup>27</sup> [Paym](#) is a service launched in April 2014 that enables consumers to send and receive payments directly to a current account held with a participating bank or building society using just a mobile number.

<sup>28</sup> See [Barclays Pingit](#).

43. Additionally, possibilities to outsource core banking platforms (often termed 'bank-in-a-box') provide new entrants with a wider range of potentially more cost-effective IT options with which to compete.
44. In SME banking, digital banking and new payment options are similarly evolving; however, beyond this common theme, there appears to be less dynamism in the provision of BCAs than for PCAs. In regard to lending, we note the recent growth of alternative finance, such as peer-to-peer lending, crowd-funding and debt-based securities, coinciding with banks scaling back their loan books in the wake of the financial crisis. However, awareness and interest in alternative finance among SMEs is currently low<sup>29</sup> and it remains a very small part of the SME lending market in the UK.<sup>30</sup> We will consider further whether and, if so, the extent to which such alternative methods of financing may constrain retail bank lending to SMEs.
45. The research that Deloitte is undertaking (see paragraph 14 above) will provide further insights into the level of innovation in the UK and the possible implications for competition in PCAs and in SME banking, by reference to international comparisons. We will draw on this work in further considering the potential impact of innovation, and will take into account the level of innovation observed alongside other indicators in the round, in our assessment of competition.

## Theories of harm

46. The hypotheses (theories of harm) we identified in our statement of issues were:
  - Theory of harm 1: Impediments to customers' ability to effectively shop around, choose and switch products or suppliers, resulting in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation.
  - Theory of harm 2: Concentration giving rise to market power of some banks leading to worse outcomes for customers.
  - Theory of harm 3: Barriers to entry and expansion leading to worse outcomes for customers.

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<sup>29</sup> Survey research shows that 56% of SMEs are unfamiliar with any form of alternative finance and 60% are unlikely or very unlikely to begin/continue using an alternative finance platform in the near future. Nesta (2014), [Understanding Alternative Finance](#).

<sup>30</sup> Nesta, for example, forecast that at the end of 2014, alternative finance would have represented 2.4% of cross-national bank lending to SMEs based on the Bank of England's 2013 baseline figures. See Nesta (2014), [Understanding Alternative Finance](#).

47. We have not identified any additional hypotheses and the three hypotheses we identified remain the focus of our investigation. Whilst the three hypotheses remain broadly unchanged, we have developed further our framework for analysis of concentration under theory of harm 2. We will be publishing a working paper on the review of literature on competition in banking, and paragraphs 93 to 100 below set out in further detail how we propose to analyse theory of harm 2.
48. In addition, as set out in our statement of issues there are strong interrelationships between the three theories of harm which may mean that effects from one reinforce the effects of another and through their combined effect may lead to an adverse effect on competition.
49. For example, if our hypothesis under theory of harm 1 is correct (resulting in low rates of switching) and this is combined with modest rates of new customers into the market, this may mean that market shares and levels of concentration will change only slowly. Consequently large changes in the market may not occur through organic growth but only through acquisition, divestment or insolvency. In addition, difficulties in searching and switching and customer inertia may provide banks with large market shares with an incentive to charge higher prices and/or provide lower levels of quality service and products. Low levels of switching and customer inertia may also make it more difficult for new entrants and smaller banks to gain market share and may therefore constitute a barrier to entry and expansion relevant to theory of harm 3.
50. Consequently, whilst we have retained three separate theories of harm, each theory needs to be considered and will be affected by our findings in relation to the other theories of harm. In our assessment of theories of harm 2 and 3, we focus on the extent to which they may result in worse outcomes for customers over and above any adverse effects captured by our first theory of harm. Furthermore, in relation to theory of harm 2, barriers to entry and expansion (which could include barriers arising from a high cost of customer acquisition should theory of harm 1 hold) would be needed for there to be an adverse effect on competition from market concentration.<sup>31</sup>
51. In the following sections we consider each of the three theories of harm based on the evidence reviewed and the analysis undertaken to date. We also highlight where analysis is ongoing and whether further working papers will be published accordingly.

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<sup>31</sup> CC3, paragraph 195.

***Theory of harm 1: Impediments to customers' ability to effectively shop around, choose and switch products or suppliers, resulting in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation***

52. In our statement of issues we identified as a potential concern the previously widely documented limited levels of customer engagement in the market. We set out three hypotheses within the framework of 'access, assess and act'. If there are impediments to customers being able to: access information about – and compare – alternative offers; assess which offers are best for them; and act on this knowledge by switching products or providers, competition will be weak, which is likely to lead to worse outcomes for customers, as for example banks offering better products and/or services will not acquire customers.
53. In applying this framework in the banking market, we recognise that there may be reasons why some PCA customers or SMEs are not engaged, ie do not even consider searching for alternative providers, and we aim to explore these reasons at each stage of the 'access, assess and act' framework.<sup>32</sup> The market might not work well because:
- (a) customers do not engage with the market – ie they do not consider the potential gains from searching and switching, cannot effectively estimate these gains, and/or perceive them to be insufficient; and/or
  - (b) there are significant perceived or actual costs of searching and switching.
54. We also note that lack of customer engagement, or existence of barriers to searching or switching, may act as a barrier to entry and expansion, as it will be difficult for new entrants to attract customers. This and other interrelationships between our theories of harm are covered above in paragraphs 46 to 51.
55. We recognise that there are differences between PCAs and SME banking products, and our analysis, where appropriate, focuses on each separately. Therefore, we first set out our early considerations in relation to PCAs, and then cover SME banking, as indicated below:
- (a) Indicators of customer engagement, searching behaviour and consideration of switching.

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<sup>32</sup> For example, customers may not be engaged as they are not aware of alternative offers which might reflect a lack of transparency (ie a problem with accessing information) or a behavioural bias (ie a difficulty in assessing information).

- (b) Access to information, including transparency of information available to customers (in particular price/cost and quality of products and services) and mechanisms for comparisons.
- (c) Potential barriers to assessing information including potential customer biases.
- (d) Switching behaviour including the profile of switchers, the reasons for switching, as well as the operation of the CASS.

## PCAs

### *(a) Indicators of lack of customer engagement*

- 56. The behaviour of customer plays a central role in providing competitive constraints on providers if customers are engaged and willing to search for and, implicitly, to threaten to switch to another provider, which offers them a better deal. The level of searching, and then actual switching, can be an important indicator of the extent to which customers are engaged in the market and in fact are creating such a constraint.
- 57. Our PCA survey suggests a number of indicators of low customer engagement (Appendix D):
  - (a) 37% of respondents to our PCA survey had been with their main PCA provider for more than 20 years and a further 20% for between 10 and 20 years.<sup>33</sup>
  - (b) 73% of customers have not shopped around in the last three years, and 81% have not done so in the last year.<sup>34</sup>
  - (c) Approximately 3% of customers switched their main PCA between banks last year.<sup>35</sup> Initial evidence suggests that this switching rate is lower than in other UK retail markets such as car insurance and energy.<sup>36</sup>
- 58. Low rates of engagement in themselves may not be a concern if they reflect that customers are already getting good outcomes. Our PCA survey indicates that, looked at overall, a high proportion of customers appear to be satisfied with their main current account provider, with 52% and a further 39% stating they are 'very satisfied' and 'fairly satisfied' respectively. Comparing these

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<sup>33</sup> More details are included in Appendix D, Figure 1.

<sup>34</sup> More details are included in Appendix D, Figure 4.

