

Retail banking market investigation final report

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Appendix 7.1: SME banking market shares

Overview

1. This appendix sets out the evidence on market structure and concentration for SME banking products.
2. We provide estimates of market structure for each of the following product markets identified under our market definition:¹
 - BCAs.
 - Business loans, including general purpose business loans (GPBL), asset finance, invoice finance and credit cards.
 - Business deposit accounts.
3. Where possible, we have calculated concentration estimates separately for each of the geographic markets of GB and NI. However, in some cases data limitations mean we have used UK-wide data.
4. The market shares presented in this section have been calculated primarily using data submitted by the banks in response to our information requests.² In some cases data is not available for all banks in all years. While we have sought to cross-check our findings against those obtained from the Charterhouse BBS, we recognise that particular caution should be exercised in interpreting market shares where data on (a) market participant(s) is not available.

BCAs

5. Using data submitted by the banks, we estimate that the total size of the BCA market has remained broadly constant since 2012, at around 5.5 million accounts (see Table 1). Approximately 89% of these accounts were active in 2015.³

¹ See Section 4.

² An information request was sent to the following banking groups: AIB; Aldermore; Barclays; BoI; Clydesdale; Co-op Bank; Danske; Handelsbanken; HSBCG; LBG; Metro; Santander; Shawbrook; TSB; and RBSG. In the case of Aldermore, Co-op Bank, Handelsbanken, Metro and Shawbrook, a shorter version of the information request was submitted to reflect the relative size of these banking groups' operations and the disproportionate resource impact that a full information request may have created.

³ Defined as an account that has had at least one customer-generated payment or transfer (including standing order and direct debit, but excluding charges and interest on the account) coming into, or leaving, the account in the last 12 months.

Table 1: Summary of GB BCA market 2012 to 2015

	2012	2013	2014	2015
Total accounts (000s)	5,517	5,511	5,459	5,500
Active accounts (%)	86%	87%	88%	89%
Accounts opened (000s)	733	699	642	605
Accounts closed (000s)	748	780	652	670
Net account opening (%)	0%	-1%	0%	0%

Source: CMA calculations based on data submitted by the banks.

6. Figure 1 and Figure 2, respectively, set out the volume of total accounts in GB by banking group, at an aggregate level and segmented by size of SME. SMEs with annual turnover below £2 million account for the majority of active BCAs (over 90% in 2014), reflecting the size distribution of SMEs in the UK economy.⁴

Figure 1: GB BCA volumes – all SMEs



Source: CMA analysis based on banks' response to data request.



Figure 2: GB BCA volumes – by size of SME 2011 to 2014



Source: CMA analysis based on banks' response to data request.



7. As shown in Figure 3, market shares in the GB market for BCAs have remained broadly stable since 2012, when measured by either the number of active accounts or the number of unique BCA customers. The combined market share for active BCAs of the four largest banking groups in 2015 (RBSG, LBG, Barclays and HSBCG) was 82%, and the corresponding HHIs in 2012 and 2015 were 1,932 and 1,810 respectively.

⁴ For example, the latest [Business Population Estimates](#) (produced by BEIS) show that SMEs with fewer than ten employees accounted for approximately 96% of the total SME population at the start of 2014.

Figure 3: GB BCA market shares



GB – All SMEs: Active BCAs at year end, 2011 to 2015

	%				
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
Barclays	[20–30]	[10–20]	[10–20]	[10–20]	[20–30]
Clydesdale	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[20–30]	[20–30]	[10–20]	[10–20]	[10–20]
LBG	[20–30]	[20–30]	[20–30]	[20–30]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[20–30]	[20–30]	[20–30]	[20–30]
Santander	N/A	[5–10]	[5–10]	[5–10]	[5–10]
TSB	N/A	N/A	[0–5]	[0–5]	[0–5]

GB – All SMEs: Unique BCA customers at year end, 2011 to 2014

	%			
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
Barclays	[20–30]	[20–30]	[20–30]	[20–30]
Clydesdale	[0–5]	[0–5]	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[20–30]	[20–30]	[10–20]	[10–20]
LBG	[20–30]	[20–30]	[20–30]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[20–30]	[20–30]	[20–30]
Santander	N/A	[5–10]	[5–10]	[10–20]
TSB	N/A	N/A	[0–5]	[0–5]

Source: CMA analysis based on banks' response to data request.

