Promoting competition in the UK banking industry

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About the BBA

The BBA is the UK’s leading association for the banking sector representing the interests of more than 250 member organisations with a worldwide presence in 180 countries.

Our member banks make up the world’s largest international banking cluster, operating 150 million personal accounts for UK customers and contributing over £60 billion annually to UK economic growth.

We represent our members to policymakers, regulators, the media and all key stakeholders across the UK, Europe and beyond, working together to promote a legislative and regulatory system that helps customers, promotes growth and raises standards in the industry.

For more information on becoming a member and working with the BBA, visit: www.bba.org.uk/membership or contact: Richard Adler, Relationship Director, richard.adler@bba.org.uk

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Competition in the UK banking industry
The state of competition in banking is something which has rarely been off the agenda of the competition authorities and politicians and is the focus of attention once again. The Competition and Markets Authority (CMA) is carrying out a programme of work relating to retail banking ahead of a decision in the Autumn on whether a market investigation is required and Labour leader Ed Miliband has proposed market share caps and forced divestiture of branches were he to be elected next year. It is the position of the BBA that competition in banking is vital and should continue to be encouraged so that customers can make informed choices from a range of banks. In this document we have looked at the current state of the banking sector, how competition can best be facilitated and then made some recommendations on what needs to be done.

Many characterise the banking sector as being one market that is highly concentrated with little or no competition. Yet banking in the UK is not just one market but many, ranging from mortgages to credit cards to personal loans and SME banking. The number and type of competitors in these areas vary enormously and we have been told by a number of the challengers that competition in certain segments is fierce. For many retail customers there is plenty of choice and they are able to shop around, aided by the ability to search online. Many have credit cards, mortgages and savings accounts at different financial institutions from the holder of their main bank account. Indeed, polling carried out by YouGov for the BBA shows that 43% of people with current accounts have a credit card, 23% a mortgage and 25% a savings account with a different institution.¹

¹ Note this is 23% of all current account holders, not of all mortgages. There are 11.2 million mortgages in the UK (according to the CML) and over 60 million regularly used current accounts according to the OFT. So the proportion of mortgages held at a different institution to the current account is bound to be much higher than 23%.
The same polling suggests that consumers are not particularly focused on competition in banking as a key issue. Only 25% cited it as a reason for concern about banking and just 11% cited problems with switching accounts as a cause for concern. Despite the generally bad press that the banking sector receives we also found it interesting that of those polled by YouGov only 14% had a negative view of their bank and 60% said they did not want to switch banks because they were happy with their bank account. While the Current Account Switch Service (CASS) has been a success, with switching rising by around 14%, the fact that switching has not increased more sharply likely reflects this constructive view.

The banking sector did become more concentrated in the aftermath of the financial crisis as a number of failing institutions were either merged or taken over. The OFT calculated that this took the UK personal current account market up from a concentration reading of around 1350 on the Herfindahl-Hirschman Index (HHI)\(^2\) to a peak of over 1800 (where anything above 1500 is considered to be moderately concentrated by US regulators\(^3\)). We estimate that with the divestment of TSB and Williams & Glyn this measure of concentration will drop back to around 1450 (see Box 1).

It does not and should not stop there though. We are also seeing more entrants in the retail space, with Metro Bank launching the first all new bank in over 100 years, opening 26 new stores with a target of over 200 eventually. M&S Bank and now Tesco Bank have launched current accounts with Virgin due to follow shortly. There are other competitors such as One Savings Bank and Secure Trust who have entered different parts of the market, while Atom Bank is due to launch next year as an internet-only bank. CASS gives these banks the ability to attract new customers, and we have seen both M&S Bank and Tesco Bank offering non-bank incentives to encourage people to switch. Banks will also need to compete just to stand still with a large number of new accounts being opened each year. Indeed, there are some 5.4 million new accounts opened each year across the banking sector and Lloyds estimate they need to open 1.6 million accounts a year (excluding TSB) just to stand still. The existing banks have responded by offering better features and incentives. Which?, the consumer group, recently ran the headline on its website: “Competition hots up in the current account market as Lloyds Bank introduce account rates of up to 4%\(^4\). We think this will continue to see concentration levels fall in the UK banking industry across all the different product areas.

The advance of technology means that it is easier to set up new banks, as at least some of the IT can now be sourced off the shelf. It also means that the need to have as many branches is reduced. It does not mean the branch is not important and, indeed, it remains key for consumers in terms of face-to-face contact. Of those YouGov polled 58% say a branch is important, with 57% citing its necessity for discussing issues face-to-face. Nevertheless, our polling work is showing a clear move towards using online access for day to day transactions in preference to a branch. Whereas only 9% of people visited a branch once a week and 32% once a month, 15% used online banking once a day, 59% once a week and 77% at least once a month. Some 53% of people said they were confident that they could do the vast majority of their banking online or over the

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\(^2\) Referred to as “Herfindahl Index”.


\(^4\) Which? money, 5 June 2014.
phone. The impact is clear with RBS reporting a 30% drop in footfall in their branches in the last 3 years. The evidence from our YouGov polling suggests that the arrival of cheque imaging will further accelerate this trend.

This is important because in the past the Office of Fair Trading (OFT) has regarded the branch network as a barrier to entry for the banking industry. In our conversations with the challengers most suggest they see the need for many less branches, because of these trends, in order to be competitive with the established banks.

There are areas in banking which are relatively more concentrated, such as the SME markets, but in part that reflects the more complex arrangements between banks and companies. A number of challengers have told us this market is more difficult to break into because many business customers tend to want a full range of services, including trade finance, foreign exchange etc. Here too we find customers are not unhappy with the service being offered them. In the YouGov survey of small and medium-sized enterprises (SMEs) 66% said they were satisfied with their business account vs 14% who said they were unsatisfied.

Nevertheless, we are seeing more competition here too, with Santander moving into the business banking market in the last few years, taking its corporate loan book up to some £22 billion, with around half of that to SMEs. Handelsbanken is also making inroads through its traditional banking model, which places emphasis on the branch and local, face-to-face, relationships. It now has 175 branches and £8.8 billion of corporate loans, the lion’s share of which are to SMEs. And technology is starting to break down barriers here too. We have seen a large proportion of businesses moving online to do their banking, with 68% using online banking at least once a week compared to 27% using a branch. While 68% said that having a local branch was important, 33% said that they felt it was no longer necessary to have a branch on every High Street. Again the emphasis was on the need for a branch for face-to-face meetings, with 66% saying such a service was necessary. Interestingly, though, exactly the same percentage of businesses said they could get the vast majority of their business banking done online or over the phone.

This is enabling the likes of Aldermore and Shawbrook to enter the business banking market with few or no branches and these banks are starting to build sizeable loan books (both measured in the billions of pounds). Other forms of finance such as peer-to-peer, through the likes of Funding Circle, or invoice financing, most recently Tungsten Bank, are also becoming increasingly available courtesy of the web. It seems to be particularly the case in the business banking area that niche providers of finance are able to enter the industry.

It is our belief at the BBA that competition is already in evidence in the banking industry and that an intensification of this competition is very much on the way. Indeed, it is reported that there are some 20 applications for banking licences in the pipeline at the Prudential Regulation Authority (PRA). Rather than further break up the banks to create smaller versions of the current High Street banks, we think the right approach is instead to encourage new entrants to grow and make it easier for customers to make an informed choice between different providers by increasing transparency and making it easier to switch. Indeed, many of the challengers have said

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5 Philip Aldrick, Bank shake-up sparks surge of new lenders, Times, 10 March 2014.
they think it is important to have different business models so they can target the parts of the market not reached by the incumbents.

We have seen the effectiveness of such an approach in both the supermarket and airline industries, where it was new entrants with different business models such as Aldi, Lidl, Ocado, easyJet and Ryanair that changed the state of those industries. Those new entrants have increased capacity and sharpened competition both in terms of product offered and price.

This progress of the challengers is already impressive. Work by Ian Gordon, the Investec banks analyst, suggests that the challengers’ share of gross mortgage lending rose from 17.5% in 2011 to 28.8% in 2013. Joseph Dickerson, banks analyst at Jefferies, thinks the trend can go further with so-called “challenger banks” set to double their market share of mortgage lending by 2018 if they sustain their current rate of growth.6

The key question for the government and regulators is how best to encourage this to happen. We have already seen some very significant steps forward. The fact that the Financial Conduct Authority (FCA) has a mandate to promote competition and the PRA a secondary mandate to facilitate competition is a positive step. Both regulators have worked to make the new bank application process easier and have reduced both the capital and liquidity requirements for new banks.7

There has also been progress in increasing transparency. Earlier this year a number of banks8 agreed to make customers’ account data available in a “simple standardised format” to allow those customers to assess more easily whether switching account providers would be in their interests.

Yet there is more that can be done. In writing this document we took the opinions of a number of the challenger banks in a variety of forums. The message came through that there were three key problems – capital, funding and payments. There was also an overarching message that regulators need to think about how regulation impacts smaller players. In particular there was an appeal for proportionality, i.e. not requiring the smaller banks to have to match the larger banks when meeting every regulation. The cost to the smaller banks of doing this was said to often be disproportionate to the impact of the regulation.

The issue on capital is that despite the Financial Services Authority (now PRA) reducing the initial capital a new bank has to have, the challengers are still disadvantaged vis-à-vis the established banks. This stems from the fact that the challengers (with one or two exceptions) have to use standardised capital weights from Basel, rather than model based weights (known as IRB). This is particularly disadvantageous when lending to safer borrowers (such as low loan to value mortgages), often requiring challengers to put up multiples of capital against the same risk. This tends to mean that the challengers end up with riskier loan portfolios. In some cases it means they cannot efficiently recycle the deposits they have accumulated. One proposal is for the challengers to have access to an average of the IRB weights of the biggest banks for lending purposes. Such a register would have to be provided by the regulator (in this case the PRA).

On funding there is a belief amongst some of the challengers that the large banks have an advantage in terms of funding because of their size. This is exacerbated by the fact that the large banks are also the recipients of government deposits (local and central),9 which tends to give them larger

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6 The definition of a challenger is a difficult one, some are brand new, some have been around for years, some are niche players others want to compete head on with the incumbents. We have used the term in this document to describe anyone who is not a major bank already on the High Street. Those included by Mr Dickerson in his analysis are: Aldermore, Handelsbanken UK, Metro Bank, One Savings, Secure Trust, Shawbrook and Virgin Money.


8 Barclays, HSBC, Lloyds, RBS, Nationwide and Santander.

9 Joel Benjamin, Challenger banks hope to compete for £30bn council cash pile, Guardian, 18 February 2014.
deposits and lower cost funding. It is the belief of the BBA that councils should not be prevented from placing deposits at the challenger banks and we would support any move to allow diversification.

The challenger banks are also disadvantaged in their access to the Funding for Lending Scheme (FLS) run by the Bank of England. First, because of the capital issues discussed above, resulting in higher risk loan portfolios, the Bank tends to require a greater amount of assets from the challengers in exchange for a given amount of funding (known as a haircut). That makes the funding more costly. Second, any funding granted comes in the form of Treasury Bills. In order to convert this into cash a challenger bank then has to conduct a repo operation with a larger bank, involving additional cost. The obvious solution would be for the Bank of England simply to credit the bank accounts of FLS borrowers up to a maximum amount.

One suggestion is to supplement the FLS with a funding for challengers scheme, which would have the objective of providing low cost funding for the challenger banks. An alternative is to channel more low cost funding through the Business Investment Bank. Thirdly, the challengers highlight the issue of access to and cost of the payments system. Many complain that they pay too much to access the payments systems provided by the larger banks. The counter argument is that those larger banks have to pay for the IT infrastructure to run the payments system. With the Payment Systems Regulator due to start work on this in the Autumn, all of our members are prepared to work towards a solution, which ensures that costs are fairly shared and there is transparency on pricing. As one challenger put it “we don’t want the playing field tilted in our favour, just to know that we are on a level playing field”.

Finally many challengers complained about the burden of regulation. We urge the regulators to ensure that all regulation is proportionate, so smaller banks are not adversely impacted.

Our contention at the BBA is that a combination of the efforts already made to facilitate competition and the change being brought about through technology is already generating a raft of new competitors. The challenge is to ensure that the conditions are created in the banking sector so that all banks can compete on a level playing field.

In summary we recommend:

1. Reform of the capital rules so that challengers and incumbents can lend using similar amounts of capital.
2. Reform of the funding system so that challengers have equal access to government deposits and the FLS is made more challenger friendly or is supplemented by a Funding for Challengers Scheme.
3. Payment Systems Regulator work to identify any action required to reform the payments systems so as to ensure all banks have fair access and pay a reasonable and transparent price to use the system.
4. Regulators to ensure that all regulation is proportionate.
Chapter 1

Introduction

The BBA’s position on competition is clear. We support competition and want customers, both retail and business, to have choice both in the bank and the type of banking they want. More competitive markets allow customers to choose from a greater range of products to suit their needs from a wider variety of providers. More transparency will improve the efficiency of the market and lead to customers making informed decisions about whether to switch provider in order to get the best deal.

In this document we have canvassed the views of both established banks and challengers, with a variety of different business models. The common theme from them all is that they welcome competition and want the playing field to be fair to all.

Competition in UK banking is a topic that has been discussed almost constantly in political circles and been the subject of more than 30 reports by the OFT and Competition Commission (CC) in just the last 15 years. It is certainly true that the sector became more concentrated in the aftermath of the financial crisis when household brands such as Halifax, Northern Rock, Bradford & Bingley, Bank of Scotland and Abbey National merged or were taken over by larger banks. The consolidation of the sector in the aftermath of the financial crisis has once again raised concerns about the degree of concentration in the sector in political circles. It was a key focus for both the Independent Commission on Banking (ICB) and the Parliamentary Commission on Banking Standards (PCBS).

One of the first steps of the newly formed CMA was to announce on March 13, 2014, “a short programme of work on banking, which will lead to a decision on whether or not to make a market investigation reference
to be conducted by a CMA panel of independent members. The CMA will build on the OFT’s work in the sector, by concluding the market study into banking for SMEs. It will also carry out a short update of the OFT’s 2013 review of personal current accounts”.10

It said, “that there appeared to be some important similarities between competition issues for personal current account customers and for SME customers, in particular:

- The banking providers in the sector
- How dynamics of competition operate, and
- The way that personal and SME customers consume banking services, including levels of customer engagement with banking providers.”