<sup>35</sup> This increases to approximately 5% with the inclusion of internal switchers (ie switching PCA within a customer's existing bank) – see Appendix D, Figure 5.

<sup>36</sup> More details are included in Appendix D, paragraph 7.

total satisfaction rates (ie both 'very satisfied' and 'fairly satisfied') between individual providers shows a broad degree of consistency. However, there is greater variation in the proportions of respondents reporting themselves to be 'very satisfied' with their provider, which ranges between 74 and 41%.

59. There are other measurements of satisfaction such as, for example, net promoter scores (NPS), where 2014 GfK FRS results indicate an average NPS score for PCAs of 6%.<sup>37</sup> We are considering how best to draw inferences about overall levels of customer satisfaction and how these vary between providers. To this end, we are further considering the results of our PCA survey along with other measurements such as NPS, and assessing banks' quality and level of service, including complaints information. Finally, we note that reported levels of satisfaction are potentially driven by customers' reasonable expectations, which may themselves be influenced by the alternatives currently available in the market.
60. In addition, the range of different offers available to PCA customers suggests that there may be better offers at least for some segments of customers, ie there are benefits of switching. Therefore, we are seeking to further explore how customers' perceptions of costs of searching and switching compare with actual costs. We are also exploring the extent to which customers understand their usage of their PCA and therefore can estimate potential benefits of alternative offers.
61. We have not yet reached conclusions on the underlying reasons for lack of engagement and continue to gather and analyse evidence along the access, assess and act framework. We set out below some early observations.

*(b) Customers' ability to access information*

62. Transparency about features of a current account including price and levels of service, combined with the ability of customers to compare offerings of different providers, are central aspects of the competitive process.
63. Our initial observations from the evidence gathered to date are as follows:
  - (a) Customers generally have access to necessary information, however the complexity and comparability of information varies across account features.

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<sup>37</sup> Respondents were asked the question 'how likely is it that you would recommend [bank] to a relative, friend or colleague in the next 12 months for current account banking' and choose a score between 10 (extremely likely) and 0 (not at all likely). The NPS is the difference between the percentage of respondents who are 'promoters' (ie choosing a score of 9 or 10 and the percentage who are 'detractors' (ie scoring 0 to 6).

- (b) There are a wide variety of different charges that can apply particularly when going into overdraft. The number of different charges and the different circumstances in which these apply are likely to make it difficult for customers to keep track of how costly using an overdraft is and to compare different overdraft charging scenarios across PCA providers.
- (c) There is a lack of comparative information on banks' service quality, such as customer service and bank errors, available to customers in the public domain.
64. Initial evidence suggests that price comparison websites are not used as much as in other industries and that it is difficult to make an accurate comparison of likely account costs across the range of different charges and interest payments on an account. The midata initiative, as noted above in paragraph 42, may address some of these issues by providing information on customers' account usage. However, it is too early to judge the extent of the impact.
65. In our further analysis we will consider the implication of future developments that may potentially impact transparency of information and enhance comparability of accounts, such as: an open API standard, the role of digital banking and the implementation of the EU PAD. We are inviting parties to submit their comments on these or other potential developments that are relevant in this regard.

*(c) Potential barriers to assessing information*

66. Alongside access to information, we are also considering customers' ability to assess information. In particular, we are considering whether there are any behavioural biases which might limit customers' ability to accurately assess alternative offers, and how this interacts with banks' decisions on price and product structures. This relates closely to the questions of complexity and comparability of charges noted above.
67. One particular focus of our analysis is the 'free-if-in-credit' (FIIC) model. Whilst a number of banks in recent years have introduced alternative fee-paying PCAs offering higher rates of interest or other benefits, FIIC<sup>38</sup> remains the most common form of PCA tariff in the UK, notwithstanding the central bank interest rate environment.<sup>39</sup> Under this pricing model, customers are not charged directly for their PCA if they remain in credit but they pay indirectly through interest foregone as well as through contingent fees and charges for

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<sup>38</sup> By FIIC we refer to PCAs where customers pay no monthly or yearly fees for the upkeep of the PCA or for the main package of transactions provided by a PCA such as receiving money, withdrawing cash or making payments such as cheques, standing orders or direct debits.

<sup>39</sup> Approximately 74% of active PCAs in 2014 were FIIC tariff accounts.

services outside the main package of transactions such as overdraft fees (unauthorised and authorised), paid and unpaid items fees and foreign exchange.

68. Views diverge on FIIC. Some parties have commented that FIIC is beneficial to customers, providing a low-cost simplified pricing structure. Others have suggested that FIIC is harmful because it increases customer inertia by reducing customers' perceptions of the value of different PCAs and/or softens incentives on banks to compete.
69. We have not yet reached a view on whether these pricing structures distort customers' perceptions of the cost of banking, or if so, what the impact might be on competition, and we are undertaking a range of analyses to assess the effect of FIIC on competition.
70. An important part of this analysis is understanding the profitability of particular customers, for example switchers, relative to other customers and the relative level of profitability of PCAs to other banking products. Our analysis on revenue and margins (see paragraphs 27 to 30 above) together with our PCA survey and our ongoing analysis of actual vs perceived behaviour of PCA customers will in particular inform our analyses of the effect of FIIC on competition. The methodology for the latter analysis was published on 10 March 2015 and we will be publishing a working paper on this analysis in due course.

*(d) Potential barriers to switching*

71. Even if customers are willing to shop around, have access to information and are able to compare offers from different providers, they do not always act on this information and switch providers.
72. According to our PCA survey, customers who have to some extent a higher tendency to switch banks are male and in the 18–44 age group, are customers of smaller banks<sup>40</sup> and do not hold an authorised overdraft. Our switching model, the methodology of which was published on 10 March 2015, should allow us to verify these initial findings and better identify whether there are groups of customers that are particularly active or inactive in the market. We will be publishing the results of this model in due course.

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<sup>40</sup> Our PCA survey defined 'Big banks' as follows: England and Wales = Barclays, HSBC, Lloyds, NatWest; Scotland = BoS, Clydesdale, RBS; Northern Ireland = Bank of Ireland (BoI), Danske, First Trust Bank, Ulster. All other banks were defined as small (geography was taken into account, eg in Northern Ireland Barclays was classified as a small bank).



73. When looking at possible barriers to switching, we note that lack of information about alternative products and procedural switching costs (such as online account opening process and the switching process) have been raised as areas of concern. In relation to the CASS switching process, although operationally this appears to be working well (with the exception of the risks arising when the redirection service ends), the recent FCA review of the CASS identified customers' inertia<sup>41</sup> as well as lack of awareness and confidence as areas for consideration.<sup>42</sup>
74. The same FCA report states that the CASS and ToDDaSO<sup>43</sup> switching data shows switching volumes have increased but continue to remain low. The CMA estimates the switching level for CASS to be around 2% of all UK main accounts for the last year (ending February 2015).<sup>44</sup> We are particularly interested in further understanding why, apart from the areas reported by the FCA, the CASS process does not appear to have had a greater impact.
75. We will continue to analyse aspects of PCA switching, in particular in the context of customer value, switching with or without overdrafts, demographic and other customer characteristics impacting switching and the identified potential deterrents such as the account opening process. We are also considering the implications of internal switching (ie switching accounts within a customer's existing bank) and multi-banking (ie holding current accounts with more than one provider). Finally, we will consider how far cross-product holdings (ie holding other banking products alongside PCAs with the same provider) might make switching more difficult; and whether activities such as cross-selling of products and tying or bundling of banking products occurs and may increase switching costs and act as a barrier to entry and expansion, as identified within our theory of harm 3.