Note: Data not available for Santander in 2011.

8. To test the sensitivity of these concentration estimates to the definition of market share, we have also calculated the shares of each banking group using total revenue from interest and charges shown (see Figure 4 below). Although revenue data is not available on a GB basis, the concentration indicators arising from shares of UK revenue are very similar to those calculated from shares of UK active accounts.

9. For example, in 2014 the HHI arising from UK revenue from interest and charges was 1,736, and the HHI arising from UK active accounts was 1,760. Under both definitions of market share, the combined share of the four largest banking groups was approximately 80%. We therefore consider the number of active accounts to be a representative basis for estimating concentration indices for the UK BCA market. Similarly, we find no reason to suppose that this would not be the case for GB and NI separately.

Figure 4: Comparison of UK BCA market shares by revenue and active accounts



UK – All SMEs: BCA revenue from interest and charges, 2012 to 2014

Banking group	%		
	2012	2013	2014
AIBG	[0–5]	[0–5]	[0–5]
Barclays	[20–30]	[10–20]	[10–20]
Bol	[0–5]	[0–5]	[0–5]
Clydesdale	[10–20]	[10–20]	[10–20]
Danske	N/A	[0–5]	[0–5]
HSBCG	[20–30]	[20–30]	[20–30]
LBG	[20–30]	[20–30]	[20–30]
RBSG	[20–30]	[20–30]	[20–30]
Santander	N/A	[0–5]	[0–5]
TSB	N/A	[0–5]	[0–5]

UK – All SMEs: Active BCAs by revenue at year end, 2012 to 2015

Banking group	%			
	2012	2013	2014	2015
AIBG	[0–5]	[0–5]	[0–5]	[0–5]
Barclays	[10–20]	[10–20]	[10–20]	[10–20]
Bol	[0–5]	[0–5]	[0–5]	[0–5]
Clydesdale	[0–5]	[0–5]	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]	[0–5]	[0–5]
Danske	N/A	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[20–30]	[10–20]	[10–20]	[10–20]
LBG	[20–30]	[20–30]	[20–30]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[20–30]	[20–30]	[20–30]
Santander	[5–10]	[5–10]	[5–10]	[5–10]
TSB	N/A	[0–5]	[0–5]	[0–5]

Source: CMA analysis of data submitted by banks.

Notes:

1. Revenues data not available for Co-op Bank, Handelsbanken and Metro.
2. Santander revenue data not available until 2013.
3. Danske data not available until 2013.

10. Figure 5 plots the market shares of GB active BCAs, segmented by size of SME. Account volumes segmented by SME size are not available for all banks, and therefore the market shares cannot be used as an absolute measure of concentration in each sub-segment. A comparison of the corresponding HHIs between the two segments, however, suggests a similar level of concentration in the provision of BCAs to both small and larger SMEs.

Figure 5: GB BCA market share of active accounts in 2014 – by size of SME



GB BCA market share of active accounts in 2014 – by size of SME

	%	
<i>Banking group</i>	<i>SMEs < £2m</i>	<i>SMES ≥ £2m</i>
Barclays	[20–30]	[10–20]
Clydesdale	[0–5]	[5–10]
Co-op Bank	[0–5]	[5–10]
Handelsbanken	[0–5]	[0–5]
HSBCG	[10–20]	[20–30]
LBG	[20–30]	[10–20]
Metro	[0–5]	[0–5]
RBSG	[20–30]	[20–30]
Santander	[10–20]	[0–5]
TSB	[0–5]	[0–5]

Source: CMA calculations using data provided by banks.

Note: Data segmented by SME size not available for Metro and TSB.