The CMA also said it would consider the impact of “the new Seven Day Switching Service, the impact of the planned divestments by Lloyds Banking Group and by the Royal Bank of Scotland of parts of their retail banking businesses, and the forthcoming establishment of the Payment Systems Regulator.”

The CMA said it would publish its work on current accounts and SME banking in the summer of 2014 and the provisional decision on whether to make a market investigation reference, with the final decision to be taken in the autumn of 2014.

The CMA’s announcement follows Ed Miliband’s proposal to impose a threshold on the “market share any one bank can have of personal accounts and small business lending”.11 He also proposed to launch a CMA investigation under a future Labour government that would report within six months on “how to create at least two new sizeable and competitive banks to challenge the existing high street banks”.

Whilst competition in banking has been a mainstay of consecutive governments’ political agendas, the Labour leader’s declaration put the issue back under the public spotlight at a time when the industry is undergoing other, wide-reaching, reforms.

The objective of this paper is to look at the state of competition in the banking sector and what can be done to help nurture that competition. In doing so the BBA is seeking to represent all of its banking members in the UK, both incumbents and challengers.

We will look at the existing structure of the industry and highlight that it is not one homogenous market but consists of many different and distinct product markets. When people talk of the banking sector it is often thought of as referring to the current account market for both consumers and corporates. In reality, the banking sector is much more diverse incorporating mortgages, savings, personal loans, credit cards, corporate loans, export finance and a number of other products such as invoice discounting and supply chain finance.

Many retail customers hold their current account with a different provider to where they place their savings or source their mortgage. They shop around to find the deal that is best suited to their needs.

For corporates the relationship is often more direct since much corporate lending has to be based on a judgement of a company’s prospects. But even here the competitive dynamic is changing with the rise

10 Gov.uk, CMA announces programme of work on banking, 11 March 2014.
11 Ed Miliband one nation economy speech, Labour list.
of multi-banking, as well as sources of alternative finance such as invoice discounting, supply chain financing and peer-to-peer lending coming into the market via web based platforms. The key is to ensure businesses get the right finance at the right time.

The advent of new technology is allowing new entrants into the market. Many of the challenger banks are choosing to launch with a very different type of branch presence or with no branch presence at all because the internet allows customers to access them without the need for a high-street presence. New technology also enables a better and more rapid assessment of the customer and any requirement for credit. Finally, the IT needed to launch a bank is now much more readily accessible.

Evidence confirms that technological change, as well as a determined effort by regulators to lower barriers to entry, is promoting competition. Indeed, the Prudential Regulation Authority (PRA) is reported to have more than 20 institutions applying for a banking licence currently.

It is also now much easier to switch bank accounts. CASS was introduced on 16 September 2013 and has significantly simplified the switching process for consumers. It allows for automatic switching of direct debits, standing orders and cash balances from an existing account to a new account within seven working days. It also commits banks to redirect payments from the old account to the new account for 13 months.

One of the principal benefits of the new switching service is its effect on the offers available to customers. Before the new system’s introduction, people still had the ability to switch but the process could take up to a month and was typically the result of customer dissatisfaction. As a consequence, the switch brought benefit to the individual but not to consumers more widely.

This is no longer the case thanks to the speed of switching and the guaranteed transfer of existing arrangements. The new service is forcing banks of all sizes to compete vigorously for switchers and, crucially, ensure that their own customers are not tempted to look further afield. This has resulted in a virtuous cycle where a more level playing field for incumbent and challenger banks promotes competition and wider consumer benefits, as the improved offerings from banks benefit existing customers as well as switchers.

The process appears to be running well and, according to the Payments Council, the new system has seen a 14 per cent increase in switching rates in the first six months of operation with more than 800,000 people switching as of the end of May 2014. While it is true that the majority of customers are happy with their accounts (see chapter 2), switching is making the sector more competitive and customer-orientated.

The other significant factor is the growing presence of non-bank competitors that have already entered or are looking to compete in banking markets. Global brands such as Google have already launched e-wallet services and Amazon has started to offer trade finance to its customers. Tesco and Sainsbury’s have launched banks, with the former recently entering the current account market.

It is the view of the BBA that some of the biggest changes to the banking sector in the coming years will arise from the impact of digital
banking. It is a major change that is already resulting in a new banking paradigm whereby it is easier for new entrants to compete with the existing banks in the sector. Indeed the tendency to focus on branches as a measure of market share is misleading because it does not acknowledge the impact of innovations already sweeping through the industry and resultant changes in consumer behaviour. Moreover, the fact that the larger banks are all actively trying to reduce their branch networks, suggests that the costs of maintaining such wide coverage may, in fact, now put those banks at some disadvantage.

The branch will remain a key part of most banks’ offering, but the time has gone when branches provide everything that a customer wants and needs from their bank. Already people access their mobile banking apps more than 25 times a month on average compared to around once a month for a branch visit. This level of uptake and the implication for how it changes the structure of banking must be taken into account by any assessment of the competitive landscape for banking.
Chapter 2

Competition and the regulatory authorities

The UK banking system is often said to be highly concentrated and therefore insufficiently competitive. The solution put forward by some is to break the incumbents apart to increase competition. We believe this makes three mistakes. The first is to overstate the concentration, including assuming the UK banking sector comprises one market and not many markets. The second that concentration itself automatically means ineffective competition. Third that the right way to promote competition is to break up the incumbents rather than encourage new entrants.

The UK banking system is in fact a combination of many separate product markets with competition coming from different areas and different competitors. While the High Street banks are all sizeable participants in each of the market segments, the leading bank in each segment tends to be different. In terms of stock of lending Lloyds is the largest in mortgages, Barclays in credit cards and RBS in SME lending. Moreover, each of those markets has different competitors to the High Street banks, ranging from Tesco and Metro Bank in current accounts to the Building Societies in the mortgage market and from MBNA and Capital One in credit cards to Aldermore, Handelsbanken, Santander and Shawbrook in SME lending.

The issue of concentration being the key problem from a competition perspective is equally misrepresented. The UK current account market is not particularly concentrated by international standards or when compared to other sectors in the UK. The divestments of TSB and Williams & Glyn, together with the rise of the challenger banks will take concentration levels back down to pre-crisis levels and probably below. The UK supermarket
industry is an interesting example of how a market with higher levels of concentration can be competitive and has become still more so as new competitors have entered the market. Similarly, the airline industry has been changed dramatically by new entrants encouraged by lower barriers to entry.

This has resulted in the rise of the discount supermarkets like Aldi and Lidl, internet-based competitors like Ocado, and economy airlines Ryanair and easyJet over the last few years, with greater choice and more intense price competition as a result. We believe a similar strategy is likely to be more effective in promoting competition in banking markets than trying to break up the incumbents. Many of the challengers have said to us that little would be achieved by creating more “mini-me” banks which have the same business models as the incumbents. Customers do not just want more banks they want a better choice of banks and banking models. It was the different business models of Aldi, Lidl, Ocado, easyJet and Ryanair which changed competition in their respective sectors, not the breaking up of the incumbents. We think this is particularly relevant at the moment in banking where new technology is breaking down old barriers to entry and possibly even giving new entrants a competitive advantage.

**UK competition policy and inquiries into UK banking markets**

Before we move on to look at the current state of UK banking markets it is worth looking at both how the competition authorities define uncompetitive behaviour and look at some of the issues that the OFT and Competition Commission have looked at in banking in recent reviews.

1. **How is a UK market judged uncompetitive?**

Much of the current focus of the debate around competition in banking has been focused on the Market Investigation powers of the UK’s domestic competition regulators. Market Investigations in their current form were introduced by the Enterprise Act 2002 and are a powerful tool available to UK competition regulators to examine markets they believe may not function sufficiently well and to demand wide-ranging changes to how those markets operate, including requiring companies to divest parts of their businesses. Since the introduction of the Market Investigation regime there have been 12 market investigation references, four of which to the Competition Commission as well as four references relating to banking and financial services.

**Market Investigation Reference:**

Under the new Enterprise Act the CMA has the power to make a Market Investigation Reference if it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in all or part of the UK (section 131(1), Enterprise Act).

The decision making process for a Market Investigation Reference is a two part process with the CMA board (previously the OFT) taking the first phase of the decisions and the second phase decisions taken by a panel of specialist members (previously the Competition Commission inquiry groups). In many cases a relevant feature of the market may arise due to a
combination of both the market structure and the behaviour of the market participants. For example, high barriers to entry can result from both structural issues (such as high capital requirements or branch networks) and from the behaviour of the market participants (for example, the fact that licences for the necessary technology are held exclusively by the incumbent companies).

When looking at what factors influence the CMA in making its decision it is useful to refer back to the Explanatory Notes to the Enterprise Act. These notes set out some of the key issues that might be included in the analysis of whether the market under consideration is competitive. (Explanatory Notes to the Enterprise Act 2002, section 300). These elements include both structural and conduct issues, ranging from the concentration and market share of participants, to the awareness of switching options amongst customers:

- **Concentration** – Previous OFT decisions have suggested that the regulators take the approach that the levels of concentration and market shares within the relevant market will provide an indication of the competitive strength of the market participants. Although a high level of concentration will not in itself be a flaw in the structure of the market, the level of concentration will always be considered as part of any market review.

- **Barriers to entry and growth** – When looking at how well a market functions the OFT will consider all possible barriers to entry and growth for example, regulatory or legal barriers; lack of capacity; resources or information; costs of entry and strategic barriers (such as the importance of reputation or brand) as well as exclusionary conduct by incumbents.

- **Switching** – The regulator will also consider how easy it is for customers to switch providers. Such consideration will extend beyond the structural ease of switching to levels of customer awareness about switching. For example regulators may deem customers having little knowledge about how to switch as relevant to any investigation. Consideration of switching was a key part of the OFT’s decision to refer the Northern Ireland banking market and the payday lending market to the Competition Commission.

- **Conduct** – When looking at conduct issues the regulator will consider both the conduct of the business in the market and the conduct of the customers. “Conduct” can involve any sort of behaviour or practice and is defined to include any intentional or unintentional failure to act and any other unintentional conduct (section 131(3), Enterprise Act). Although the conduct of customers is considered as part of any review the OFT in the past has indicated that customer conduct on its own is unlikely to justify a market investigation. However, when combined with structural features of the market it is certainly a relevant factor in the assessment.

A Market Investigation Reference is not always inevitable:
The CMA is under no obligation to make a Market Investigation Reference, even when it has reasonable grounds for suspecting that features of the market are adversely affecting competition in accordance with the terms of
section 131 of the Enterprise Act. The OFT has exercised its discretion not
to make a Market Investigation Reference (even though the statutory criteria
are satisfied) in a number of cases. For example last year the OFT used
its discretion not to refer the Personal Current Accounts (PCAs) market to
the Competition Commission. Although the OFT had concerns about the
functioning of the market, it concluded that it would not be appropriate to
make a Market Investigation Reference to the Competition Commission as
there were significant pending changes to the PCA market.15

2. Competition inquiries into UK banking

The CMA is currently carrying out work on the PCA and SME banking
markets. It has said that it will decide by the Autumn whether there will be a
full scale market inquiry and into what areas.

Such an inquiry would follow in the footsteps of many others in recent
years. Indeed, table 1 shows that there have been more than thirty OFT or
CC inquiries or rulings into competition in different banking markets since
the introduction of the Competition Act in 1998.

Many of these inquiries and investigations have focused on particular
markets, including reporting on a review of PCAs and two studies into SME
banking (the third is expected to report fully in Autumn 2014 – see below
for interim details).

We believe the industry has responded positively to the host of
recommendations from these inquiries, which have helped customers and
promoted competition.

In the 2008 OFT market study into the PCA market the OFT criticised
the banks’ practices as regards unauthorised overdrafts, citing the
“complexity in the way unarranged overdraft charges were implemented”.
It also felt that there were limited ways for consumers to manage their
exposure to such charges. Subsequent to that enquiry unarranged
overdraft charges fell from £2.4 billion in 2007 to £1.7 billion in 2011. This
was partly because people switched to authorised overdrafts resulting
in maintenance charge revenues rising from £14 million in 2007 to £448
million in 2011. The net saving to the consumer, though, was more than
£250 million and consumers got better visibility of their likely overdraft
charges.16

The OFT also raised the issue of foregone interest on current accounts.
The OFT looked at trialling the provision of this information but in the low
interest rate environment post-2008 the issue has largely gone away as
the opportunity cost is now very small.17 In fact competition for those
deposits has led to banks offering higher rates, with many banks now
offering interest bearing current accounts with rates well above the Bank
of England’s bank rate. The Which? website recently ran the following
statement: “Competition hots up in the current account market as Lloyds
Bank introduce account rates of up to 4%”.18

The same OFT report also raised the issue of switching saying that there
was “a perception among consumers that switching was both complex and
risky”. The introduction of the seven day Current Account Switch Service
(CASS) has been a substantive response from the banks to this issue.