### *SME banking*

76. Similarly to PCAs, we are first considering whether and how much SMEs are engaged in the market and whether they consider switching, or in the case of

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<sup>41</sup> The FCA report identifies customer inertia as one of the barriers to switching. Inertia is defined: "... consumers do not even consider switching, for example because of the lack of a trigger to consider switching, a perception that it is not worth switching or that a customer has grown comfortable with their bank." Furthermore: "Account opening and switching processes (which are seen by consumers as one and the same process) are typically cited as the second most important barrier".

<sup>42</sup> FCA (March 2015), [Making current account switching easier. The effectiveness of the Current Account Switch Service \(CASS\) and evidence on account number portability.](#)

<sup>43</sup> The predecessor to CASS was Transfer of Direct Debits and Standing Orders (ToDDaSO), which was an electronic payments service (effectively a back office process) used by providers to transfer payment instructions (ie direct debits and standing orders) for retail consumers between two different current accounts. It had been in operation in the UK since 2001 and accounted for a gradually increasing proportion of current account switches until the launch of CASS. It continued to run until the end of 2014.

<sup>44</sup> Not all account switching takes place through CASS, which is why our survey estimates slightly higher rates of switching (3%), as noted in paragraph 57.

start-ups whether they shop around when opening their first BCA. We are gathering evidence on engagement through a mixture of qualitative and quantitative surveys, and will publish a summary of our findings in due course. Below, we set out our early observations.

*(a) SMEs' engagement and search behaviour*

77. As mentioned above in paragraph 56 in relation to the PCA market, similarly if SME customers are engaged they may provide a competitive constraint on retail banking services providers. In the following section we set out our emerging findings on current levels of searching and switching, which are often used as an indicator of engagement. A selection of supporting evidence is included in Appendix E.
78. Initial indications from the evidence we have seen to date suggest that only a minority of existing businesses have considered switching their main bank in the past year (less than 20% based on data from the Charterhouse survey<sup>45</sup>) and an even lower proportion of SMEs have actually switched in the past year (approximately 4%). Furthermore, approximately half (51%) of SMEs set up their BCA with their main PCA provider.<sup>46</sup>
79. There are multiple reasons that might explain the low levels of engagement, and switching behaviour among SMEs. The Charterhouse survey shows that the majority of businesses are satisfied with their main bank, with approximately 53% rating their satisfaction level as 'excellent' or 'very good', and an additional 38% rating their satisfaction level as 'good' or 'fair'. Satisfaction levels are lower for younger businesses and businesses under £2 million turnover, compared with larger turnover businesses.
80. However, there is some evidence to show that despite these levels of satisfaction among SMEs, advocacy rates for their main bank remain negative. Only 28% of SMEs say they would promote their bank to another business and overall NPS, which measure the proportion of businesses that would recommend their bank minus the proportion that would actively discourage their usage, are negative (-9%), meaning that a greater proportion of SMEs would discourage businesses from using their bank compared with those that would promote this.<sup>47</sup> This may suggest some latent dissatisfaction with banking.

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<sup>45</sup> Charterhouse Business Banking Survey 2014. For more information about this syndicated research, which is conducted by Charterhouse Research and is available by subscription, see the Charterhouse [website](#).

<sup>46</sup> Charterhouse Business Banking Survey 2014.

<sup>47</sup> Charterhouse Business Banking Survey 2014.

81. This is broadly consistent with evidence from FCA qualitative research<sup>48</sup> and our qualitative research<sup>49</sup> which will soon be published, which found examples of SMEs that had been unhappy with their bank, yet remained disinclined to switch. Typically, these respondents were ‘tolerating’ their situation. We are further examining quality issues as part of our analysis of the SME banking market.
82. Other reasons for lack of engagement may be an inability to easily compare and assess the benefits of switching, whether these are financial benefits or service quality issues. This may be due to the complexity of the information or the lack of information available on quality of service. Lack of engagement may also be associated with high barriers to switching. If the barriers to switching are high, for example it is too time-consuming or the costs and risk of switching are perceived to be much higher compared with the perceived benefits, then SMEs may be willing to tolerate poor services without switching.

*(b) SME: Transparency and comparability of information on BCAs*

83. In this section, we examine whether SMEs are able to easily compare prices and quality of service across banks. Although banks offer standard BCA pricing, unlike in the PCA market, elements of the offer tend to be negotiated hence resulting in challenges in comparisons across banks.
84. We will continue to analyse these issues but initial indications show the following:
  - (a) While BCA prices are generally transparent (price schedules are readily available on banks’ own websites and through publications, such as Business Moneyfacts), comparing prices between banks and between bank accounts is complex. Comparison of different tariffs requires an SME to have a good understanding of the current and projected account usage broken down by type of transactions. This could be difficult if a business is going through a period of high growth or contraction. They also need to have a good understanding of the different BCA packages. It may not be as simple as applying the relevant transaction charge to an SME’s transaction profile as some accounts will bundle some free charges. This means comparison is unlikely to be a quick and easy process.

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<sup>48</sup> FCA, [CASS qualitative consumer research](#).

<sup>49</sup> CMA, [Notice of appointment and SME qualitative research survey methodology](#).

- (b) Negotiation of charges is also more common for SMEs, which means comparisons may be further complicated.
- (c) There is an absence of effective price comparison websites for BCAs. A number of banks have begun to implement price calculators to enable businesses to more easily compare between different price plans within their individual bank, but SMEs cannot compare across banks.
- (d) The extent of complexity is supported by many of the banks' own internal surveys and documents which show that a large proportion of SMEs either do not know the monetary benefits of switching or erroneously believe there are no monetary benefits to switching.
- (e) The relationship and service component is often more important to SMEs than the price element. Similar to the PCA market there is currently a lack of independent indicators to compare quality of service and relationship management. Information on quality is often gathered through word of mouth by speaking with other businesses that have had similar experience or through advisers such as accountants.
- (f) In offering other products such as SME loans, banks have to take account of an assessment of a business's credit risk, leverage of the business, affordability and amount of collateral. These products are therefore typically offered to businesses on bespoke terms. This makes it hard for SMEs to compare prices without entering into discussions with different banks.

*(c) SME switching behaviour*

85. This section discusses the initial evidence on barriers to switching.<sup>50</sup> The following issues have been identified:

- (a) For SMEs, the account opening process can be lengthy and onerous depending on the complexity of the business. This is partly because of anti-money laundering regulations. Under existing requirements banks are required to perform a number of 'Customer Due Diligence' (CDD) measures, such as verifying the nature and identity of the business as well as those of the business's owners. In addition to this, banks may require further verification of the sources of the business's funding, including verification of its customers.

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<sup>50</sup> This evidence includes the CMA's qualitative research with SMEs among other evidence and, where stated, the qualitative research conducted as part of the FCA's review of CASS.

- (b) Evidence from the FCA qualitative research ‘highlight[ed] the lack of awareness of CASS, particularly amongst businesses and charities’.
- (c) Similarly, the FCA qualitative research indicated that confidence in the switching process is low. In particular there seems to be concern about:
- payments (ingoing and outgoing) going missing;
  - charges being wrongly incurred; and
  - mistrust that banks would get it right.
- (d) The perception that switching accounts is high effort and will require some time.
- (e) The perception that switching BCA may have implications on a business’s ability to access future finance. A key reason why businesses go to their main bank for finance is that they assume that the process of applying for finance will be faster, they will be more likely to have their finance approved and/or they will receive more favourable rates.
- (f) Finally, many businesses place a premium on all their accounts and finances being in one place. This facilitates their ability to monitor and move their money between accounts. Many businesses will be willing to forego any benefits of switching to have their accounts in one place. In this context, we will consider the extent to which activities such as cross-selling of products and tying or bundling of banking products may increase the cost of switching, and act as a barrier to entry and expansion, as identified within our theory of harm 3.