11. We observe slightly lower levels of concentration in the flow of new BCAs (see Figure 6 below). For example, the HHI of the share of new BCAs was 1,629 in 2015, compared to 1,810 for active BCAs. Smaller providers such as also received among the greatest volume of net account openings (as a proportion of their stock of BCAs) in 2015 (see Figure 7). In contrast, the four largest banking groups experienced a net outflow of accounts in 2015.
12. Nevertheless, the four largest banking groups continued to enjoy a combined share of around 75% of BCA flow in 2015 and the high rates of net account opening enjoyed by the smaller banks have not translated into a significant change in their shares of the stock of active BCAs.

Figure 6: GB shares of BCA flow



GB – All SMES: new BCAs opened in year 2011 to 2015

	%				
<i>Banking group</i>	<i>20 11</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
Barclays	[20–30]	[20–30]	[20–30]	[20–30]	[20–30]
Clydesdale	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[20–30]	[20–30]	[10–20]	[10–20]	[10–20]
LBG	[20–30]	[20–30]	[20–30]	[10–20]	[10–20]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[10–20]	[10–20]	[20–30]	[20–30]
Santander	N/A	[5–10]	[5–10]	[10–20]	[10–20]
TSB	N/A	N/A	[0–5]	[0–5]	[0–5]

Source: CMA analysis based on banks' response to data request.

Note: Data not available for Santander in 2011.

Figure 7: GB BCA net account opening in 2015



Source: CMA calculations using data submitted by banks.

13. A summary of the total BCA market in NI is presented in Table 2. There were approximately 193,000 BCA accounts in 2015, of which around 88% were active. The total size of the market has remained unchanged since 2012 with account opening (including both switchers and start-ups) and closing occurring at a broadly similar rate of around 9% on average each year. This is slightly lower than the corresponding average rate of churn in the GB market (12%).

Table 2: Summary of NI BCA market

	2012	2013	2014	2015
Total accounts (000s)	189	190	190	193
Active accounts (%)	n/a	86%	85%	88%
Accounts opened (000s)	16	17	16	21
Accounts closed (000s)	17	16	17	19
Net account opening (%)	0%	1%	0%	0%

Source: CMA calculations based on data submitted by the banks.

Note: Active accounts data not available for Danske in 2012.

14. Figure 8 and Figure 9, respectively, set out the volume of total accounts in NI by banking group, at an aggregate level and segmented by size of SME. The proportion of total active BCAs accounted for by SMEs with annual turnover below £2 million (around 85%) is slightly lower than observed in the rest of GB (93%).

Figure 8: NI BCA volumes – all SMEs



Source: CMA analysis based on banks' response to data request.



Figure 9: NI BCA volumes – by size of SME



Source: CMA analysis based on banks' response to data request.



15. As shown in Figure 10 below, shares in the NI market for BCAs have remained broadly stable since 2012, when measured by the total number of accounts, the number of active accounts or the number of unique BCA customers. The combined market share of the four largest active BCA providers in 2015 (RBSG, Danske, BoI and AIB) was around 86%, a reduction of two percentage point since 2013, and the corresponding HHIs were 2,108 in 2013 and 2,015 in 2015.

Figure 10: NI BCA market shares



NI – All SMES: BCAs at year end 2011 to 2015

	%				
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
AIBG	[10–20]	[10–20]	[10–20]	[10–20]	[10–20]
Barclays	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Bol	[10–20]	[10–20]	[10–20]	[10–20]	[10–20]
Danske	[20–30]	[20–30]	[20–30]	[20–30]	[20–30]
HSBCG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[30–40]	[30–40]	[20–30]	[20–30]	[20–30]
Santander	N/A	[5–10]	[5–10]	[5–10]	[5–10]

NI – All SMES: Active BCAs at year end 2011 to 2015

	%				
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
AIBG	[20–30]	[20–30]	[10–20]	[10–20]	[10–20]
Barclays	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Bol	[20–30]	[20–30]	[10–20]	[10–20]	[20–30]
Danske	N/A	N/A	[20–30]	[20–30]	[20–30]
HSBCG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[40–50]	[40–50]	[20–30]	[20–30]	[20–30]
Santander	N/A	[10–20]	[5–10]	[10–20]	[10–20]