More recently, the ICB and PCBS examined competition in the industry
while a study into competition and innovation in payment systems in the

15 Office of Fair Trading, Update on review into personal current account market, 15 May 2013.
16 OFT, January 2013 taken from Lee Boyce, Customers spared £1bn in overdraft fees from bank charge reforms - but we all pay more if we slip into red, Daily Mail, 25 January 2013.
17 Although Tesco has said it will provide this information with its new current account. www.which.co.uk/money, 5 June 2014.
18 Which? money, 5 June 2014.
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<td>ft1498</td>
<td>UK Payment systems (July 2013)</td>
</tr>
<tr>
<td>oft1005rev</td>
<td>Review of personal current accounts in the UK (January 2013)</td>
</tr>
<tr>
<td>oft1349resp</td>
<td>Payment surcharges – Response to the Which? super-complaint (updated July 2012)</td>
</tr>
<tr>
<td>oft</td>
<td>Travel money – super-complaint (September 2011)</td>
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<tr>
<td>oft</td>
<td>UK equity underwriting market review (August 2010)</td>
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<td>oft</td>
<td>Cash ISAs – super-complaint (March 2010)</td>
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<td>oft1071</td>
<td>Review of the operations of the Payments Council (March 2009)</td>
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<td>oft1068</td>
<td>Northern Rock: The effect of public support on competition (March 2009)</td>
</tr>
<tr>
<td>oft1005</td>
<td>Personal current accounts in the UK (July 2008)</td>
</tr>
<tr>
<td>oft978</td>
<td>Credit card comparisons (February 2008)</td>
</tr>
<tr>
<td>oft937</td>
<td>SME banking review (August 2007)</td>
</tr>
<tr>
<td>CC</td>
<td>Payment Protection Insurance market investigation (February 2007)</td>
</tr>
<tr>
<td>oft903</td>
<td>OFT response to Banking Codes Review 2007 (February 2007)</td>
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<td>oft901</td>
<td>Final report of the Payment Systems Task Force (February 2007)</td>
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<td>oft899</td>
<td>Payment protection insurance (February 2007)</td>
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<td>oft849</td>
<td>Second annual progress report of the Payment Systems Task Force (May 2006)</td>
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<tr>
<td>oft842</td>
<td>Calculating fair default charges in credit card contracts (April 2006)</td>
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<td>oft836</td>
<td>BACS Access and Governance Working Group report (March 2006)</td>
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<tr>
<td>CC</td>
<td>Personal Current Account Banking Services in Northern Ireland market investigation (May 2005)</td>
</tr>
<tr>
<td>oft796</td>
<td>An economic analysis of the potential benefits and dis-benefits of faster payments clearing (May 2005)</td>
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<tr>
<td>oft789a</td>
<td>Payment Systems Task-Force annual report (May 2005)</td>
</tr>
<tr>
<td>CC</td>
<td>LINK Interchange Network Limited/Transaction Network Services (UK) Limited merger inquiry (January 2005)</td>
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<td>CC</td>
<td>Home credit market investigation (December 2004)</td>
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<td>Store Card Credit Services market investigation (March 2004)</td>
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<td>Credit card survey (March 2004)</td>
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<td>Store cards (March 2004)</td>
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<td>oft705</td>
<td>Debit consolidation (March 2004)</td>
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<td>oft620</td>
<td>Banking services to small and medium sized enterprises (October 2003)</td>
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<td>oft658</td>
<td>UK payment systems (May 2003)</td>
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<td>oft634</td>
<td>MasterCard interchange fees – preliminary conclusions (February 2003)</td>
</tr>
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<td>CC</td>
<td>Supply of banking services to SMEs (March 2002)</td>
</tr>
<tr>
<td>oft251</td>
<td>Mortgage redemption fees (November 1999)</td>
</tr>
<tr>
<td>oft264</td>
<td>The rules on the polarisation of investment advice (August 1999)</td>
</tr>
<tr>
<td>oft255</td>
<td>Vulnerable consumers and financial services (January 1999)</td>
</tr>
</tbody>
</table>

Sources: OFT and Competition Commission

[See p. 73 for full references for all tables and figures]
UK informed HM Treasury’s work on creating a new regulator for payment systems in the UK (see chapter 3).

The Treasury Select Committee also recently undertook an inquiry into competition and choice in retail banking and there have been a number of EU inquiries into the banking sector, including the European Commission’s 2007 inquiry into retail banking.

3. Recent OFT Inquiries

It is worth looking at the most recent OFT inquiries to get a feel for the competition issues facing the sector. In May 2010 the OFT launched a review of the PCA market “to understand better the barriers to entry, expansion and exit in both personal and SME banking markets.” The review covered four areas – regulation, access to essential inputs needed to offer retail banking services, the ability of new entrants to attract customers and achieve scale, and barriers to exit.

That report found that “[whilst] most prospective new entrants were able to meet regulatory requirements and source the necessary inputs to offer retail banking services, new providers faced difficulties in attracting customers and expanding their market share. This was largely due to the reluctance of personal and small business customers to switch providers, their loyalty to established brands, and preference for banks with a local branch.”

The OFT “also found that existing capital requirements may disproportionately affect new entrants and smaller banks by requiring them to hold proportionately more capital than incumbents. (They) concluded that, as capital and liquidity requirements are updated, it may be appropriate for the prudential regulators to consider and monitor their impact on competition.”

In chapter 5 on the challengers we will argue that many of the issues in the first part of the OFT’s findings above have diminished since that was written and that the challengers are truly able to compete with the large banks for customers, aided by the advent of seven day switching. The second issue of capital and liquidity requirements remains a real issue and many of the challengers that we have spoken to as part of this work believe that more needs to be done by the prudential regulators.

Given the 2010 report, and other concerns, the ICB recommended that the OFT consider making a market investigation to the Competition Commission by 2015 if sufficient improvements in the market had not been made by that time. The CMA’s work on considering a referral clearly reflects this recommendation. However, the ICB also recommended that a referral not be made until the impact of the Lloyds Banking Group divestiture, the switching redirection service and a pro-competition FCA is known.

We would argue that it remains too early to be able to take those properly into consideration since the switching service is only 9 months old, TSB has only been operating as a separate challenger bank in the High Street since last September (it has only recently been partially floated on the London Stock Exchange by Lloyds Banking Group), Williams & Glyn is still to come and the FCA is still finding its feet as an economic as well as conduct regulator.
Personal Current Account Market

The more recent OFT review of the PCA market, launched in July 2012, was to understand whether the market was moving towards an equilibrium that works well for consumers. It focused on three key issues. Whether the Current Account Switch Service had improved the switching process, whether the transparency of personal account charges had increased and thirdly whether people were able to manage their accounts more effectively.

The OFT wanted to see a retail banking sector where:

- **The banking sector is more customer focused.** Providers’ products are well-suited to their customers’ needs and are provided in a way that makes it easy for customers to make well informed decisions about how and when they are used.

- **Consumers are sufficiently engaged with their banking services to drive competition.** Banks equip their customers to make better decisions about which products they use, and how they use them.

- **Competition between banks (and from non-banks) is driving providers to operate more efficiently and to innovate.**

- **Customers have a broad choice of provider.** The sector is less concentrated, with greater competition from ‘challenger’ banks and/or new technology providing scope for increased competition from outside the traditional banking model.

- **Barriers to entry and expansion are lower.** Credible new providers are able to join the market and have reasonable prospects for attracting the scale of customer base needed to achieve economies of scale required to operate effectively.

In its work on the PCA market the OFT found that there were approximately 76 million accounts in the UK, of which 61 million are used regularly. It estimated that the banks earned £8.8 billion of revenue from the accounts in 2011 – equivalent to £139 per active account.

It did find that, in comparison with 2008, there had been a reduction in interest on credit balances and unarranged overdrafts, although they were still the two most important parts of PCA revenues. It also found, positively, that whereas in 2008 lower income consumers paid a much greater proportion of overdraft charges, revenues from these charges are now more proportionate to the level of consumer income. Overall, PCA costs are progressive meaning that higher earners pay relatively more than those on lower incomes.

The OFT noted that the most common pricing model for PCAs is the standard account, known as a “free-if-in-credit” account. The account has no fee for the account or using core services, but charges are levied for overdrafts and certain other services, such as using cards overseas. There is, however, a cost of interest foregone on credit balances, prompting the OFT to state that they viewed “free-if-in-credit” banking to be a “myth”.

This account was some 66% of the market in 2011, with packaged accounts (offering other services such as travel insurance or breakdown cover) counting for a further 14% of accounts. Other account types including premium accounts, student accounts and basic accounts (which...
offer reduced functionality compared to standard accounts). The latter accounted for 12% of all accounts in 2011.

As we noted above the OFT found that unauthorised overdraft fees had fallen between 2008 and 2011, but interchange revenue had increased (due to higher usage of cards) from £568 million to £814 million. Revenues from packaged accounts had also increased from £742 million to just over £1 billion, reflecting a growth in the number of accounts and an increase in the average account fee.

Table 2: Average Revenue per account

<table>
<thead>
<tr>
<th>Account type</th>
<th>Average revenue per account</th>
<th>Share of revenue</th>
<th>Share of accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard</td>
<td>£146</td>
<td>61%</td>
<td>65%</td>
</tr>
<tr>
<td>Packaged</td>
<td>£300</td>
<td>35%</td>
<td>15%</td>
</tr>
<tr>
<td>Premium</td>
<td>£31</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Student</td>
<td>£18</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Basic</td>
<td>£34</td>
<td>2%</td>
<td>12%</td>
</tr>
<tr>
<td>Youth</td>
<td>£14</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Other</td>
<td>£118</td>
<td>1%</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: Source: OFT 2013

Table 3: Breakdown of average revenue by income source

<table>
<thead>
<tr>
<th>Revenue component</th>
<th>Standard</th>
<th>Packaged</th>
<th>Basic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Credit Interest</td>
<td>£87</td>
<td>£99</td>
<td>£15</td>
</tr>
<tr>
<td>Arranged Overdraft Revenues</td>
<td>£21</td>
<td>£39</td>
<td>£0</td>
</tr>
<tr>
<td>Unarranged Overdraft Revenues</td>
<td>£25</td>
<td>£50</td>
<td>£14</td>
</tr>
<tr>
<td>Packaged account fees</td>
<td>£0</td>
<td>£103</td>
<td>£0</td>
</tr>
<tr>
<td>Interchange fees</td>
<td>£14</td>
<td>£17</td>
<td>£5</td>
</tr>
<tr>
<td>Total</td>
<td>£128</td>
<td>£279</td>
<td>£35</td>
</tr>
</tbody>
</table>

Source: Source: OFT 2013

One of the reasons for the OFT focus on PCAs is that it views them as a gateway product to the sales of other retail banking products such as loans, investments and credit cards. It estimated that in 2011 the four largest PCA providers earned 54% of their retail banking revenues from their account holders’ use of other retail financial products and services.

One of the biggest changes between 2008 and 2011, shown in figure 1, was the rise in revenues from mortgages, rising from 12% to 24%, and the drop in revenues from savings of 13% to 4%, which it attributes to the aftermath of the financial crisis. Interestingly our work in compiling this document suggests that the mortgage market is one of the most fiercely competitive of all banking markets (see chapter 3).

The OFT noted in 2011 that the UK PCA market had seen increased concentration since the financial crisis care of mergers and acquisitions with the share of the largest four providers dropping from 74% in 2000 to 64% in 2008, then rising to 77% in 2010. The OFT work showed the four
Figure 1: Retail banking revenues in 2008 and 2011

Source: OFT 2013

Figure 2: PCA market share data pre- and post-divestiture of TSB and Williams & Glyn

Sources: OFT 2013 and BBA calculations
largest providers having a market share of around 74% and Santander the next biggest at around 11%. This drove a jump in the Herfindahl Index (the standard measure of concentration) from 1354 to around 1800 (see Box 1).

This though preceded the spin outs of TSB and Williams & Glyn, while some of the challengers have also made market share gains since then. Figure 2 compares the results of the OFT’s 2012 PCA market share data with the market shares following the divesture of the two spin outs.

The market will have no doubt changed slightly since the OFT’s report was published in January 2013, but nevertheless the addition of TSB and Williams & Glyn will have a notable effect in reducing market concentration. The divestment of the two reduces the industry’s Herfindahl Index on our calculations from 1715 to 1446 (see figure 3), which is close to pre-crisis levels. With the challengers picking up market share we would expect this to fall further over time. Indeed if the analysis of the Jefferies banking analyst Joseph Dickerson is correct and the challengers reach the 7% market share, which he thinks is possible by 2018, then the concentration Index would be well below 2007/8 levels.

The debate about concentration levels and whether this creates a situation where the PCA market is not competitive and not delivering the service for consumers is to some extent an academic one. You can always find people who are not satisfied with the service they are receiving in any market. We asked YouGov to carry out some polling to provide an independent assessment of peoples’ views on banking.

The public dislike of banks post the financial crisis is well known and appears time and again in opinion polls. Yet if you ask about peoples’ view of their main bank the results show the opposite. YouGov found 53% of those polled had a positive view of their bank and only 14% had a negative view.

Also interesting was that when YouGov asked people about what concerned them about the UK banking industry only 25% cited lack of competition between banks for customers and only 11% difficulties with

Box 1: The Herfindahl-Hirschman Index

In order to measure concentration levels, the US Department of Justice, European Commission and Office of Fair Trading/ Competition Commission apply the Herfindahl Index (HHI). The HHI is calculated by summing the squares of the individual market shares of all the firms in the market. The HHI gives proportionately greater weight to the market shares of the larger firms.

However, as the Bank of Canada notes, “It does not appear that concentration alone provides a particularly good indication of competitive behaviour.” A high HHI score may be correlative to levels of competition within the market, but it is not a guarantee that the relationship is causative. Many markets are highly competitive and considered concentrated via this measure.

Nevertheless, it is useful used by the regulators as a useful proxy for the relationship between concentration and competition. US Agencies classify markets into three types: markets with a HHI below 1,500 are competitive, markets between 1,500 and 2,500 are moderately concentrated and those with a HHI above 2,500 are highly concentrated markets.

Considerations of the HHI score are slightly stricter in Europe. The Commission considers markets with a HHI below 1,000 to be competitive with markets between 1,000 and 2,000 sufficiently competitive as long as the changes to the HHI from a merger or over a short period of time are below a differential of 250. Markets with a HHI above 2,000 are considered concentrated but mergers may be allowed if the resultant change in HHI is below 150.

The joint OFT/Competition Commission guidelines mirror the Commission’s stating that a market with an HHI exceeding 1,000 may be regarded as concentrated while a market with an HHI exceeding 2,000 may be regarded as highly concentrated.

21 J Dickerson and team, NUKEs will fundamentally alter the UK banking landscape, Jefferies, 19 May 2014. Also, see chapter 6.
22 The BBA commissioned YouGov to undertake two sets of polling with regard to personal retail banking and business banking. The total sample size for the retail customer survey was 2,352 adults. Fieldwork was undertaken 5 – 6 June 2014 and the figures have been weighted and are representative of all GB adults (aged 18+). The survey was carried out online.
Figure 3: Concentration levels in the PCA market using the Herfindahl-Hirschman Index

Sources: OFT 2013 and *BBA calculations

Figure 4: What is your opinion of your main bank?