86. Our work is ongoing and we will continue to look at these issues.

*Overall current thinking on theory of harm 1*

87. Our initial view is that customer engagement through shopping around and switching can play an important role in driving better competitive outcomes in retail banking markets. If customers are not engaged and do not switch, banks have little incentive to improve their offering, and potential new entrants will find it difficult to build a customer base even if they have a better product.

88. Rates of searching and switching remain low in banking markets (both PCA and SME banking) compared with other industries. Low switching rates themselves do not necessarily mean that there is a competition problem. For example, a highly competitive market could have low rates of switching if customers are already getting a good deal and there are low gains from

switching. Indeed we have seen some evidence from PCA and SME surveys that a majority of customers state that they are satisfied with their existing banking provider.

89. However, our initial pricing analysis suggests that there is a wide variation in PCA and BCA prices, indicating potential gains from switching providers of these products. In addition, there is an indication that the complexity of PCA and BCA tariffs, and negotiation in the case of BCAs and other SME products, make it hard for customers to compare them. Survey-stated satisfaction rates also need to be considered in light of other indicators such as NPS.
90. Our initial view on the basis of the evidence we have seen so far, including looking at the stability of market shares of the large established banks over a long period, is that these low switching rates may not be consistent with a well-functioning market and that more engaged customers (both personal and SMEs) would be expected to drive better competitive outcomes.
91. In considering the features of the PCA and SME banking markets that might lead to worse outcomes for customers, we intend to gather further evidence focusing particularly on understanding:
  - (a) whether customers are aware of the costs of banking or potential incremental benefits of searching and switching;
  - (b) whether there are particular costs of, and barriers to, searching and switching;
  - (c) whether quality of service, as well as price, is reflected in a customer's decision-making process when shopping around or considering switching;
  - (d) whether there are incumbency/first mover advantages related to customer acquisition costs driven by low engagement and switching, brand loyalty, cross-selling and tying/bundling and ability to spend more on marketing and advertising; and
  - (e) whether there are particular issues related to overdrafts, including in relation to searching and comparing providers and their offers (ie are overdraft charges transparent and accessible) and in relation to switching (ie are there impediments, perceived or actual, to switching for overdraft users).

## ***Theory of harm 2: Concentration giving rise to market power of some banks leading to worse outcomes for customers***

92. In our statement of issues we identified concentration giving rise to market power leading to worse outcomes for customers as a theory of harm. We set out first our more developed thinking on our framework for assessing this theory of harm. We then summarise our ongoing work to test whether concentration is leading to worse outcomes for customers.

### *Framework for our analysis of theory of harm 2*

93. The relationship between concentration and outcomes in banking has been considered by past investigations and more recently by the ICB in 2011. The Treasury Select Committee's recent report on conduct and competition in SME lending<sup>51</sup> also examined the issue of concentration and the scale required for a bank to be an effective 'challenger' to the large incumbent banks.
94. There is a range of empirical academic research looking at the relationship between concentration and competition in banking internationally. The ICB's overview of this research pointed to a general consensus that greater concentration is associated with weaker competition, although it recognised that only a few of the studies focused on the UK, and that the methodologies involved in some of the research had been called into question.<sup>52</sup> We will be publishing shortly a working paper on our own review of this academic research including more recent research. The studies we have reviewed similarly point to concentration being associated with weaker competition although they have the same limitations as highlighted by the ICB and mostly relate to wider banking markets rather than more specific markets such as PCAs, BCAs or general purpose business loans to SMEs. Such studies are therefore best seen as providing context for assessing the specific UK markets that are the focus of this investigation.
95. Moreover, a general relationship between concentration and weaker competition is not sufficient in itself to imply a direct causal link between the two. In assessing theory of harm 2, therefore, we need also to look at the means by which higher concentration might lead to poorer outcomes for customers.
96. In doing this, as explained in paragraphs 48 to 50 above, we recognise that there are strong linkages between our three theories of harm. In our

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<sup>51</sup> [Treasury Select Committee report](#).

<sup>52</sup> [ICB interim report](#), Annex 4, and [ICB final report](#), Annex 4, paragraphs A4.15 to A4.19.

assessment of theory of harm 2, we are focusing on the extent to which higher levels of concentration result in worse outcomes for customers over and above the effects of weak customer response (theory of harm 1).

97. Concentration may give rise to market power and lead to worse outcomes for customers through, for example, firms having unilateral market power or as a result of firms coordinating their behaviour.<sup>53</sup>
98. In relation to coordinated behaviour, in line with our statement of issues, we do not consider that coordinated behaviour is a feature in the provision of PCAs or SME retail banking services. The market conditions necessary for coordination to be sustained, as set out in our Guidelines,<sup>54</sup> are not met. We have therefore focused our analysis on unilateral market power.
99. In relation to unilateral market power, we have identified two main mechanisms through which there might be a link between concentration or market shares and outcomes:
  - (a) **Ability of banks with higher market share to differentiate products and exercise market power.** PCAs and SME banking markets appear to be characterised by a degree of product differentiation – banks each have their distinct brands, branch networks and websites and the characteristics of their products and services differ. Consequently the products of different banks are not perfect substitutes for each other. Product differentiation will affect the degree to which each bank's products compete with other banks' products. This may give banks the ability to raise prices above marginal costs and/or to lower quality because there is limited loss of business following a price rise or quality reduction. The more concentrated the market, other things being equal, the higher the prices and/or the lower the quality/levels of innovation as the degree of competitive constraint is less. Most banks have several different product and service offerings (for example, interest-bearing PCAs as well as standard PCAs), and some banks have multiple brands (for example, LBG with the Halifax, Lloyds and BoS brands; and HSBCG with First Direct and M&S Bank as well as the HSBC brand). This is another dimension of competition in a differentiated products market; but the presumption of a relationship between concentration and margins continues to hold.
  - (b) **Difficulty in discriminating between active and inactive customers.** Given high levels of customer inertia, banks, irrespective of size, will tend

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<sup>53</sup> CC3, paragraph 170.

<sup>54</sup> CC3, paragraph 251.



to have some unilateral market power over their existing customer base of inactive customers which would be expected to lead to higher price/cost margins on sales to such inactive customers. The effects of all banks' unilateral market power over existing customers are considered under theory of harm 1. Under theory of harm 2, we consider whether banks with higher market shares may have weaker incentives to lower prices or improve quality/innovation than a bank with a smaller market share. Where banks cannot discriminate between active/switching and inactive/non-switching customers, larger banks may lose more revenue than a smaller bank from such a reduction in price or incur greater costs through improving quality/innovation. In particular, a bank with a large market share may set relatively high prices in order to earn greater profits from its existing customer base and accept a lower share of new customers.

100. We would particularly welcome submissions from parties as to whether the mechanisms we have identified are appropriate and whether other mechanisms should be considered.