NI – All SMES: Unique BCA customers at year end 2011 to 2015

	%			
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
AIBG	[20–30]	[10–20]	[10–20]	[10–20]
Barclays	[0–5]	[0–5]	[0–5]	[0–5]
Bol	[10–20]	[10–20]	[10–20]	[10–20]
Danske	[20–30]	[20–30]	[20–30]	[20–30]
HSBCG	[0–5]	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[30–40]	[20–30]	[20–30]	[20–30]
Santander	N/A	[5–10]	[10–20]	[10–20]

Source: CMA analysis based on banks' response to data request

Notes:

1. Data not available for Santander in 2011.
2. Active accounts data not available for Danske before 2013.

16. We observe lower levels of concentration in the flow of new BCAs in NI (see Figure 11 below). For example, the HHI of the share of new BCAs was 1,856 in 2015, compared to 1,999 for the total stock of BCAs. Smaller providers such as [✂], received amongst the greatest volume of net account openings in 2015 (see Figure 12). Three of the four largest active BCA providers ([✂]) experienced a net inflow of accounts in 2015.

Figure 11: NI shares of BCA flow



NI – All SMES: new BCAs opened in year

	%			
<i>Banking group</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
AIBG	[10–20]	[10–20]	[10–20]	[10–20]
Barclays	[0–5]	[0–5]	[0–5]	[0–5]
Bol	[20–30]	[20–30]	[20–30]	[20–30]
Danske	[10–20]	[10–20]	[10–20]	[10–20]
HSBCG	[5–10]	[0–5]	[0–5]	[0–5]
LBG	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[10–20]	[10–20]	[20–30]
Santander	[10–20]	[10–20]	[10–20]	[10–20]
Other	[0–5]	[0–5]	[0–5]	[0–5]

Source: CMA calculations based on data submitted by the banks.

17. Hence, the four largest active BCA providers continued to enjoy a combined share of nearly 80% of BCA flow in 2015 and the high rates of net account opening enjoyed by the smaller banks have not translated into a significant change in their shares of the stock of BCAs.

Figure 12: NI BCA net account opening in 2015



Source: CMA calculations using data submitted by banks.

SME lending products

18. SME lending products include GPBL and commercial mortgages, credit cards, asset finance, invoice finance and alternative lending platforms. As discussed in Sections 4 and 9, certain types of business loan are offered by a wider range of providers than others. We only have full data from the largest banks and certain smaller banks, and we consider separately the different SME lending products, commenting as appropriate on the presence of other providers.⁵

General purpose business loans (including commercial mortgages)

19. Using data submitted by the banks we estimate that the total stock of outstanding GPBL in the UK was around £96 billion in 2015, consisting of approximately 580,000 loans (see Table 3).

⁵ Data for these products (except for credit cards) is not available separately for the GB and NI geographic markets, and we have therefore estimated market structure indicators at a UK level.

20. A total of £21 billion worth of GPBL (including commercial mortgages, but excluding residential property loans)⁶ were granted in the UK in 2015, with an average loan value of approximately £240,000.⁷ The number of new loans granted per year has fallen since 2011 by approximately 16.5%. The same is true for the value of loans granted, which has returned to its 2012-2013 level of around £20 billion a year in 2015, following a strong increase to £26 billion a year recorded in 2014.
21. For 2015, we have requested banks to report data on the volume and value of outstanding and new GPBLs separately for GB and NI. Table 3 summarizes this information.
22. Tables 4 and 5 set out the volume and value of outstanding and new GPBLs in GB and NI respectively, segmented by size of loan. Loans higher than £50k account for the majority of the stock and the flow of loans in 2015 in both markets.