Source: YouGov
switching accounts. That suggests that while the public are still angry due to the past problems of the banks they are not concerned about the lack of competition between banks.

When asked what would improve the reputation of the banking industry, increasing competition for customers was cited by only 25%, while only 15% raised the issue of making it easier to switch accounts. Even increasing lending to businesses and making it easier to take out a mortgage figured relatively lowly on the list at 26% and 25% respectively.

The final question YouGov asked relating to competition was about choice of products, such as overdrafts, loans, credit cards etc, which you would expect to be limited if there was a lack of competition. In fact 57% of people agreed that there was enough choice and only 10% said there was insufficient choice.

The OFT has in the past highlighted the branch network of banks as a barrier to entry. In its 2013 report, it still found the branch network to be important with 78% of customers using the branch once a year. In comparison 59% used the internet at least once a year, 27% the phone and 17% a mobile device. Interestingly their analysis showed a big difference on a weekly basis, with branch usage dropping from 27% in 2008 to 16% in 2012, while internet and mobile jumped from 35% to 56%. Telephone access also dropped from 12% to 5% reflecting the growth of online usage. The OFT said in its report that there was still a significant proportion of customers using a branch weekly.

Our work, however, shows the trend away from branch usage is accelerating. Work we have seen suggests that the average use of a branch is now less than once a month, compared to somewhere between 25 and 30 times for internet and mobile devices. RBS has seen a 30% drop in footfall at its branches in the past three years.

The fact that the larger banks are all actively trying to reduce their branch networks suggests that the costs of maintaining such wide coverage may, in fact, now put those banks at some disadvantage. Further, the absence of significant numbers of bidders for the Rainbow and Verde divestments seems to suggest that a branch network is not essential for entry by challenger banks (see chapter 5).

The online YouGov polling underlines how this shift reflects peoples’ changing behaviour and attitudes. While 82% seem to have visited a branch at least once a year (in line with the OFT findings) only 9% visited a branch at least once a week and 32% once a month. Compare that to online or mobile banking where 15% use this at least once a day, 59% at least once a week and 77% at least once a month. There is a significant minority that do not use this form of access at 16% but it is clear how usage is shifting.

It is true that customers still value branches for some banking services, so that having one in close proximity remains useful for some people. As the OFT noted, “to have significant size in the market, a significant branch network was required”. The OFT had “not seen evidence that the declining frequency of branch usage has led to any reduction in the importance of the availability of a network of branches to consumers”. By contrast, our polling evidence suggests that this is starting to change.
Figure 5: Is there enough choice of products and services offered by banks for me?

Source: YouGov

Figure 6: Methods used to access a PCA used on a weekly basis

Source: OFT 2013
Figure 7: Use of branch banking

Source: YouGov

Figure 8: Use of online or mobile banking

Source: YouGov
While 58% of people said that having a local branch was important, 53% said they were confident that they could do the vast majority of their banking either online or over the phone. Indeed, 12% agreed that we are coming to the stage where a branch is no longer needed on every high street and, to emphasise the importance of technology, 19% said that the ability to scan and pay in cheques remotely would lead them to use branches less often. The key reason for wanting a local branch seems to be for when people want to discuss issues face-to-face, with 57% of respondents agreeing with this point.

There are those like the soon to be launched Atom Bank, whose founder also launched Metro Bank, who are actively choosing and promoting different business models. The success of First Direct, with some 1.25 million customers, also provides some evidence that people are prepared to move away from a branch model. While they have HSBC branches as a back-up the vast majority of First Direct business is online and via the phone. By contrast, the larger banks are reducing their branch networks at the same time as investing in digital services as customers change the way they bank. This situation is analogous to the grocery sector, where Aldi and Lidl are not seeking to replicate the store locations of the major incumbents, preferring to adopt a different model.
The OFT also cited inertia as a big problem and said that consumers were not proactive enough. In particular the OFT found in their survey that people did not regularly monitor their accounts. They argued that customers had to have knowledge of the current balances, commitments, payments coming and crucially the timing of these. A few years ago this was undoubtedly difficult to manage and did result in many entering into unauthorised overdrafts. However, this is now changing dramatically as the result of advances in technology. Mobile apps are frequently used for checking on accounts and the main account providers are now using text alerts to warn customers if they are close to becoming overdrawn or nearing a specified threshold. Indeed, Lloyds Bank sent out over 300 million texts to its customers last year, while HSBC said that 64% of its text alerts were informing customers that their bank balance had dropped below a certain level. This enables customers to react to avoid or reduce the charges associated with going overdrawn. With faster payments it is also easier to move money between accounts if the account holder keeps a savings account at another bank, which our YouGov polling suggests is the case with around 25% of people.

Such issues are clearly important since, according to YouGov, while 36% of people believe having an overdraft is a very useful facility to have, 34% try to avoid going overdrawn as they object to the fees (figure 9). Technology, together with the switch to more approved overdraft facilities is clearly helping people to manage their accounts and reduce fees. What is also interesting though is that only 14% of people would rather have their payments refused than go overdrawn and be charged.

While the OFT acknowledged that “free-if-in-credit” accounts might well account for the low level of switching it did not support a move away from this model. Our conversations with the banks suggest that it is generally felt that the first mover away from the model would be at a significant competitive disadvantage. Thus it seems likely to remain the prevailing model for some time to come. The decision by Tesco Bank to charge customers unless they pay a minimum of £750 into their account monthly, while attracting a good deal of attention, is actually in line with much market practice elsewhere. The “free-if-in-credit” model tends to apply only to the main bank account where a person’s salary is paid into it.

The OFT argued that the new entrants like Metro and M&S were too small to have a significant impact on the market, although it acknowledged that both Tesco and Virgin were likely to launch current accounts and because of their brands could have a significant effect on the market. Also the spin offs of TSB and Williams & Glyn were a lot further away when this report was published.

Today, as we explore further in the chapter on challenger banks, there is genuine momentum amongst the challengers and the Current Account Switch Service is providing a mechanism for them to pick up customers. It is our view at the BBA that the PCA system is changing rapidly and the necessity for, and nature of, any regulatory intervention needs to take this into account.
Payments

The OFT also committed at the same time to consider the operation of the payments system which it did in a report published in July 2013. The OFT argued that the payments sector had “a number of characteristics that mean competition may not always work well. These characteristics include high fixed costs and economies of scale in infrastructure that enables electronic payment systems, as well as network effects, where the value of a payment system is dependent on the number of users it attracts. When combined, these characteristics give rise to a significant first-mover advantage in this sector, such that competition may not be an effective discipline on those that own or control the existing payments systems.”

The OFT noted that there were two routes for smaller providers to access the payments systems. Either they can seek to join the systems directly or they can request indirect (or agency) access from one of the larger providers in the market who themselves have direct access to payments systems. The OFT said both require the larger banks to provide access to a potential rival and it expressed concerns that there would not be competition among the large banks to provide this access. The OFT expressed concerns that:

- Obtaining direct access to payment systems can involve time consuming regulatory processes and significant variations in security deposits
- There appears to be little choice or competition in practice for some providers seeking indirect access to payments systems, and
- Some providers with indirect access have slower and more limited access to payment systems and the cost of this can be high.

The OFT recommended that the new regulator has objectives to “minimise barriers to entry in retail banking markets and ensure that both existing and new providers are able to compete on an equal basis for business and personal customers:

- To ensure that fair, reasonable and non-discriminatory direct access to existing payment systems is available to all banks and building societies. Barriers to accessing payments systems directly, such as cost of access, the regulatory process, or the management of payments risk, should be minimised.
- To ensure that indirect or agency access to existing payment systems is offered on a fair, reasonable and non-discriminatory basis by a range of competing licensed banks, by compelling some member banks and building societies to make this service available to smaller competitors. The regulator should set minimum terms of access and conditions, including the service level, with the regulator also having powers to review pricing where this is not constrained effectively by competition.”

The OFT also wanted the new regulator to “relax rules that determine the scope of payments that can be processed by recognised electronic payment systems to give at least some of these systems broader scope to process a wider variety of payments, so that more than one system is capable of processing certain payment types.” It also asked “to
develop the infrastructure of the existing electronic payment systems to allow for broader access to the systems, giving new providers access to the underlying payment systems.” Thirdly it argued that “generating competition in (these) ways may require changes in the scope of, and access to, existing systems.”

Payments was one of the key issues raised by challengers when we spoke to them and obviously the new Payment Systems Regulator is already looking at how systems should best operate in the interests of users of payment services. The challengers obviously want better and cheaper access while the established banks make the point that they have had to pay to put the IT systems in place. The sponsoring banks also take on a variety of risks when processing payments for their agency banks. The one constant from the BBA’s small and large members is that they are prepared to work with the regulator to find a solution that works for all.

The SME market

Turning to the SME markets the OFT also provided an update of its work in March of this year. It welcomes a number of the actions that have been taken or are planned to respond to questions over the effectiveness of competition. Those included:

- Changes to the authorisation regime for new banks
- Changes to the capital requirements for new banks which lend to SMEs
- The regulation of the payments system through the forthcoming establishment of the Payment Systems Regulator, as a subsidiary of the FCA.
- The introduction of seven day Current Account Switch Service (including for smaller SMEs) and
- Proposals to increase the availability of credit information, which should enable new or small providers to make more effective lending decisions, thereby helping them to compete more effectively with the larger banks.

The OFT noted that there had also been continued investment by the banks in service quality and delivery including in mobile and digital technology.

The OFT said that its emerging analysis suggested “that despite these and other positive developments, there may be competition concerns in SME banking that:

- The markets are concentrated and levels of concentration have remained stable over recent years. The four largest providers of Business Current Accounts (BCAs) to SMEs account for over 80% of SMEs’ main banking relationships in Great Britain and around 90% in Northern Ireland. The supply of lending is also concentrated and the tendency of SMEs to approach their main BCA provider when seeking lending appears to limit the degree of competition for lending.
- Barriers to entry and expansion have apparently contributed to smaller providers finding it difficult to enter and expand their business across core business banking products, such as BCAs and general purpose business loans.”

23 See chapter 7 for more details.
The OFT said it was considering concerns that have been expressed to them including:

- Access to key information, particularly information on the creditworthiness of prospective borrowers needed to make effective lending decisions.
- The high cost of accessing payments systems, which are necessary for a provider wishing to operate BCAs.
- The cost of expansion arising from developing and running IT systems.
- The need for a broad branch network given the continuing preference of many SMEs for using branches for many core banking services.
- Banks’ conduct in relation to existing security which appeared to hinder SME customers from accessing finance from alternative providers.
- Aspects of SME behaviour, including the tendency of many SMEs to make their initial choice of BCA provider on the basis of which bank supplies their PCA or the proximity of the local branch, and low levels of switching which limit newer and smaller providers’ ability to acquire customers.

The OFT also said that while there has been some entry into the provision of SME banking services (and evidence that other providers are also considering entry), the scale of entry remains very limited and typically focuses on servicing particular niches (such as particular types of lending) or particular types of SMEs (such as larger SMEs or particular industry sectors).

They argued that the ability of SMEs to shop around to obtain a BCA or loan on best terms appears to be restricted by difficulties in comparing the offering available from different providers due to the limited transparency of information on price and service quality. They noted that:

- Tariffs on BCAs are often complex and loan pricing and conditions take account of a wide range of individual SME specific factors, making comparisons between providers difficult.
- The quality of a bank’s service is an important consideration for SMEs but it is difficult for them to assess which bank would provide the best service for their individual circumstances.
- SMEs generally exhibit a significant degree of inertia and low level of engagement with their banking providers, albeit that some highly value their relationship with their bank and their bank’s products and services. Shopping around for BCAs and loans is limited as is switching provider. SMEs also perceive little benefit in switching BCAs, partly because they see little difference between them. They tend to switch if pushed by poor service from their current provider.
- Finance from alternative providers such as peer-to-peer lending, venture capital and equity finance may be available and suitable for some businesses. However, the OFT observed low awareness of the existence of alternative forms of finance among SMEs. For example, the Business Growth Fund has provided more than £300 million of equity finance to SMEs.
Figure 10: Satisfaction with business account

Source: YouGov

Figure 11: Sufficient choice of products and services for my business

Source: YouGov
In summary the OFT concluded that the evidence suggested that the market for SME banking exhibited:

- Concentrated markets and stable market shares
- Barriers to entry and expansion
- Difficulties in comparability of price terms and service
- Low customer engagement contributing to low shopping around and switching activity.

The OFT concluded that these issues could be consistent with a provisional finding that the statutory criteria are met for a potential market reference. The CMA is completing this market study alongside the one for PCAs.

As with consumers we also asked YouGov to carry out polling on SME attitudes to banks, which provides an interesting counterbalance to some of the arguments of the OFT above. Perhaps one of the most striking comments from the SMEs surveyed was how content they were with their business bank accounts. 66% of those surveyed said they were very or fairly satisfied and only 14% fairly or very dissatisfied. Also relevant to the OFT’s comments are SMEs views on the choice available to them in terms of bank products. 55% said they agreed that there is enough choice of products and services vs just 16% who disagreed.

These are remarkable figures for a part of the banking system that is most frequently cited as the most concentrated and therefore least competitive. With those satisfied with their bank outweighing those dissatisfied by 4½ times and those who thought there was enough choice of products more than 3½ times against those who did not, this suggests the banks are at least doing something right for their customers.

The OFT highlighted barriers to entry and in particular the branch network. While some businesses are arguably more reliant on branches than consumers it is the case that the same technology trends that are changing the nature of banking for consumers are also impacting SMEs. 27% of SMEs say they use a branch to bank with a bank employee once a week or more, compared to 9% for retail customers who do any in-branch banking and 47% of SMEs banking with an in-branch employee once a month vs 32% for retail customers who do any type of in-branch banking. But online banking is making a difference here too with 39% using online banking every day and 68% at least once a week. Only 7% never use online banking.

This leads to some interesting answers when asked about the importance of a branch. 68% said having a local branch is important but also 33% said they thought we were coming to the point where we no longer need a branch in every high street. 65% said they were confident they could do the vast majority of their business over the phone while 52% said they were less likely to use branches if they could scan and pay in cheques remotely. 66% though said that a local branch is necessary for face-to-face meetings. The conclusion would seem to be that branches are necessary but you do not need to have them everywhere. That is good news for challengers with smaller branch networks.