#### *Next steps on theory of harm 2*

101. In order to test these mechanisms, we are looking at a range of evidence and we will be assessing all the various strands of evidence together in order to come to our view on theory of harm 2. Our analyses will look at PCAs and each of the relevant SME product markets we have provisionally identified across each of England and Wales, Scotland and Northern Ireland as appropriate. We have yet to form a view as to whether either of the mechanisms we have identified are in practice causing concentration to lead to worse outcomes for customers in relation to PCAs and/or any relevant SME retail banking products. We summarise below the main analysis that we will be undertaking to test theory of harm 2.
102. As set out in paragraphs 18 and 21 above and at Appendix B, our initial market share analysis has found that the provision of PCA and SME retail banking services is concentrated whether measured at the UK level or for each of England and Wales, Scotland and Northern Ireland separately. Our review of academic research suggests a link between concentration and weaker competition, but as noted above in paragraph 94, such research is subject to a number of important limitations and primarily provides only a context for our assessment of concentration.
103. We are assessing whether banks with higher market shares tend to have higher prices and/or lower quality and/or are less innovative than banks with lower market shares. We will also be looking at differences in gross margins

and banks' assessments of profitability<sup>55</sup> between banks with larger and smaller market shares. Paragraphs 31 to 37 above and Appendix C set out our preliminary results on pricing on PCAs and BCAs. As noted, the evidence to date on pricing outcomes for PCA customers shows wide variation in prices across the banks and mixed evidence on whether larger banks' prices are higher or lower than smaller banks prices. We are also carrying out revenue analyses in both PCAs and BCAs, details of which are contained in Appendix C. These analyses and our analysis of average monthly charges for BCAs are at an early stage and we will be publishing working papers on our pricing analyses and on our revenue and margin analyses in due course.

104. Any pricing analysis needs to take into account any differences in quality of service between banks. As noted previously our work on quality and levels of innovation is at a preliminary stage. We note that some of the larger banks are innovating at least as much as smaller banks/new entrants.<sup>56</sup>
105. We will be analysing further trends in market shares and our initial analysis is set out in Appendix B. Whilst the combined UK market shares of the larger incumbent banks in respect of PCAs, BCAs and general purpose business loans between 2011 and 2014 have decreased slightly, there are variations between the larger banks with some increasing their respective market shares. Similarly, whilst smaller banks and new entrants have generally seen their UK market shares increase there are variations with some smaller banks' market shares remaining stable and/or decreasing.
106. We are analysing a number of recent mergers including LBG's acquisition of HBOS in 2009 to understand their impact on the relevant markets including changes in strategy post-merger. In relation to the Lloyds HBOS acquisition, we note that the LBG Halifax brand has one of the lowest-priced PCAs<sup>57</sup> and is the brand that has attracted the second largest number of PCA switchers. The Lloyds and BoS brands have also maintained interest-paying PCAs post-merger. In addition, LBG's PCA market share has not declined post-merger. We are continuing to assess events following this merger as well as other structural change including LBG's divestment of TSB to understand whether changes in concentration are associated with changes in outcomes.
107. Banks appear to some degree to be able to offer different prices and services to existing/inactive customers than to new/active customers. This is more apparent in relation to BCAs with most banks offering 'free banking' periods for start-ups and switchers but some banks also offer one-off rewards to PCA

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<sup>55</sup> See paragraphs 25–30 above for further details on this analysis.

<sup>56</sup> See further paragraphs 39–45 above on levels of innovation.

<sup>57</sup> Halifax Reward Current Account.

switchers. We are undertaking further work on the ability of banks to discriminate between active and inactive customers.

108. The BCA markets throughout the UK appear to be more concentrated than the PCA markets. We are gathering further evidence including banks' own assessments of BCA versus PCA profitability and comparing gross margins in order to assess whether higher BCA concentration is associated with higher profits or margins after impairment costs are taken into account. Our PCA and BCA pricing analyses will also compare price-cost margins between Northern Ireland, Scotland and England and Wales (see Appendix C).
109. As highlighted above, we have at this point not taken a view on either of the mechanisms identified or the evidence on outcomes and we will be developing all the analysis relevant to theory of harm 2 further. Our analysis thus far, as summarised above, indicates that there are likely to be limitations in isolating a 'pure' concentration effect from other factors influencing market outcomes. The early evidence shows that banks with similar market shares appear to some extent at least to have adopted different strategies, and achieved different outcomes as a result. In itself, this does not imply that higher concentration does not lead to poorer outcomes for customers, but it does mean that the assessment of theory of harm 2 will need to recognise other contributory factors.

***Theory of harm 3: Barriers to entry and expansion leading to worse outcomes for customers***

110. Entry and expansion by firms or the prospect thereof within a short period of time will often stimulate competition and can sometimes countervail against market power. On the other hand, if there are barriers to entry and/or expansion this can eliminate or at least significantly reduce a major source of competitive discipline and can therefore enable incumbents to exercise market power.
111. Firms entering or expanding in a market will invariably incur costs and will be influenced in devising their entry and expansion strategies by a range of different factors. These include costs (sunk and ongoing costs), scale, timescale and the likely response of incumbents. In assessing the significance of factors that prevent or deter entry or expansion we consider whether such factors may be absolute barriers, or whether they restrict firms to a sufficient degree to impact on firms' decisions to enter or expand. We also consider the

extent to which barriers to entry and expansion may interact with and magnify each other's effect.<sup>58</sup>

112. In isolation, the existence of barriers to entry and expansion does not necessarily give rise to an adverse effect on competition. Essential to our assessment is understanding the impact that the barriers to entry and expansion identified have on incumbents' ability to maintain their position and on the ability of entrants to stimulate competition. As noted above in paragraph 50, barriers to entry and expansion may often constitute a feature in combination with other features – such as market power – that harm competition.
113. In our statement of issues we identified a number of potential barriers to entry and expansion. In this section, we first outline the extent of recent entry and expansion. We then summarise briefly the six case studies which we undertook, details of which are contained in our working papers on barriers to entry: case studies. We then summarise our current thinking on the following:
- (a) Regulatory barriers: looking at the authorisation process to becoming a bank, at the capital requirements and at the anti-money laundering obligations on banks.
  - (b) Natural or intrinsic barriers to entry: looking at the cost of IT systems, access to funding and payment systems, the need for over-the-counter services/branches and whether it is necessary to provide a range of retail banking services ('full-service provision').
  - (c) Strategic advantages of incumbents: looking at access to distribution channels, in particular in the SME sector, and access to proprietary information. Conduct by incumbents that may increase the costs of switching such as cross-selling and tying/bundling are considered as part of our assessment under theory of harm 1 above.
  - (d) Other incumbency/first mover advantages related to customer acquisition costs such as customer inertia and low switching, brand loyalty and ability to spend on advertising. These are being considered as part of our assessment of theory of harm 1 above and are not considered further in this section.
114. Our working paper on barriers to entry and expansion: regulation, IT systems and payments systems, contains further details of our analysis to date in relation to prudential regulation, payment systems and IT systems. It also summarises recent entry and exit. We will be shortly publishing a working

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<sup>58</sup> CC3, paragraph 210.

paper considering branches. We have set out below a summary of our initial analysis set out in the barriers to entry and expansion working paper together with details of ongoing work and/or current thinking in relation to potential barriers to entry and expansion not covered in the working paper. We have not identified any potential barriers to entry and expansion which are specific to any regional or national geographical area and our views are therefore UK-wide.