Table 3: Summary of UK GPBL market, 2015

	<i>UK</i>	<i>GB</i>	<i>NI</i>
No. of loans at year end	576,327	549,821	26,505
Value of loans at year end (£m)	95,944	90,455	5,489
No. of loans granted in year	87,744	81,533	6,191
Value of loans granted in year (£m)	20,839	20,014	824
Average value of loan granted (£k)	238	245	133

Source: CMA calculations using data submitted by banks.

Note: Figures include commercial mortgage lending and exclude residential property lending.

Table 4: Summary of GB GPBL market, 2015 – by size of loan

	<i>£0-£25k</i>	<i>£25k-£50k</i>	<i>>£50k</i>
No. of loans at year end	160,651	73,595	315,575
Value of loans at year end (£m)	1,322	1,856	87,115
No. of loans granted in year	28,425	9,749	43,379
Value of loans granted in year (£m)	318	327	19,360
Average value of loan granted (£k)	11	34	446

Source: CMA calculations using data submitted by banks.

Note: Figures include commercial mortgage lending and exclude residential property lending.

⁶ Residential property loans are loans to SME customers for the purposes of residential buy-to-let, residential property development or investment in finished residential properties. Due to differences between banks in how these loans are reported, and in particular how they are classified as either personal or SME lending, we have asked all banks to exclude such loans from the submitted business lending accounts and value data. On the basis of the data provided by the banks, we estimate such loans to account for approximately 3% of business loan volumes and 8% of business loan values.

⁷ CMA analysis of data submitted by the banks.

Table 5: Summary of NI GPBL market, 2015 – by size of loan

	£0-£25k	£25k-£50k	>£50k
No. of loans at year end	7,319	3,772	15,415
Value of loans at year end (£m)	62	107	5,319
No. of loans granted in year	3,375	840	1,976
Value of loans granted in year (£m)	28	31	765
Average value of loan granted (£k)	8	37	387

Source: CMA calculations using data submitted by banks.

Note: Figures include commercial mortgage lending and exclude residential property lending.

Table 6: Summary of UK GPBL market

	2011	2012	2013	2014
No. of loans at year end	647,975	631,394	610,061	579,785
Value of loans at year end (£m)	99,339	93,793	94,636	92,333
No. of loans granted in year	104,724	93,420	85,750	82,643
of which % to SMEs <£2m	83%	83%	81%	77%
Value of loans granted in year (£m)	23,655	20,603	20,596	25,321
of which % to SMEs <£2m	49%	51%	51%	46%
Average value of loan granted (£k)	226	221	240	306

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.

2. Data not available for Santander until 2012.

3. Loan data excluding residential property lending not available for LBG and AIB (up to 2014). Lending volumes for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks. LBG has submitted its own estimates to identify residential property based on different assumptions. Respective market shares calculated using either methodology are broadly comparable.

23. Table 6 presents historical data for the UK wide SME lending market (on the basis of GPBLs). Smaller SMEs (ie with annual turnover less than £2 million) accounted for around three-quarters of the number of new loans granted in the UK in 2014, but less than half the value of these loans. The share of smaller SMEs in both new numbers and new loan values has decreased slightly since 2011.
24. Figure 13 sets out the shares of each banking group in the number and value of outstanding UK GPBL. We find that the level of concentration differs depending on whether shares are measured by the volume or value of outstanding loans. Whereas the combined share in 2015 of the four largest banks in the number of outstanding loans was 86%, the equivalent figure using the value of outstanding loans was around 77%. A similar pattern is observed when comparing the HHIs calculated using the share of loan volume (approximately 2,100) and the share of loan value (approximately 1,800). We have focused on market shares by value since a very small loan is not of equal importance to a very large loan.