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24 The BBA commissioned YouGov to undertake two sets of polling with regard to personal retail banking and business banking. The total sample size for the business survey was 1,034 SME decision makers (from businesses with less than 250 employees). Fieldwork was undertaken 27 May - 02 June 2014 and the figures have been weighted and are representative of GB business size. The survey was carried out online.
Figure 12: Branch usage by SMEs

Figure 13: Online usage by SMEs

Source: YouGov
Figure 14: How important is a branch to your business and is it becoming less important?

The SME market is relatively more concentrated as we acknowledge in the next section, but that is starting to change. As with the current account market new entrants and alternative sources of finance are starting to grow in importance. Santander is growing its corporate business strongly and Handelsbanken is steadily expanding while Aldermore, Shawbrook and now Metro are starting to make inroads. The SME market will always be less straightforward than the current account market, particularly in the pricing of loans, where they are always going to be more specific to the particular business being run and the relationship between the company and its bank. That is why it makes sense that SMEs will want to have those face-to-face relationships with their banks.

The polling though does suggest SMEs’ attitude to banks are changing. They are prepared to do more online and as such are less attached to having a branch in every high street. That in turn suggests that the new entrants who cannot have as big a branch network as the established banks should be able to compete more effectively for the business of those SMEs. The success of Aldermore and Shawbrook in growing their businesses, despite not having a branch network, in recent years is perhaps testimony to this.

Source: YouGov
Is the UK banking system concentrated?

Claims are regularly made by politicians and the media that the UK has one of the most concentrated banking systems in the world. We do not believe this is borne out by the evidence. In the previous chapter we looked at the OFT’s work on the PCA markets and concluded that while the sector did become more concentrated post the financial crash this is now reversing, as a result of the divestment of TSB and Williams & Glyn and the rise of the new entrants. We think the Herfindahl-Hirschman Index (HHI) will likely drop below pre-crisis levels in the not too distant future.

Comparing market shares via the HHI Index market share of the UK’s largest banks on an international basis the results also tend not to support the contention that the market is overly concentrated. On numbers compiled by the ECB the UK currently ranks well below the EU average for its credit institutions, with a HHI score of 436 in 2012 compared to an EU average of 1066 (see figure 16). The picture further improves when you examine member states’ average market concentrations for the period 1997-2012 (see figure 17).

Similarly, the World Bank calculates the concentration by taking the fraction of assets held by the three largest banks in each country. The results for G7 economies reveal that the UK ranks fifth out of seven in terms of the concentration. Note that under this measure the industry is less concentrated than France, Italy and Germany (see figure 15).25

These numbers are also likely to be improved further by the divestment of TSB and Williams & Glyn. Whilst it is difficult to verify the precise impact on the proportion of the market owned by the largest credit institutions,
Figure 15: Concentration of top three banks’ assets in G7 economies

Figure 16: The Herfindahl Index for credit institutions’ total assets in EU member states in 2012

Source: World Bank

Source: ECB 2012

the creation of two, mid-scale challengers is likely to see the percentage of total assets held by the UK’s top five credit institutions return to trend levels of around 37%. This would only serve to reinforce the UK’s position as one of the least concentrated sectors in Europe.

The UK banking system – not one market but many

Such measures are simplistic as they do not account for the fact that the UK banking system is not just one market – it is a collection of product markets. This is best illustrated by best illustrated by figures 17 and 18, which show which show the breakdown of the different product markets that form part of the UK banking system.

Measures of concentration tend to focus on current accounts (as the OFT did in its study) or assets. There are some c.100 personal loan providers, c.60 mortgage providers, c.50 current account providers and c.30 credit card issuers. The shares of the participants in those different markets vary significantly.

Figure 18 shows the Herfindahl Index calculated by market segments based on BBA data. As we discussed earlier 1500 is a level of this index below which an industry is deemed to be sufficiently competitive by US authorities, between 1000 and 2000 sufficiently competitive by the EU and below 1000 competitive. The chart shows how different the banking sector is in each of the areas. All areas fall below 1500 with the exception of the Business Current Account segment. Only the calculations for the PCA have been adjusted for the forthcoming divestments of TSB and Williams &
Glyn, while personal loans and branches have been adjusted for the TSB divestment. Accordingly some of the measures, notably business current accounts, should fall further when the full divestments have taken place. What it shows is that for mortgages, credit cards and personal loans the markets are quite competitive on this measure. While Lloyds Banking Group obviously holds a large position in mortgages as a result of its combined market share with the Halifax, the fact is that many other building societies and lenders who together have a significant impact on the market. Googling available mortgage offers would tell you the same story. Google UK listed 70 plus providers when we searched under best mortgage offers. According to our polling with YouGov 23% of people, with a current account, had a mortgage from a provider other than the provider of that account. Given that there are 61 million active current accounts and 11.2 million mortgages in the UK this suggests that a very high proportion of those with mortgages have them with a financial institution other than where they hold their current account. Given this is normally the single biggest source of borrowing by consumers that is a substantial figure. It is not surprising that many of the banks we spoke to, both established and challenger, said the mortgage market was very competitive.

In credit cards the concentration is only just above the 1000 mark on our calculations, putting it on the cusp of the EU’s definition of competitive. While the High Street banks hold a substantial position in the market, led by Barclaycard, there are many other significant market participants, including Capital One, MBNA, Tesco and M&S. Both Capital One and

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Figure 18: The approximate Herfindahl Index score of different banking markets in the UK

Source: BBA calculations

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27 Branches – this number refers to the branch network post the divestiture of TSB and Williams & Glyn.
MBNA have been able to enter the market from overseas and establish a significant market share. In the YouGov polling 43% of people said they had a credit card from an institution other than their main current account provider.

Savings products are another area where there is intense competition. Here the building societies, overseas banks and even the Government through National Savings and Investments provide competition for the banks. Again a Google search generates a multitude of different offerings. The YouGov polling again suggests that people are willing to look outside their home bank for such products. 25% said they held a savings account elsewhere, whereas 31% had an ISA and 28% a pension product not from their current account provider. Again since the number of people with pension products is significantly lower than the number of current accounts, this again suggests that a high proportion of pension products are held with institutions other than the current account bank.

The data on personal loans is also interesting, with a Herfindahl Index of sub 1000. Again while the High Street banks are important there are plenty of other specialist finance providers who offer alternatives in this market.

This analysis is also supported by evidence on pricing, which in non-competitive markets is normally higher. A review of the current offers would suggest that the market is competitive. Currently there are offers of 5%
AER on current account credit balances, 4.3% APR for personal loans and mortgages as low as 2.1% APR for variable rate and 3.7% for fixed rate mortgages.\(^3\)\(^0\) Obviously such rates will vary depending on the terms and the quality of the borrower, but the fact that there are so many available via a simple internet search suggests the offer of free in credit current accounts is also something which banks are very reluctant to give up for fear of damaging their competitive positions. New entrants feel they have to match it or provide an alternative service to compensate for it. Perhaps it is not surprising therefore that the YouGov polling showed concerns on competition to be towards the bottom of concerns about banking.

There are areas that appear more concentrated, notably in branches where the High Street banks are the dominant operators in this market. Indeed, as we noted in the previous chapter the OFT has highlighted the branch network as a barrier to entry. This is reduced somewhat though by the divestment of the TSB and even here the concentration index stands comfortably below the 1500 level. The likes of Metro and Handelsbanken continue to open branches eating into the market shares of the incumbents, as both see the branch (or store in the case of Metro) as a key part of their offering to customers. It is also the case that technology is changing the role of the branch and reducing the need to have so many. Our YouGov polling is clear that people are increasingly comfortable carrying out the bulk of their transactions online.

Internet access to banking has been building steadily in recent years but the advent of the mobile app has changed this dramatically. Whereas the average person uses a branch less than once a month they access their app more than 25 times a month. In 2013 banks processed some 18.6 million mobile transactions per week, more than double the 2012 average.\(^3\)\(^1\) Barclays alone processed £134 billion of payments and transfers through its digital app. This has had a knock on effect on the use of branches with NatWest data showing that the average footfall in branches has dropped by 30% in the last three years. Our conversations with those challengers expecting to build branch networks suggest that they see the ideal size of such a network to be markedly smaller than the current branch networks of the banks. The potential of new entrants to use the Post Office, which has more branches than all of the banks and building societies combined, also suggests that this is no longer the barrier to entry it once was.\(^3\)\(^2\)

That does not necessarily mean the end of the branch, more that it will change from a place where operations, such as depositing cheques or withdrawing cash, take place to one where the predominant service will be advice or problem solving. Branches will remain a key part of the business model for some, perhaps most market participants, but their role is changing. Customers are increasingly relying on branches for face-to-face meetings to make the big decisions, such as buying a house, rather than day-to-day transactions.

For the retail customer where they hold their bank account is often not the key factor as to where they place their savings or where they source their loans. While the Current Account Switch Service has made changing bank account much easier, with more than 800,000 people using the service to May 2014, it is still the case that the amount of switching is
relatively modest. That reflects the contentment with current accounts shown in our YouGov polling (where 60% said they were unlikely to switch because they were happy with their accounts). With current accounts dominated by the free when in credit model it is likely that consumers are more focused on more price sensitive banking products such as loans, mortgages and savings.

The digitalisation of banking is also making it easier for new banks to enter the market, aided by the PRA’s fast track licensing regime. It is reported that there are now more than 20 banking licence applications in the pipeline. While not all of these will translate into new banks the fact that it is easier to set a bank up without a full blown branch network is likely to attract new entrants. First Direct has shown that it is possible to grow a sizeable presence via internet banking without a formal branch presence, with 1.25 million customers. Interestingly, some 89% of their contact with the bank coming via a digital channel.

Another indicator of weak competition is a lack of new entrants. Yet we are seeing new competitors entering the retail market, such as Metro, Virgin, Tesco and the Post Office. As we noted above the Post Office has more branches than all of the banks and building societies combined, while Tesco and Virgin, already have a sizeable banking footprint. Tesco has 7 million customers and a loan book of £6.9 billion. Virgin Money has more than £20 billion of mortgage assets and 3 million customers. It too has said it will launch a current account product. The Paragon Group is the most recent to have been awarded a banking licence and intends to launch a challenger bank. Similarly, Metro Bank founder Anthony Thompson is in the process of applying for a banking licence for Atom, which would become the UK’s first digital-only bank. That does not suggest that the presence of the High Street banks is acting as a deterrent. We discuss the impact of the Challengers in more detail in Chapter 5.

It is true that the business market has been relatively more concentrated and the business current account market registers an approximate Herfindahl Index score of around the 2000 mark. That does put it into the more concentrated part of the EU’s band but within the moderately concentrated bracket for US markets. This is in part a function of the fact that many SMEs have wanted a full service account offering from banks, something we have heard from a number of the challenger banks. Interestingly, our YouGov polling shows most customers are satisfied with their business bank and the choice of products at 66% and 55% respectively, with only 14% dissatisfied with their account and 16% thinking there was not enough choice.

It is more difficult in the lending market too since making a business loan is much more of a judgement than a mortgage, a credit card or a personal loan. Nevertheless, they are making a difference in the business lending market, with Handelsbanken building their corporate loan book to £8.8 billion. Aldermore’s lending to SMEs reached £1.7 billion by the end of 2013 and Shawbrook’s total lending book now exceeds £1.3 billion.

Again though we think technology is beginning to change this with many more forms of finance on offer. Supply chain financing, internet invoice discounting, crowd funding and peer-to-peer lending have all emerged in the last few years to provide alternatives. The Asset Based Finance

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33 Philip Aldrick, Bank shake-up sparks surge of new lenders, Times, 10 March 2014.
34 Virgin Money, 2014.
Association found that the invoice discounting market grew at 9% last year while NESTA’s report on peer-to-peer lending shows the market is currently doubling every year, albeit from a small base. This supports the BBA’s findings which show that loan and overdraft borrowing from the largest five banks by SMEs accounts for around 60 per cent of all SME borrowing from banks.

There are likely to be others entering this market too. Amazon, for example, has launched finance for its sellers in the US.\textsuperscript{35} For online sellers like Amazon, with a day-to-day understanding of their customer’s business and sales this is an understandable move (see chapter 5).

It is the view of the BBA that changing technology is allowing new competitors to emerge in UK banking and that the best way to facilitate competition is to ensure that there is as level a playing field as possible to allow those banks to compete. We return to this in our chapter on how to promote competition.
Chapter 4

Banking competition and market share caps

Labour’s proposals

In his first economic speech of 2014, Ed Miliband outlined his vision for how a future Labour Government would reform the UK banking system. As part of these reforms he proposed establishing a threshold for the market share any one bank can have of total personal accounts and small business lending. The policy aims to improve the price and quantity of lending to small businesses, the quality of customer services and to create at least two new challenger banks with significant market shares.

Ed Miliband said a future Labour Government would instruct the CMA to report within six months of the election on how to implement such a plan, ruling on:

1. How many additional branches the big banks would need to sell off and other regulatory changes needed to bolster competition.
2. The timetable for the divestment of branches beginning within six months of the report and completed within a five year parliament.
3. The maximum threshold for future market shares which would automatically trigger another CMA investigation if breached – and prevent any merger or acquisition taking place which exceeds that threshold.

Specific reference was made to the US cap on bank size, which is set at a 10% share of deposits. The Labour leader also expressed his concern that UK was one of the most concentrated banking systems in the world, with four banks controlling 85% of small business lending.
This chapter examines whether forced divestiture and market share caps actually promote competition. We identify a series of issues with using the US market share cap as a justification for their use in the UK and raise doubts over whether Project Verde and Rainbow\(^36\) offer a blueprint for further branch-based divestiture. We also analyse existing legislation surrounding competition inquiries and challenge the assumption that a future UK government could force the CMA to investigate and report on a market within six months.

Do market share caps promote competition?

State-initiated market interventions aimed at boosting competition and promoting choice are a long established policy response to anti-competitive practices. There are some examples of forced divestiture in the UK, but the policy is most associated with the US, where it achieved mainstream political approval following the antitrust movement against the so-called “robber barons” in the nineteenth century.