### *Recent entry and expansion*

115. As set out in our working paper on barriers to entry and expansion: regulation, IT systems and payment systems, to be published shortly, there has been significant new entry in the provision of PCAs in the UK in the last five years. This has included the first new full-service bank in 100 years, Metro, which launched in 2010; the divestment by LBG in 2012 of TSB (which is to be acquired by Banco Sabadell); and the planned divestment by RBSG of Williams & Glyn, which is due to be launched as a new bank at the end of 2016. A large number of banks present in ancillary financial services have also entered such as Virgin Money (PCA), the Post Office (PCA), Tesco Bank (PCA) and Handelsbanken (PCA and SME banking), and there are some prospective new entrants such as Atom (PCA and SME banking) and Starling (PCA).
116. There has been less new entry into SME banking. However, a number of specialist SME banks such as Aldermore, Shawbrook and Paragon Bank have entered offering specific products such as asset finance, invoice discounting and commercial mortgages. There are also some prospective new entrants to SME banking including Civilised Investments which plans to offer a range of SME banking services and OakNorth which will offer lending services to SMEs but not a BCA.

### *Summary of case studies*

117. We have undertaken six case studies looking at examples of entry and expansion in the provision of PCAs and SME retail banking services including examples of where banks contemplated entry or expansion but decided against doing so as well as cases where they had gone ahead. In addition to the six case studies, we also gathered information from a number of prospective new entrants in the process of seeking banking authorisation.
118. Whilst our six case studies and the information on prospective new entrants confirm that entry can be relatively costly and that entry takes time, they suggest that there are a number of different strategies available to potential entrants. However, such strategies suggest that entry and subsequent

expansion beyond small-scale and/or targeted entry is limited. Excluding TSB, the combined anticipated PCA market share by 2020 of all the relevant banks including prospective new entrants in our case studies is less than approximately 8%. The cost of IT systems and/or the need for a branch network have been key factors in the relevant banks adopting strategies that appear to limit the scale of entry and future expansion. Customer acquisition costs whether arising from weak customer response or other factors are also an important factor in limiting the scale of expansion following entry. Theory of harm 1 focuses on these issues.

### *Potential regulatory barriers*

#### *Authorisation*

119. The case studies and responses from parties suggest that the authorisation process for becoming a bank including under the previous authorisation process is proportionate and efficient. This is consistent with a number of recent reports examining this issue.<sup>59</sup> Those firms currently seeking authorisation are benefiting from changes in the authorisation procedure introduced in 2013<sup>60</sup> aimed at simplifying and speeding up the process. We are looking at whether it is possible to obtain further evidence from firms that may have considered but not subsequently initiated or completed authorisation. We would particularly welcome submissions from interested parties who may have felt deterred from applying for authorisation due to the process/requirements for authorisation.

#### *Capital requirements*

120. Existing regulations require all banks to hold a minimum amount of capital in order to protect customer deposits and ensure that banks are able to absorb losses in the event of becoming insolvent or near insolvent. The framework for setting out capital requirements for banks is set internationally by the Basel Committee on Banking Supervision. Some banks in our case studies raised concerns that capital rules favour incumbents, because new or smaller banks are required to calculate their risk weight for credit risk using a standardised approach, which has been set by the regulator using information from external credit rating agencies. Larger banks can use the internal ratings based (IRB) approach which allows banks to use their own internal risk models and data to

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<sup>59</sup> Including the ICB report 2011; FSA and Bank of England review 2013 and the Banking Services to SMEs report 2014. Further details on these reports are contained in our working paper on barriers to entry and expansion, regulation, IT systems and payment systems.

<sup>60</sup> Our working paper on the [regulatory background](#) contains details of the authorisation process and these changes.

calculate risk weights for each class of asset they hold. The lack of track record and the relatively high fixed costs involved in developing and maintaining risk models mean that it is often difficult for new entrants and smaller banks to become IRB approved. Further details on capital requirements are contained in our working papers on barriers to entry and expansion and on the regulatory background.

121. On a like-for-like basis, the IRB approach is likely to lead to significantly lower requirements than using the standardised approach. This is particularly apparent for mortgage lending. Mortgages are a particularly important part of a typical bank's business. However, whilst the IRB approach and the costs of gaining IRB approval potentially give larger incumbent banks an advantage there are a number of other requirements and policy measures that partially counterbalance this advantage, in addition to the cost of developing and maintaining the models required for IRB. These include capital buffers which only large systemically important banks are required to maintain, reduced capital requirements for new entrants, and the leverage ratio.
122. In areas where the Prudential Regulation Authority (PRA) has discretion, it has taken a number of steps to level the playing field between new and incumbent banks. These have included a number of capital concessions for new entrants. In addition, a number of developments are being considered internationally that may change the future approach to calculating the risk weights for credit risks.<sup>61</sup> In addition, the PRA has a secondary objective to facilitate effective competition in relevant markets so far as possible. The way this objective is applied could have an important impact on potential barriers to entry in this area which we will be considering. We are continuing to liaise with the PRA in respect of these issues.

#### *Anti-money laundering*

123. The Money Laundering Regulations 2007 require banks to perform CDD to prevent criminals from using financial products or services to store and move around their money. CDD requires banks to undertake a number of checks when an account is first opened and ongoing monitoring. We have not received evidence to suggest that the anti-money laundering regime is a barrier to entry. However, the CDD processes it requires may act as a deterrent to switching and therefore potentially constitute a barrier to expansion and we will be considering this further.

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<sup>61</sup> These include revisions to the standardised approach to credit risk proposed by the Basel consultation in December 2014. See [Revisions to the standardised approach for credit risk – consultative document](#).

## *Other*

124. It may be the case that other types of regulation could inhibit entry and expansion and we will be mindful of this as we progress our analysis. For example, regulation could chill innovation and thereby create a barrier to entry and expansion by banks/other providers that may otherwise have been able to compete effectively through differentiation. The research Deloitte is undertaking on innovation and its possible implications for competition in the UK retail banking market will consider evidence from multiple countries and seek to draw insights from this into possible drivers of success or failure, including if relevant the contribution of regulation.

## *Natural or intrinsic barriers*

### *(a) Funding*

125. Our case studies and the evidence we have received to date do not suggest that potential entrants or banks wishing to expand have had significant difficulties in raising funds. Whilst several new entrants have had the benefit of existing businesses outside of retail banking with strong brands such as Tesco Bank or Virgin Money or an overseas parent such as Handelsbanken, this is not the case, for example, for several other, albeit smaller-scale, entrants such as Aldermore and Shawbrook.
126. Deposits are an important source of bank funding. The inability of new entrants to attract sufficient volumes of customer deposit, due to low levels of switching, means that they are likely to be constrained in their ability to expand their banking (or lending) business. Moreover, unlike larger banks that can go to wholesale markets to raise funds, new entrants will be limited in their size and scale and may not have this option.

### *(b) Branches and a branch network*

127. In assessing the extent to which branches and/or a branch network may constitute a barrier to entry or expansion we have distinguished between: the need to provide retail banking counter services; the need for a bank to have its own premises for counter services (as opposed to an arrangement with a third party); and the need for a bank to have its own branch network (whether national or concentrated in regions).
128. Our case studies suggest that for some customers, counter services are crucial and the cost of providing such services, whether themselves or through a third party, was an important factor in driving the banks' entry and/or expansion strategies. This applies equally for SMEs as well for



personal customers. Several banks designed their product offering to target particular customers whose requirements for counter services were more limited (for example, Tesco Bank and Nationwide) thus limiting their potential market. Others, like Handelsbanken and Metro, have a branch-based growth strategy. Advances in technology that have led to an increased take-up of digital banking are enabling different banks to adopt such different strategies towards branches and it will be important for our analysis to consider how this will influence future branch use and importance; for example, Atom is planning to launch as a digital-only bank.