Angered by allegations of collusion and price-fixing, President Cleveland enacted the Sherman Act (1890) and President Wilson passed the Clayton Act (1914). The landmark legislation prohibited a firm from monopolising trade or from entering a transaction that would create a monopoly in the US.\(^37\)

Both pieces of antitrust legislation are still in operation and give the US authorities the right to limit a business’ market share or force it to sell part of its operations if it is proven to be in a monopolistic position. However, instead of promoting competition, a recent paper examining competition benefits arising from cases of forced divestiture in the US concluded the measure has “generally not proven to be effective as a remedy in monopolisation cases in terms of increasing competition, raising industry output, or reducing prices for customers… a competition analysis focusing solely on market concentration could be fundamentally flawed because it ignores other factors, including the height of barriers to entry and the extent of sunk costs incurred by new entrants”.\(^38\)

Commenting on their effectiveness over time, former Chairman of the US Federal Trade Commission William Kovacic said: “To most students of antitrust, the history of the Sherman Act deconcentration endeavours is largely a chronicle of costly defeats and inconsequential victories”. Academic Richard Posner concluded, “there is no evidence that any of these extreme measures [in the US]… had salutary effects”.\(^39\)

The lessons from the US are striking. Selling assets can take years, by which stage technology has often changed the market so much that the solution is no longer applicable to the prevailing conditions. As a result, the administrative and legal costs for the taxpayer of pursuing forced divestiture outweigh the social benefits and the money could achieve a higher social return by being spent elsewhere. Similarly, a lack of expertise in the legislative process coupled with the complexity of sector markets may lead to unintended consequence such as removing economies of scale and scope. This can lead to the perverse scenario of market interventions leading to higher prices and less choice for consumers.\(^40\)

Aware of the dangers of using a simple concentration measure, the current...
focus of US antitrust policy has shifted to taking measures that prevent a firm from exercising market power.

The UK was slow to follow the US’ lead on market intervention policies and forced divestiture only became legal under UK competition law in 1973. One of the most widely known examples is the 1989 market investigation’s decision to force the six largest brewers to sell 22,000 premises to independent retailers. The divestiture was justified by regulators and politicians alike on the basis that it would create a greater number of small and medium-sized vendors who would provide more choice for customers as well as lowering wholesale and retail prices.

Three subsequent studies into the impact of the decision have concluded that far from achieving the forecasted results, forcing the brewers to sell premises actually resulted in higher prices for customers. In many cases, smaller vendors were unable to achieve the same economies of scale in either the buying or selling markets and pass these savings on to the end consumer.41

Another analogous example to banking is the UK’s grocery market. In 2005, the Competition Commission launched a market investigation into whether the four leading supermarkets – Asda, Sainsbury’s, Tesco and Morrisons – were exercising market power.

The study focused on the practices surrounding supermarkets’ commercial land holdings and whether the entrance by the “big four” into the convenience market was leading to anti-competitive behaviour.

After several years of deliberation, the CC was reluctant to limit market share growth because it saw it as the result of competitive practices. It concluded that, “It is not for the competition authorities to deny any players in a market opportunities for organic growth where they arise out of a perceived need and ability to meet customer demand”. Adding, “Divestitures would represent a significant intervention in property rights, as well as being disruptive to consumers. We do not believe that such an intervention is supported by the gravity and prevalence of the [evidence] we found”.42

The CC agreed that there was evidence of restrictive practices that prevented competitors from acquiring land to open shops, but decided that the best course of action was to lower barriers to entry for retailing.

The latest market share figures for the grocery market suggest that this conclusion has been a success with the shape and composition of the UK supermarket changing notably. Online shopping coupled with aggressive new entrants has created a more stratified and competitive sector with incumbents surrendering market share and customers benefiting from greater choice and lower prices, see figure 20. It is interesting to note that the approximate HHI score for supermarkets has fallen from 1658 in 2006 to 1604 in 2014.

The other major case of forced divestiture in the UK that has received some plaudits was the recent decision by the CC to force the British Airports Authority (BAA) to sell Gatwick, Stansted and one of Edinburgh or Glasgow airports. The decision was justified on the grounds that both passengers and airlines were being negatively impacted by the concentration of ownership. The CC’s inquiry chairman Christopher Clarke
concluded, “[that] given the nature and scale of the competition problems we have found, we do not consider that alternative measures, such as the sale of only one of the London airports or greater regulation will suffice”.

Yet BAA was explicitly created as a privatised monopoly in 1987. There was a strong case made at the time to break up the airports and have competition, but this was rejected on political grounds. Commenting on the decision at the time, Sir John Vickers said: “We conclude that, above all else, the privatisation of BAA was simply the transfer to private hands of a monopoly with valuable property assets. A case for promoting competition and enhancing the effectiveness of regulation by separating the ownership of BAA’s airports was rejected”.

Similar proposals to “break up the banks” via forced divestiture were made by some respondents to the ICB’s consultation on how to reform UK banking recommended following the 2008 financial crisis.

The Vickers’ Commission examined the case for divestiture in some detail as a tool for achieving a safer and more stable banking industry. After careful examination of the evidence at hand, the final report concluded: “Measures such as capping market share, or balance sheet size… did not receive much support from respondents, nor has significant new evidence been provided on them. The Commission’s view therefore remains that these measures would not be beneficial for competition in UK retail banking”.

It added: “There is no evidence to change the view that (additional divestiture of LBG/RBS over EC state aid conditions) would be more
disruptive and less cost effective than other options which should deliver comparable benefits”.46

The Commission’s conclusions, in what was the biggest examination of the UK’s banking industry in a decade, should not be underestimated. They reflect an appreciation of the limits of divestiture, the chequered history of past state interventions and lack of clarity associated with the evidence for such action.

Crucially, few amongst the industry’s key players were actually calling for market share caps or for legislation to force incumbents to shed branches:

“Just breaking up an institution doesn’t necessarily create a more intensive competitive structure... It’s not just about one aspect. You need to look at the entire business model and risk profile.” Mark Carney, Governor of the Bank of England.47

“We believe it is important to give customers choice and that means market forces should dictate who gets what market share, provided that there is a level playing field,” Jayne-Anne Gadhia, CEO of Virgin Money.48

“The real priority for the regulators is to use their new powers to make it easier for new challenger banks to give people a genuine choice, make sure the payments system is fit for purpose and make banks release data to help consumers find the right bank for them,” Richard Lloyd, Executive Director of Which.49

A recent paper by the Bank of Canada reviewing the academic literature surrounding competition in banking arrived at a similar conclusion. It found that “Overall, it does not appear that concentration alone provides a particularly good indication of competitive behaviour”.50

Banking competition policy should facilitate an environment that promotes competitive behaviour while recognising the need to balance systemic concerns, such as market stability. Satisfying both the prudential and customer demands of participating in banking markets is likely to lead to some degree of market power as companies seek to spread costs by achieving scale. Indeed, this trend can achieve certain social benefits.

Does the creation of TSB and Williams & Glyn offer a blueprint for future divestiture?

Following the financial crisis, there were a several international incidents of forced-mergers and government bail-outs of banks that had the potential to create competition issues. Two such cases took place in the UK.

The decision to merge HBOS and Lloyds TSB (and subsequent partial nationalisation) was sanctioned by the former Labour Government notwithstanding concerns expressed by the OFT on the grounds that the new entity would have a c.30 per cent share of the current account/mortgages markets.

However, in bailing-out HBOS, the UK Government triggered European Commission State Aid rules. The Commission called upon Lloyds Banking Group to divest a proportion of its retail banking customers and branch network in an agreement that became known as Project Verde and led to the resurrection of the old TSB brand.
The Government’s support for the Royal Bank of Scotland also led to a requirement from the European Commission to reduce the bank’s market share via Project Rainbow. Rainbow involved RBS divesting up to 5 per cent of its market share in SME banking via the creation of a new bank – which is in the process of emerging as another revived brand known as Williams & Glyn.

TSB and Williams & Glyn will be two new, mid-tier challenger banks with c.945 branches, or nearly 10% of the national branch network.54 The national geographical range made possible by these branches as well as their market shares enables the banks to have sufficient scale to compete across the full range of retail and business banking customers. Their combined impact will be to reduce market concentration in the UK’s PCA market and business lending market by between five and ten per cent (see chapter 2).

However, a close examination of the sale of TSB illustrates the difficulties associated with forced divestiture as a method to promote competition.

The Commission initially instructed Lloyds to complete the divestiture process by November 2013, but the bank requested an extension because of the failure of Project Verde. While the relative merits of Project Verde are out of the scope of this report, a lack of viable bidders was one of the leading justifications for Lloyds’ request to extend the deadline.

Speaking at the Treasury Select Committee, Lloyds chief executive Antonio Horta-Osorio noted that they approached approximately 40 plus people about purchasing the divested entity as early as 2010. This breadth reflected, in the words of Lloyds Chairman Sir Win Bischoff, “a fiduciary duty to try and ensure the best deal for [Lloyds’] shareholders” – including the British taxpayer.

Despite these efforts only three parties expressed a formal interest in the offer. Commenting on the state of market interest, Mr Horta-Osorio said: “If you go out to the market and say, ‘Gee, we approached 40-plus people and there were only three interested parties,’ which quickly became two, it sends a powerful message to the two or three remaining people saying ‘Well, what is there about this asset that maybe we are not picking up that the 37 or so did not like?’”52 This sentiment seems to support the suggestion, above, that a branch network is not essential for entry by challenger banks.

According to Sir Win Bischoff, “there were numerous reasons why potential bidders had failed to firm up their interest in Verde”. In a letter to the Chancellor about the deal, former OFT chief executive Clive Maxwell argued that one of the reasons for the lack of demand may have been that the branches and banking assets are in direct competition with Lloyds and other high street retail banks.53 Creating a “mini big bank” therefore potentially makes it difficult for the new entity to create its own market identity.

The Commission’s original timescale gave bidders less than three years to transact, which may also have acted as a deterrent for several potential bidders. Another issue is whether the cost associated with spinning out TSB was the best use of up to £2 billion that could otherwise have been
used to lend to the real economy. Sir Win Bischoff estimated that creating TSB cost £1.6 billion and up to £300 million for the Initial Public Offering.

The failure of Project Verde also shows the problems associated with the significant level of capital, risk management and governance required to complete a take-over based sale. RBS’ initial plan to sell Rainbow to Santander also collapsed when Santander withdrew.

Fortunately, “[the Commission] agreed to extend the deadline for divesting TSB because the UK authorities and [Lloyds] have demonstrated their commitment to create a viable and competitive bank. The proposed changes in the divestment perimeter will enhance TSB’s profitability and preserve its viability as a challenger in the market”.

TSB and Williams & Glyn will be welcome additions to the market because of “the complementary strengths of Verde in serving the needs of small SMEs and Rainbow in serving larger SMEs”. However, the sale process demonstrates that forced divestitures designed solely to promote competition can lead to lengthy, costly and risky processes that generate unsubstantiated social benefits.

As Clive Maxwell noted to the Chancellor, “Changes in [market] concentration alone cannot be the sole basis for analysing the effect on competition of the divestments. Small banks can… represent effective competitors which are potentially stronger than their market shares suggest”.

We believe that an attempt to impose market share caps and forced divestitures of bank branches is not the right way forward. YouGov polling shows that more than half of people think making it easier for new banks to enter the market and for small banks to grow is preferential to forced divestiture. However, nearly one in two polled said they bank with a larger bank and did not want to be forced to change bank account provider because of government intervention. Market share caps also run the risk of banks reducing their competition for customers if they approached a cap or perhaps looking just to keep their more profitable customers.

Add this to the fact that there is little evidence that forced divestiture has promoted competition in other countries and the spin offs of TSB and Williams & Glyn are proving to be very difficult and a clear picture emerges. The industry supports competition via market-based initiatives and people respond more positively to this approach.
Box 2: The US has market share caps for its banks, so why don’t we?

The debate in the UK often looks across to the approach US regulators have taken to market share caps. What is often missed is the fact that US banking markets are analogous in size to the entire EU market and have actually become more concentrated since the introduction of caps in 1994. Basing a similar strategy in the UK on the lessons from America is dangerous. It ignores fundamental differences in the idiosyncrasies of national market structures and political systems – and would be likely to generate perverse and unintended consequences.

The Riegle-Neal Act (1994) prevents banks from merging to form a single bank that controls more than ten per cent of total US deposits. The Act also introduced a concentration limit on any consolidation of financial companies of 10 per cent of financial industry liabilities.

It is this act that the Labour leader referred to when he said:

“In America, by law, they have a test so that no bank can get too big and dominate the market. We will follow the same principle for Britain and establish for the first time a threshold for the market share any one bank can have of personal accounts and small business lending.”

To fully understand the US cap, it is important to understand the context within which this measure was introduced.

The US has a long standing tradition of decentralised, state-based banking. Banks and the services and products they offered were entirely state-based in the nineteenth century. Much of this period was known as the “free banking era” because barriers to entry were extremely low and state banks were relied on to issue notes as well as providing basic deposit and lending functions.

It was not until the 1863 National Banking Act that banks were subject to any form of regulator over and above general business rules and a national currency backed by US Treasury holdings was introduced.

Banks wishing to issue “national dollars” had to hold a national banking licence. Crucially, this licence did not entitle them to operate on an inter-state basis. While regulators soon allowed inter-state branching, most remained unit or single branch banks. This meant they only needed to meet the 10 per cent capital margin requirement to operate.

This tendency towards decentralisation and small institutions is a leading explanation for why the history of the US banking system is one of frequent banking failures.

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Figure 21: National deposit shares of the four largest US depository institutions

Source: Financial Stability Oversight Council 2011

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61 National deposit shares of four largest US depository institutions, Study and recommendations regarding concentration limits on large financial companies US Treasury financial stability oversight council, Figure 1 p. 24, January 2011.
63 Ibid. p. 361.
64 Ibid. p. 362.
The most severe crisis came in 1907 when a liquidity crisis spread throughout New York’s banks. A national crisis was only staved off by the decision by a private conglomerate to step in and offer the necessary liquidity. Seeing the benefits of such actions, US legislators introduced the Federal Reserve Act (1913), which established an American central bank - the Federal Reserve – to act as “lender of the last resort”.

The success of the Federal Reserve set in chain a set of policies over the course of the twentieth century that aimed to promote centralisation and concentration within US banking.

*The Act gave banks the ability to offer national branch coverage by ending the restrictions on state-banking. Greater geographical dispersal allowed banks to consolidate their operations under one brand. It encouraged banks to expand, diversify their holdings and realise economies of scale. These processes made banking simpler for customers, increased financial stability and improved banks’ efficiency.*

Figure 21 reveals that the Act achieved its primary objective of increasing financial stability by allowing banks, starting from a low base, to grow into national players. Between 2003 and 2009 the share of the national deposits held by the biggest four US banks nearly doubled from 19% of the market to 35%.

However, it is also important to note three important caveats in the Act:

1. **Banks are only prevented from surpassing the cap via mergers.** No restrictions are placed on institutions holding more than ten per cent of deposits if the expansion is the result of organic growth.

2. **The definition of a bank was limited to insured depository institutions.** The regulation ushered in a period of extensive merging amongst US banks that took a small number of institutions close or slightly over the cap. However, all were deemed legal because they involved non-insured depository institutions, such as insurers and savings banks.

3. **A national cap on market share for depositors was not considered relevant from an antitrust perspective.** The cap did not apply to retail or business lending markets, in which it would be possible to excessive market power.

State politicians feared that mergers would lead to overconcentration and anti-competitive behaviour towards smaller banks. It was with these concerns in mind that the secondary 10 per cent cap on deposits was introduced. The cap was a concession to the legacy of the US state-based banking system and nature of state-federal politics in the US. The decision to build a ceiling of market concentration into the legislation was a long-term concession in what remained a highly fragmented national market.

This is supported by Former Federal Reserve Board Governor Roger W. Ferguson Jr., who argued that the “caps are a second line of defence that focuses more on perceptions of concentration of power as opposed to the science of economics” (Selberg, 1998).

The US deposits cap is allowing big banks to consolidate across the financial services sector and compete elsewhere. But it does not preclude organic growth and is highly targeted to just deposits.

While US banks continue to compete for customers, evidence suggests they are increasingly turning their attention to parallel banking markets when they approach the market cap for deposits – as seen by the recent purchases of Merrill Lynch by the Bank of America and Wachovia by Wells Fargo. This displacement of competition could have significant unintended consequences for the UK market. Steven C. Sunshine, the former deputy assistant Attorney General for the US-Justice Department’s Justice and Anti-Trust Division argues that the deposit cap may even hurt customers because “[i]t prevents efficiencies and raises costs, which is the antithesis of what you want to achieve.”

Mr Miliband has said that organic growth would trigger the proposed new cap. Customers of banks reaching the cap would potentially stand to suffer as the bank turns their attention to attracting customers by offering favourable terms in other markets, such as credit cards and mortgages.

crises – 1819, 1837, 1873, 1893 – in which tens of thousands of local banks failed. 56
In our work on competition the one element that is clear will change the competitive landscape is technology and in particular digital banking. This is such a game changer that any analysis of the competitive landscape that does not consider how this is likely to change the banking industry is missing a huge part of the picture.

Despite the advent of digital technology large parts of banking until very recently still resembled banking of 30 or 40 years ago. We still used cheques and cash to pay people, we used basic electronic transfers like standing orders and direct debits and we visited branches to pay in cheques and cash and to arrange loans. Bank statements were printed on paper and arrived monthly. If you wanted to check up more frequently you called the bank or printed a statement when you visited a cashpoint.

The advent of the internet and in particular the digital app is changing so much of that. We now have faster payments, contactless cards and access to our bank account on a minute by minute basis. Payments can be made online and direct debits (within limits) and standing orders set up online. Even pocket money is often paid this way. This enables individuals and companies to manage their banking affairs from their home, their office or even on the road. As RBS said to us “Do you know what our busiest branch is in the UK? It’s our mobile app in the morning rush hour.” Barclays, for example, saw £134 billion of payments and transfers through digital banking in 2013.

There is more to come with the ability to pay people via mobile phones (Paym) having just been launched. With this you can now log into your banking app and send someone a payment merely by entering their mobile
phone number.\textsuperscript{65} That payment will land in the person’s account just a few hours later. This should in time reduce the need for cheques and cash still further. Similarly cheque imaging, which is currently being considered by the Government, would allow individuals and companies to pay in cheques remotely. Similar to Paym this would require the recipient of the cheque to simply scan it with an app and once it has been recognised the cheque would enter the clearing system. There would be no need for the paper cheque ever to have to be sent to a branch.

This is changing the role of the branch and how it is used. As we noted earlier RBS has reported that footfall in its branches has dropped by some 30\% in the last three years. That means that banks are now reconfiguring branches from being places that received and paid out cash and processed payments to places where people can get advice. Metro Bank does not even use the term branch preferring the term stores.

This is important from a competition perspective as in the past the OFT has looked at the branch network as a significant barrier to entry. It is interesting that some new entrants (Shawbrook, Aldermore and Atom Bank for example) are actively choosing different means of service delivery, eschewing branches altogether, while others such as Metro and Handelsbanken are currently building branch networks in the low hundreds rather than the low thousands currently operated by the major banks.

If we look at the results of the YouGov polling commissioned by the BBA it is not surprising that this is happening. If we look at online usage vs branch usage we can see the dominance of online. 39\% of SMEs use online banking at least once a day, with a further 30\% using it at least once a week. Only 7\% never use it.

Branches are still used but only 5\% use them once a day for banking with a branch employee and 22\% once a week. 14\% claim never to use a branch in this way. 65\% of SMEs agreed or strongly agreed that they could do the vast majority of their business online or over the phone. Only 17\% disagreed or strongly disagreed. While around 75\% of businesses used online technology to keep a closer eye on their cashflow or to pay bills, 57\% said that it meant they had fewer or no trips to the branch as a result. In addition 52\% of SMEs thought that the ability to pay in cheques remotely would reduce their usage of branches, while only 18\% disagreed or strongly disagreed with that view.

While 68\% of SMEs still thought that having a branch on every high street was important only 50\% disagreed that we’re coming to a stage where we no longer need a branch on every high street, while those who agree is up to 33\%. Not surprisingly 66\% thought that a local branch was necessary “when you want to discuss financial issues face-to-face”. This would tend to suggest that businesses are becoming more comfortable doing much of their banking business online, but still require a place to conduct more complicated business.

First Direct is a good case study here: it has 1.25 million customers, which equates to around 4\% of the current account market. Some 750,000 of its customers use its online service and 89\% of customer contact is via a digital channel, despite customers having access to branches through the HSBC network.

\textsuperscript{65} The recipient also has to be registered for Paym.
Figure 22: Can you do the vast majority of the business’ banking either online or over the phone?

Source: YouGov

Figure 23: Are you coming to the stage where you no longer need a bank branch on every high street for your business banking?

Source: YouGov
That technology is also allowing the likes of Tesco, Sainsbury’s and M&S to enter the banking world. Each of these has different models but the fact that you can do the bulk of the administration through call centres and over the internet makes the setting up of banks a lot easier. It is interesting to note that both Tesco and M&S have set up current accounts. What the supermarkets do have though are their own strong brands and the ability to offer banking services through their stores.

With today’s younger generation being the first that has grown up with the internet and online access we suspect that the trend towards banking being a less physical and more virtual operation is only going to strengthen. That suggests that the number of branches needed to be a genuine full service competitor will be much lower than before. Others may well be able to follow the First Direct model perhaps by using the Post Office branch network as their surrogate. Perhaps the insurance industry is a model. Whereas in the past people used to go in to see their insurance company or broker in person the vast majority of insurance business is now done over the phone or online. According to an Accenture survey in 2010 it was already the case that 66% of people were purchasing or renewing their insurance online and 27% over the phone.

We have only spoken of banking in the retail sense here. Even online banks are built in the model of traditional banks offering loans, current accounts, credit cards and savings accounts. There are other potential competitors to banks who are already starting to enter certain areas of banking.

Figure 24: How often does your business use online banking?

Source: YouGov

Tesco for example has decided to go down the route of setting up its own bank, whereas M&S Bank operates as a subsidiary of HSBC albeit with its own branding and products.
There are direct providers of finance such as invoice discounters, supply chain finance companies and peer-to-peer lenders. These are particularly prevalent in business finance and although small are growing quite quickly. Funding Circle for example has (at the time of writing) advanced some £293m to UK businesses.\(^67\) In many cases they are partnering with banks to provide alternative sources of finance. These firms though are probably not the biggest source of future competition for banks. This may well come from outside the banking industry. We noted earlier that the supermarkets were entering banking using their brands. In a similar vein the likes of Paypal, Google, Facebook and Amazon have started to enter areas of finance. Paypal, Google and Facebook are either already providing or looking to provide payment services. Paypal is well established and Google Wallet has started in the US as a way to pay online, shop in stores or send money. In the US Google Wallet enables you to send money to someone else via their email address. They can then spend it with their Google Wallet or even withdraw it from cashpoints using the Google Wallet card. Facebook has applied for a payments licence in Ireland. It has said that it will allow money to be stored on a Facebook account and sent to other Facebook users.\(^68\)
Technological change and a more pro-competition regulatory regime have seen a significant increase in the number of new entrants into the UK banking sector. We now have the likes of Metro, Secure Trust, Aldermore, Shawbrook, Tesco, Virgin and Handelsbanken competing against the major banks. Santander could also be described as a challenger in the corporate banking market having previously been predominantly focused on the personal market. There are more to come with more than 20 banks reported to be seeking licences from the UK authorities.

Many of these banks have very different business models from the established banks, indeed most argue that they see that as a key competitive advantage. While some have argued that they are too small to represent a significant challenge to the incumbents the evidence would suggest otherwise.

Some of the challengers are well established. Tesco for example already has 7 million financial services customers and a loan book of more than £5 billion. It has just launched a current account. Virgin has recently announced that it has topped £20 billion of mortgage balances and grew its mortgage book by 17% in 2013. It too is due to launch a current account this year. Santander had grown its corporate loan book to £22.1 billion in 2013, with lending to SMEs up to £11.7 billion up from £9 billion in 2011. Handelsbanken too has been around for some time, with more than 170 branches and £1.6 billion of loans last year.

The new challengers obviously started smaller but have started to grow quite quickly. Metro Bank for example grew its deposits by 131% in the
Figure 25: Selected Challenger mortgage lending

Source: Investec

Figure 26: Gross mortgage market share

Source: Investec
year to Q1 2014 to £1.6 million, lending rose by 298% on the year to £960 million. It now has 318,000 customers with 26 branches – referred to as stores. Aldermore launched in 2009 and by August 2012 SME lending had reached £1 billion and deposits £2 billion. Now it has £1.8 billion of SME lending and £3.8 billion of deposits. Shawbrook is a similar story lending more than £1 billion to SMEs and consumers in 2013, and gaining some 44,000 customers in the process.70

While these look impressive at an individual level it has been questioned, not least by the OFT, whether it is sufficient to make an impact on the banking system as a whole. The evidence is that they can make an impact however. Figures 25 and 26 have been taken from a report by Ian Gordon the Investec banks analyst.71 The first shows the net lending performance of five of the challenger banks – Aldermore, Metro Bank, Shawbrook Bank, Tesco Bank and Virgin Money – from the Bank of England’s Funding for Lending Scheme data. It shows around £5.5 billion of net new mortgage lending from the challengers.

It is, of course, worth observing that even traditional shares in this sector have not been as static as is often suggested. In 2007, for example, RBS had less than 6% of stock and less than 5% of gross new lending, but has grown its balances by 50% in six years. Nevertheless, the new challengers tell an impressive story: the second chart shows that outside the big six mortgage lenders (Lloyds, Barclays, HSBC, RSB, Santander UK and Nationwide) the share of gross mortgage lending rose from 17.5% in 2011 to 22.8% in 2012 and 28.8% in 2013.

Gross mortgage lending by banks and building societies outside the top six more than doubled from £24.7 billion in 2011 to £50.8 billion in 2013.

Work by Joseph Dickerson, banks analyst at Jefferies,72 suggests that there is room for the challengers to continue to increase their market share, in part reflecting the continued deleveraging of some of the large banks. He thinks there is room for the challenger banks to nearly quadruple their market share. The research assumes that the larger banks will cede around four points of lending market share over the next five years. Even if the challenger banks only maintain their current rate of growth they would double their market share by 2018.

Mr Dickerson argued the following: “Several factors will allow the so-called challenger banks to capitalise on this propensity to switch: first the Current Account Switch Guarantee that came into place in September 2013 allows for fast, seamless switching to new banks; second, the most sweeping regulatory reform in a generation discourages consolidation and fosters an environment in which new competitors can flourish; third, non-Utility Bank players are becoming increasingly focused in specialist areas (e.g. SME lending).”

He believes there is a £100 billion market with £5 billion of potential revenue available for the challengers, as the larger banks still have to reduce loan to deposit ratios. He calculates that the challenger banks (excluding supermarket banks and TSB) have increased their share of loans by 62% in just 2 ½ years while the share of deposits has risen by 1/3 over the same period. As a group they have grown loans by 25% and deposits by 23%. He calculates that they account for 2.1% of the UK lending market and 2% of the deposit market.
Figure 27: Average loans per year since establishment

Figure 28: Deposit creation per year since establishment

Sources: Jefferies estimates and Bank of England

73 Jefferies calculations for Shawbrook include the acquisition of Laidlaw, which had a pre-existing loan book. Excluding that acquisition Shawbrook’s loan creation would be c30-40% not the 10% shown by Jefferies.
Figure 29: Challengers loans and deposits

Figure 30: Challengers market shares

Sources: Jefferies estimates and Bank of England
Whether he is right or not in the magnitude of likely change we believe the challengers will continue to move in that direction. The challengers have a variety of different business models which leads to greater choice for customers and it also drives innovation. There is evidence from our polling that different customers want different things from their banks. Some are happy to do more and more of their banking online and are relaxed about there being fewer branches, some see a branch as essential for face-to-face meetings. Some seem to be happy to take their banking products from their main bank, others are willing to look elsewhere for loans or other services. That suggests there is room for the challengers to offer differentiated products to different types of customer. A good example in the SME market is Handelsbanken’s traditional full service local branch approach with the more web based targeted approach of Shawbrook and Aldermore.