129. Branch availability was either essential or very important to 63% of respondents to our PCA survey and a further 27% indicated that it was a fairly important factor in choosing their bank. A national network was identified as essential or very important by 58% of respondents. Some 48% of respondents also indicated that closure of their most used branch would lead them to open a new account with a more convenient branch of another bank. However, only 40% of respondents visited a bank branch once or more per month and of those only 9% once a week or more. The most common reasons given by our respondents for branch usage were paying in money and cheques at the counter (85%), paying in cash or cheques at a machine (54%), paying bills and transferring funds (46%) and checking balances (44%).
130. At least 80% of SMEs have used a branch counter service over the past year and around a quarter of SMEs (23%) report that this is their most used method of banking, above online banking, telephone banking, or contacting their relationship manager or relationship director.<sup>62</sup>
131. Some of the banks in our case studies made alternative arrangements through third parties for access to counter services including through the Post Office as well as through other banks. For example, Starling is negotiating with one of the larger banks for access to its branch network for basic counter services.
132. Whilst several more recent entrants have adopted strategies which do not involve a branch network, it is too early to judge whether new online- or mobile-only banking services will be profitable and/or will achieve a sufficient scale where they are able to represent a competitive constraint on the larger banks. Moreover, as noted above, the larger new entrants such as Handelsbanken and Metro (and indeed TSB) are branch-based providers and

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<sup>62</sup> Charterhouse Business Banking Survey 2014.

view a branch network as essential to their strategy (although in the case of Metro this network is smaller in scale).

133. We are undertaking further analysis to understand in greater detail the need for counter services, branches and a branch network for personal as well as SME customers together with an analysis of the acquisition and running costs and the usage of branches. We are also looking at changes in channel usage, in particular the increasing use of mobile and internet banking. We will be publishing a working paper in due course on barriers to entry: branches.

*(c) IT systems*

134. IT systems have traditionally accounted for a significant proportion of a new entrant's costs. To assess whether IT costs are a barrier to entry and/or expansion we have considered them in the context in which the investment was made and the complexity of the project (for example, the extent to which it entailed integrating a new platform with legacy systems and/or migrating customers across to a new platform, the nature of the products to be supported and the sales channels being used to deliver them).
135. The costs of IT systems required for entry or expansion varied greatly among the banks in our case studies. Some incurred or would potentially have incurred significant sunk IT costs (for example, Tesco Bank and Nationwide) whilst others faced much lower IT costs (for example, those firms currently seeking authorisation including Atom, OakNorth and Starling).
136. The availability of off-the-shelf solutions and the ability of banks to adopt third party hosting/Software as a Service (SaaS) models has reduced IT costs for new entrants significantly. These solutions enable more flexible pricing models, for example with charges increasing in line with customer volumes, and thus do not necessarily require significant upfront capital outlay. Metro, for example, outsourced its IT infrastructure and hosted its banking platform with a third party data centre which reduced its initial investment and lessened implementation time.
137. It would therefore seem that firms providing banking products for the first time may not face significant entry barriers in relation to IT systems. However, those banks seeking to expand and in particular expand into the provision of PCAs and/or BCAs from other banking or related financial services may find the cost of the relevant IT systems, as well as the time to design and build such systems, a deterrent. Our case studies, for example, pointed out the very high costs to both Nationwide and Tesco Bank of designing and building a platform to support a new current account product and of integrating it with their legacy systems.

138. More generally, we noted that the legacy IT systems of the established banks may place them at a competitive disadvantage compared with the lower-cost efficient solutions available to potential new entrants today and that the costs and risks entailed in migrating their customers across to a new platform would be very significant for the established banks. On the other hand we also noted that adopting off-the-shelf software solutions, while cheaper than building a system from scratch, may restrict a new entrant's ability to customise its product and differentiate it from competitors using the same core banking platform.
139. We are gathering further information from parties and from technology providers to gain a better understanding of likely future developments in the provision of financial IT services. The research we have commissioned from Deloitte will also provide insights on how the use of such systems might develop based on the experience of other countries.

*(d) Payment systems*

140. To compete in the provision of retail banking services, financial institutions require access to interbank payment systems. These systems enable the transfer of funds between customers and the banking institutions in the UK.
141. These clearing systems (with the exception of LINK and UK card operators) operate on a two-tier access basis consisting of direct members who own an interest in the relevant system and indirect participants who access the systems through contractual arrangements with a direct member (or 'sponsor bank'). Four banks with direct access to payment systems currently provide the vast majority of sponsoring services to indirect payment service providers (PSPs) in the UK. Barclays, HSBCG, LBG and RBSG facilitate access to Bacs, CHAPS, C&CC and Faster Payments Service (FPS) for indirect participants.<sup>63,64</sup> Smaller and/or newer banks tend to be indirect members. The PSR will, through its market review into indirect access, be exploring what factors may limit the number of sponsor banks offering indirect access to payment systems.
142. We have not received evidence that new entrants have been unable to access payment systems either directly or through a sponsor bank. However, there is some evidence to suggest that the requirements and costs involved in becoming and remaining a direct member mean that it is only practicable for credit institutions that process large transaction volumes to be direct members

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<sup>63</sup> PSR, [Access to Payment Systems, CP 14-1.4](#), p11.

<sup>64</sup> LINK is another main interbank payment system but it does not have indirect PSPs.

The PSR's access rule, with which scheme operators must comply from 30 June 2015, is aimed at ensuring that direct participation in payment systems is not unnecessarily or disproportionately restricted by scheme access requirements.

143. In looking at whether indirect access to payment systems is a barrier to entry or expansion we have looked at four different issues:
- (a) The quality of service provision by sponsor banks to indirect participants.
  - (b) Fee arrangements between sponsor banks and indirect participants.
  - (c) Information provision by sponsor banks to indirect participants.
  - (d) Reliance by indirect members on its competitors for access.
144. The evidence we have gathered in regard to each issue is set out in more detail in the barriers to entry and expansion working paper. We briefly summarise below our initial findings.
145. A number of banks that access payment systems indirectly have told us that the quality of service they can offer their customers is constrained by the quality of service (in terms of speed, reliability and security of supply) that their sponsor bank provides, thus limiting their ability to effectively compete and innovate. We have also received evidence that the quality of service provided by sponsor banks can impact on the ability of indirect PSPs to participate in certain service offerings. These issues appear to be more pertinent for indirect PSPs who also have indirect technical access (that is, they connect to payment systems through their sponsor bank's infrastructure) and arise mainly in the context of the FPS. The PSR is currently supporting the development of technical access solutions by industry including facilitation of direct technical access to FPS. The PSR's market review into indirect access<sup>65</sup> will also look to assess indirect offerings in terms of both quality and prices, which is also relevant to pricing (see below).
146. In relation to pricing, the information we have at present is not sufficient to draw any conclusions about access fees and charges paid by indirect PSPs to sponsor banks for providing indirect access. Pricing is relatively complex and is usually dependent on transaction volumes. Entrants and smaller banks may therefore pay higher per-transaction prices for access. We are aware, however, that there are a number of fixed costs involved in being a direct member

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<sup>65</sup> [PSR policy statement](#).

which indirect PSPs are not explicitly charged by the scheme operator or their sponsor bank.