This will be a challenge for the major banks as different parts of their business will come under pressure from different types of competitor. They have already started to respond, whether it is by changing opening hours, product types or offers on those products. This forces innovation as well, as we have seen in the airline and supermarket industries. If politicians and regulators want to increase competition in the banking sector then ensuring the playing field is level to facilitate this growth is the best way to do it.
The Challenger Banks

Launched in 2009, by March 2014 the bank had total deposits of £3.8 billion, with lending to UK SMEs at £1.8 billion and to UK homeowners of £1.9 billion. It now has more than 155,000 accounts.

Handelsbanken has been present in Britain since 1982, designating it a home market in 2002 when it started domestic banking for both British individuals and corporates. It now has a network of 175 branches across the country, stretching from Aberdeen to Truro. As per Q1 2014, Handelsbanken had made £12.5 billion of loans to the UK public, of which £8.8 billion was to British companies - many of whom are SMEs. In 2013 it grew its total UK lending by 20% and its total UK deposit taking by 32%.

Metro has launched on a smaller scale with just 26 “stores” currently, although it aims to get to around 200 by 2020. It has also launched an internet banking service and is now entering the corporate market too. As of 31st March 2014 it had deposits of £1,616 million, total loans of £960 million and 318,000 customers.

The Post Office hopes to have 2000 branches offering current accounts by the end of the year. It has 11,500 branches in total so could eventually offer a more widespread choice than any current retail bank. By way of comparison, Lloyds has just under 2300 branches post the TSB spin off.

Santander initially grew through the purchase of former building societies but is now growing its corporate loan book. It had some £22.1 billion of corporate loans as of end 2013, an increase of 12.7% on 2012.

Established in 1952, the bank has 550 staff looking after over 350,000 customers across its current, deposit and consumer loan products and has recently begun SME lending activities.

As at end 2013 Shawbrook had total assets of £1.7 billion and 52,000 borrowing customers. In 2013 alone it originated £1 billion of new business. Total loans now total £1.37 billion.

Tesco Bank has just launched a current account but already has 7 million accounts. It already has a loan book of £6.9 billion.

Virgin Money provides savings, mortgages, credit cards, pensions, investment and protection products to its 3 million customers. The business acquired Northern Rock plc in 2012, which included a mortgage portfolio amounting to £14 billion. Virgin Money’s mortgage balances rose to £19.6 billion by the end of 2013, having grown some 17% during the year. It was the third largest net mortgage lender during 2013 based on Bank of England Funding for Lending data.
As we discussed in chapter 5 the banking sector is set to undergo substantial change in the coming years led by technological advances and in particular the advent of digital. The challenge for those who want more competition in banking, and we at the BBA are among them, is to work out how best to facilitate competition.

In the process of our research for this report we have spoken to challengers and incumbents alike to seek their views as to the best ways to facilitate competition going forward. The resounding response was the need to focus on creating a level playing field and then allow the banks to compete for customers and business. From a BBA perspective we believe competition is about enabling customers to exercise informed choice between a variety of banks. That means increased transparency, making it easier to switch and reducing barriers to growth and new entrants.

Progress on competition to date

To begin with we should recognise the progress already made. CASS is proving successful and challengers have been beneficiaries of this change. As people become more aware of it, and crucially the fact that it now works well, we think that it will be used to a greater extent. All banks have responded by actively promoting their new accounts to attract new customers. Indeed, as we noted above Which? have commented positively on the competition for current accounts.

Second, the regulatory authorities have reduced the barriers to starting up a new bank. We have been told that the new system, while still time
intensive, is actually fairly straightforward and that anyone who wants to set a bank up and has the necessary skills and capital, should now be able to do so.

Third, there are a number of initiatives currently proposed by the Government to help SMEs find the right finance for their needs, such as Better Business Finance, mi-data, Business Banking Insight, the review of CASS to extend it to the business lending market, deeds of priority and the referrals process.

For instance, mi-data will allow PCA customers (who are registered for online banking) to receive their own current account data, on demand, in an electronic format by 31st March 2015. This will enable customers to compare their existing current account with any alternative account more easily. The referrals scheme provides a mechanism whereby a company that has been turned down for finance by a bank is referred to other organisations, banks or alternative providers of finance, who might be able or willing to provide the finance the company needs. This is in addition to the Better Business Finance portal that already provides a access to more than 500 finance providers in the UK and a search function to find offers in SMEs’ local areas.

Finally the lowering of capital requirements for new banks, with new banks allowed to open with capital equal to 4.5% of total assets, was definitely a step forward in helping to level the playing field. It also saw a lowering of liquidity requirements for small banks to bring them more into line with their larger peers. A six month approval process was also introduced to speed up applications.

**Levelling the playing field**

There is more that can and should be done to level the playing field. In our discussions with the challenger banks four elements came through loud and clear: payments, capital, access to funding and proportionality of regulation.

**Payments – fair access for all**

All of the challengers that we spoke to highlighted access to payments systems as a particular concern. Any new bank that wants to offer a service to its customers’ needs to have access to the payments systems to be able to give them the ability to undertake faster payments, CHAPS or BACs payments. A new bank has two options either to access the payments system via an agency or to build a system to access it directly. Given the cost of going it alone at the beginning most opt for third party access.

While some acknowledged that they would not even be able to challenge if they were not able to use the major banks’ systems, many also argued that they were paying too much. Some challengers argued they were paying a multiple of what it cost the incumbent banks to process payments. This is particularly an issue when current accounts tend to have to be offered as “free-when-in-credit” to be competitive. A number of challengers argued that the cost of using the payments system meant it was very hard even to break on the provision of current accounts. The issues raised by HMT, in its report on payments (see chapter 2) very much

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74 Helen Knapman, Banks pledge to provide data that may help you find your perfect current account, 17 March 2014.
75 See 8.
76 For challenger banks with branch networks, securing access to counter services - the gateway to the Cheque and Credit Clearing System - is also a crucial payment systems issue.
chimed with the concerns of the challengers and they are waiting with interest to see what the Payment System Regulator does in this area.

The larger banks argued it was important to consider all costs not just the short term marginal costs of using the system since there had to be sizeable investment in the system from an IT and resource perspective to put it in place. The sponsoring banks also take on other risks for their agency banks. For example liability for certain payments made on the agency’s behalf in case of insolvency; claims made through the direct debit guarantee; also the payment traffic of the agency bank effectively becomes the sponsoring bank’s own traffic in terms of no-compliance with anti-money laundering/payments to sanctioned countries.

Where there was agreement was in a desire to work with the payments regulator to find a solution that works fairly for everyone. In particular there was much discussion of the need to reflect the long run marginal cost in the pricing of any service. There was also some discussion on the development of a ‘payments utility’ to provide an alternative way for agencies to achieve technical access to the payments systems, but no clear view as to how that might work or whether it would risk being a single point of failure.

Account Number Portability – not the solution

One option that has been put forward is to introduce Account Number Portability (ANP). Yet in our discussions few raised it as something that would dramatically change the landscape. There were considerable concerns about the cost of any such project and whether the spending on IT that it would entail could be better deployed elsewhere. This was true for challengers as well as incumbents, as they too would have to spend on technology to accommodate ANP. Others were concerned about the risks of one single point of failure and also the fact that it could make bank runs easier in a crisis.

In 2011 the Australian Government came close to introducing ANP. Former central bank Governor, Bernie Fraser, conducted a comprehensive review into the measure. Mr Fraser’s findings make a strong and successful case for not introducing ANP.

Mr Fraser argued that: “It would be akin to taking a gold sledge hammer to crack what is really quite a small nut in the broader scheme of competition and account switching in banking services in Australia.” Adding that it would actually harm competition in banking because it would disproportionately affect small banks: “Smaller players in the banking services market — who are often viewed as potentially significant drivers of increased competition — are inevitably the ones least able to participate in costly major new developments of this kind (even where the benefit/cost numbers are reasonably attractive).”

These are all important points that would perhaps have to be re-assessed if there was a public clamour for such an initiative. However, the YouGov polling suggests this is simply not the case. When they asked what initiatives would improve the reputation of the banking industry, making it easier to switch comes last with just 15% of people agreeing. When asked whether keeping a single number would make them more likely to switch 60% of SMEs and 64% of consumers said it would make no difference.
Bear in mind too that only 11% of consumers and SMEs thought that it was likely that they might switch accounts in the next year.

A number of people raised the point that Paym has the potential to become a system for account portability through the use of a mobile number as a unique identifier. It would allow consumers to link their account numbers to their mobile phone number. They could then simply change the account linked to that number without having to change all the payments associated with that account. That would be an option using existing technology at a fraction of the cost of a full conversion to ANP.

Based on the lack of demand for ANP and the costs and risks involved it would seem more sensible to stick with the CASS, which most challengers thought had shifted the playing field sufficiently anyway.

Capital weightings – a move to some form of IRB?

Capital weightings remain a problem despite the regulators having lowered the initial capital new banks must hold. The reason for this relates to Basel Capital Rules and the fact that there are two types of capital weighting available to banks. There are the standard capital weights, such as 35% for the standard 60% LTV mortgage and 100% for the normal SME loan. Then there are model based (or IRB) weights. These are based on a bank’s own experience of losses on its loan portfolio. These can generate significantly different capital weights from the standardised ones. In some cases a low loan to value and loan to income mortgage can result in a significantly lower capital weight, potentially requiring as little as one sixth of the capital required by standardised weights. The Bank of England has levelled this playing field to an extent by requiring a minimum capital weight on all forms of lending. Nevertheless, we estimate that this can still result in a model based bank putting up just 30-40% of the capital of a bank on standardised capital weightings.

The problem is mostly for safer assets. For riskier lending such as unsecured SME lending the difference in weights is much less and indeed in some cases those on standardised weights might even have to put up less capital. For the challengers this pushes them in the direction of riskier lending because they are at a competitive disadvantage to the bigger banks when competing for safer assets. Many feel that this means they have to run a less balanced portfolio than they would like. It also restricts their ability to recycle their deposits as much as they would want.

The problem with the Basel Capital Rules is that to be able to use IRB weights banks have to have sufficient historical data to be able to work out their expected loss and probability of default on any particular type of loan. This is why some low loan to value and loan to income mortgages have triggered significantly lower required capital weightings because historic losses have been very low. For the challengers it would not only take them years to establish this type of data it would also cost a lot of money in terms of the IT and expertise they would have to commit to it. In the meantime they would continue to be forced to hold more capital and be biased towards riskier lending.

The challenger banks felt that this disadvantaged them significantly vs the established banks and would like access to some form of IRB weights for their lending. Some have suggested that the PRA provide an
Figure 31: Would ANP make it more likely that you switch bank account? [SME]

Source: YouGov

Figure 32: Would ANP make it more likely that you switch bank account? [Personal]

Source: YouGov
average of the IRB weights of the top 10 banks. Whether this is something that the PRA would want to do or is logistically possible is difficult to say. Nevertheless, if the authorities really do want to stimulate competition then they should look to provide the challengers with something that does allow them to deviate from the standardised Basel weights when it is safe to do so. We acknowledge that this will not be straightforward and will likely require EU/ Basel sign off but it seems to be a logical step forward.

**Funding – Equal access to funding for all**

A number of the challenger banks raised the issue of funding. They felt that the larger banks had an unfair advantage because of their scale. Some attributed it to the fact that Too Big To Fail is still yet to be fixed and highlighted that the Bank of England’s own work suggesting this provided a subsidy to the large banks.79 There was also some acknowledgement that larger banks had an advantage because they were better known and deemed to be safer.

The fact that local authorities and government tend to place all of their deposits with the larger banks was raised as an issue by a number of challengers. The move towards the bigger traditional banks after the Icelandic bank failures is understandable but it was generally felt that government could be proactive in this area to ensure the challenger banks could have a fair opportunity at securing these deposits.

Funding for Lending has, of course, been opened to the challenger banks. While many said that it was good that the government had done this many also criticised the way the scheme was operated as being adverse to smaller banks. One frequently cited problem was that the capital issues meant that their loan portfolios looked riskier from a Bank of England perspective (a number argued they were not in reality), resulting in the Bank applying a bigger haircut to their portfolio. That made the use of FLS much less effective in lowering the funding costs of the challengers.

The challengers argue that the Bank of England should be more generous with its terms until the capital problem discussed above is sorted out.

Another issue was that FLS was designed for the bigger players. There was some frustration that any money drawn down from the FLS came in the form of Treasury bills which meant that challengers had to put in place a repo line to access the funds. Allowing the funds for the challengers to be credited straight to their bank accounts at the Bank of England would reduce the cost of accessing the facility.

One option that was recommended to us was the establishment of a “Funding for Challenger Bank Scheme” that would provide low cost funding for the challengers to offset the advantages of the bigger banks. Such a facility might be particularly useful as and when Funding for Lending is withdrawn. Not all challengers agreed with this but it is perhaps an option the Treasury and Bank of England could explore, possibly through the new Business Bank.

**Regulation – the need for proportionality**

There was also some feeling that the Bank of England and the PRA should think about the consequences for challengers (and indeed all different types of financial institutions) of any programmes they put in place. Many

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79 Angela Monaghan, Banks received “implicit” subsidy of up to £220 billion, Bank of England says, Telegraph, 28 May 2012.
facilities are designed with the larger banks in mind without always thinking through the implications for smaller banks. Perhaps a solution here is to have a challenger bank advisory board for the regulators to consult whenever they are thinking of making a change. This would be a way to head off potential problems before they arise.

Conclusion

The view of the BBA is that customers should have a wide variety of choice of both banks and banking products. We believe competition should be encouraged to provide this choice and drive innovation in the industry. We would argue that there are already signs that the challengers, together with reforms such as seven day switching, are producing change.

We believe the right approach is to ensure that there is a level playing field so that all banks large and small can compete fairly. While there have been some major improvements in various areas in recent years our research with the challengers has unearthed four key issues of capital, funding, payments and proportionality of regulation as the ones that need to be addressed to ensure that level playing field. We would urge the authorities to try and find solutions to them.

Such an approach is likely to be more effective than either market share caps, further divestments or the introduction of ANP. Competition is here and is increasing in the form of the challengers. The authorities just have to facilitate it.
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