147. We have some evidence that there is a lack of transparency in relation to charges and service offerings which potentially reduces the power of prospective PSPs to compare options and to negotiate terms and prices.
148. The PSR has introduced a direction, which will be effective from 30 June 2015, requiring the four sponsor banks to publish access-related information to improve transparency and enable indirect members to make more informed choices in terms of selecting sponsors. A sponsor-bank code of conduct which is in the process of being developed and agreed by industry participants and will require approval by the PSR is also aimed at improving transparency. The PSR expects the code of conduct to be in place by 30 June 2015 and sponsor banks to be complying with the code from 30 September 2015. The lack of transparency and comparability of information provided by sponsor banks on prices and quality of service also potentially creates a barrier to indirect members switching sponsor banks. The PSR, as part of its review into indirect access to payment systems, will be looking at the difficulties in switching sponsor banks and in becoming a sponsor bank.
149. Certain aspects of the vertical relationship between sponsor banks and indirect participants of payment systems could disadvantage indirect PSPs and weaken their competitive position relative to their sponsor bank, in view of the fact that indirect PSPs and their sponsor banks are usually competitors. The proposed industry code of conduct referred to above will, among other things, include provisions regarding handling by sponsor banks of sensitive commercial information.
150. We are liaising closely with the PSR in respect of the above issues relating to payment systems which are being considered as part of the PSR's ongoing work programmes. Also, the research that we have commissioned from Deloitte will draw on international comparisons to look at innovations such as alternative payment systems, including whether there are any barriers to their development and expansion.

*(e) Full-service provision*

151. Our case studies do not suggest that full-service provision is a prerequisite to entry. Indeed several examples of recent entry have been targeted at particular market segments. We are undertaking a number of analyses to assess whether PCAs and BCAs are gateway products and the extent to which full-service provision may therefore be a factor in expansion.

## *Strategic advantages of incumbents*

### *(a) Intermediaries*

152. Concerns have been raised that in relation to SMEs, incumbent banks may benefit from a more established network of sources for SME customer acquisition, including intermediaries such as accountants, solicitors and brokers. We have therefore considered whether access to intermediaries may pose a barrier to entry or expansion. Initial evidence suggests that while accountants can often influence SME decision-making in terms of choice of BCA and loan providers, this network of relationships tends to be of an informal and localised nature. Moreover, accountants can help open up a wider range of financing options that may be better suited to the diversity of SME funding needs. In relation to brokers, some smaller banks have indicated to us that these intermediaries are important in introducing new lending business as part of a normal arm's length commercial relationship. Our case studies do not suggest that access to intermediaries has constrained entry or expansion. We also note that intermediaries have a professional duty of care to provide recommendations suitable to their clients with commission arrangements being transparent.
153. We will continue to consider the role intermediaries play and how this may impact on competition, but the evidence to date does not suggest that access to intermediaries is problematic for new entrants or that incumbents have any significant advantages in terms of access to intermediaries over new entrants and smaller banks to give rise to a barrier to entry or expansion.

### *(b) Tying/bundling and other activities increasing cost of switching*

154. We will consider the extent to which tying/bundling of banking products and other activities that may increase the cost of switching are barriers to entry or expansion as part of our theory of harm 1.

### *(c) Information asymmetry*

155. Asymmetry of information between incumbents who hold the existing banking relationship, and new entrants, can also pose a barrier to entry or expansion. Banks may be able to use data on their customers' usage and behaviours to make faster or better commercial decisions (eg on overdrafts and loans) and to cross-sell and respond to customers' needs more effectively. This may provide them with an advantage over competitors who do not have access to this information in both customer acquisition/retention and credit risk management.

156. For PCAs, the midata initiative aims to help address such issues more generally by empowering consumers to use their personal data and enabling businesses to provide services informed by consumer information. In regard to creditworthiness, which is a particular area where the incumbent bank may have an advantage, credit reference agencies (CRAs) assist to bridge this information gap. We will continue to consider the extent to which credit issues may affect switching, including if relevant any part that credit information provision plays in this.
157. For SME banking, similar issues arise, particularly in respect of lending, where absent information on past financial performance, providers may either miscalculate risk so that they turn away potentially viable prospects, or include a risk premium for protection against lack of information which prices them out of the market. We are therefore concerned that limited access to credit information on the part of smaller and newer providers may constitute a barrier to entry or expansion in SME lending. We note, however, recent legislation in the form of the Small Business, Enterprise and Employment Act 2015, which includes measures aimed at improving the ability of challenger banks and alternative finance providers to conduct accurate risk assessments on SMEs. This Act provides for the sharing of credit information on SMEs by, among other things, permitting HM Treasury to make regulations<sup>66</sup> that require banks (meeting a certain market share threshold) to share data on their consenting SME customers with other lenders through CRAs, and requiring those CRAs to ensure equal access to that data for all lenders. As with PCAs we will continue to assess whether credit issues may be a barrier to entry or expansion.

### *Summary of current thinking on theory of harm 3*

158. We are still gathering information and undertaking analysis of potential barriers to entry and expansion. We are also continuing to liaise with the PRA and PSR respectively. Our analysis so far suggests that although new entry has taken place and there continues to be the prospect of further new entrants, such entry appears to be relatively small scale and/or targeted at particular market segments. This entry has also been more focused on PCAs rather than SMEs with the exception of specialist lenders that do not currently provide BCAs.
159. The availability of off-the-shelf and third party hosting/SaaS solutions has reduced IT costs for new entrants significantly. However, those firms seeking

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<sup>66</sup> [The Small and Medium Sized Businesses \(Credit Information\) Regulations 2015](#), published by HM Treasury in draft form on 15 December 2014.

to expand from other banking or related financial services appear to find the cost of linking new platforms to their legacy systems a deterrent. We also note that the costs and risks for established banks of adapting their existing IT systems are also significant. Whilst several existing banks and several new entrants have adopted digital strategies, our case studies and other initial evidence suggest that the need for a branch network may be a barrier to expansion beyond a small scale. Finally, as discussed under theory of harm 1, the high costs of customer acquisition may impede entry and expansion on a scale sufficient to stimulate competition and constrain the incumbent banks.

## Next steps

160. As indicated throughout this paper, a number of areas of analysis are ongoing and we will be publishing further working papers over the coming month or so. We will continue to consider all the issues further taking into account our analysis and responses to this statement and papers. Hearings and roundtable discussions are being held with a number of interested parties in June and July and we propose to publish our provisional findings at the end of September.
161. We are also continuing to concurrently review the undertakings that were put in place following the 2002 Competition Commission investigation into SME banking (the 2002 SME Undertakings).<sup>67</sup> A number of parties made submissions on change of circumstances since the 2002 SME Undertakings when the CMA was considering whether to open an own-initiative review into the 2002 SME Undertakings, which we will take into account. However, we welcome any further submissions any parties wish to make in relation to any change of circumstances since the 2002 SME Undertakings.
162. The current timetable envisages publishing a provisional decision on change of circumstances in parallel to the provisional findings in the retail banking market investigation. If we were to provisionally find an adverse effect on competition, we propose to amend the timetable in order to align the provisional decision on change of circumstances since the 2002 SME Undertakings with the provisional decision on remedies, due to be published in January 2016 if required. This would allow for any remedies proposed during the market investigation to be taken into account as a change of circumstances, if relevant. In any case the final decision on change of

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<sup>67</sup> [SME banking undertakings review case page](#).



circumstances would be aligned with the final report in the market investigation. We also welcome views on whether we should amend the timetable in the event of a provisional finding of an adverse effect on competition.

163. In addition, the CMA has published an invitation to comment on whether it should open a review of the 2008 Northern Ireland Personal Current Account Order as varied in 2011.<sup>68</sup>

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<sup>68</sup> NI PCA Banking Market Investigation Order consultation.