Figure 13: UK GPBL markets shares of stock



UK – All SMEs: no. of loans at year end

	%				
<i>Banking group</i>	2011	2012	2013	2014	2015
AIBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Aldermore	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Barclays	[10–20]	[10–20]	[10–20]	[10–20]	[10–20]
Bol	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Clydesdale	[5–10]	[0–5]	[0–5]	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Danske	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[10–20]	[10–20]	[10–20]	[10–20]	[10–20]
LBG	[20–30]	[20–30]	[20–30]	[20–30]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[30–40]	[30–40]	[30–40]	[30–40]	[30–40]
Santander	N/A	[0–5]	[0–5]	[0–5]	[0–5]
Shawbrook	N/A	N/A	N/A	N/A	[0–5]
TSB	N/A	N/A	[0–5]	[0–5]	[0–5]

UK – All SMEs: value of loans at year end

	%				
<i>Banking group</i>	2011	2012	2013	2014	2015
AIBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Aldermore	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Barclays	[20–30]	[20–30]	[20–30]	[20–30]	[10–20]
Bol	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Clydesdale	[5–10]	[5–10]	[5–10]	[5–10]	[0–5]
Co-op Bank	[5–10]	[5–10]	[5–10]	[0–5]	[0–5]
Danske	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]	[5–10]
HSBCG	[5–10]	[5–10]	[5–10]	[5–10]	[5–10]
LBG	[10–20]	[10–20]	[10–20]	[20–30]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[30–40]	[30–40]	[20–30]	[20–30]	[20–30]
Santander	N/A	[0–5]	[0–5]	[0–5]	[0–5]
Shawbrook	N/A	N/A	N/A	N/A	[0–5]
TSB	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.
2. Data not available for Santander until 2012.
3. Loan data excluding residential property lending not readily available for LBG and AIB (up to 2014). Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks LBG has submitted its own estimates to identify residential property. Respective market shares calculated using either methodology are broadly in line and hence comparable.

25. Table 7 and Table 8 summarize the volume and value of outstanding GPBLs in GB and NI respectively, by banking group. Similar patterns are also observed in the GB market. The combined share in 2015 of the four largest banks in terms of the number of outstanding loans⁸ was 89% while the respective figure using instead the value of outstanding loans was 81%. The corresponding HHIs for the GB market were 2,287 and 1,942. However, the NI market doesn't feature such pronounced discrepancies between different

⁸ RBSG, LBG, Barclays and HSBCG.

measures of concentration. The four largest lenders⁹ account for 95% of the volume and 91% of the value of outstanding loans.

Table 7: GB – All SMEs: Outstanding loans at year end, 2015

<i>Banking group</i>	%	
	<i>No. of loans</i>	<i>Value of loans</i>
Aldermore	[0–5]	[0–5]
Barclays	[10–20]	[20–30]
Clydesdale	[0–5]	[0–5]
Co-op Bank	[0–5]	[0–5]
Danske	[0–5]	[0–5]
Handelsbanken	[0–5]	[5–10]
HSBC	[10–20]	[5–10]
LBG	[20–30]	[20–30]
Metro	[0–5]	[0–5]
RBS	[30–40]	[20–30]
Santander	[0–5]	[0–5]
Shawbrook	[0–5]	[0–5]
TSB	[0–5]	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.
2. Loan data excluding residential property lending not readily available for LBG and AIB (up to 2014). Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks LBG has submitted its own estimates to identify residential property. Respective market shares calculated using either methodology are broadly in line and hence comparable.

Table 8: NI – All SMEs: Outstanding loans at year end, 2015

<i>Banking group</i>	%	
	<i>No. of loans</i>	<i>Value of loans</i>
AIB	[20–30]	[20–30]
Barclays	[0–5]	[0–5]
Bol	[10–20]	[40–50]
Clydesdale	[0–5]	[0–5]
Danske	[20–30]	[10–20]
HSBC	[0–5]	[0–5]
LBG	[0–5]	[0–5]
Santander	[0–5]	[0–5]
Ulster	[30–40]	[10–20]

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.
2. Loan data excluding residential property lending not readily available for LBG and AIB (up to 2014). Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks LBG has submitted its own estimates to identify residential property. Respective market shares calculated using either methodology are broadly in line and hence comparable.

26. Lending data segmented by size of SME is not available for all providers, and therefore it is not possible to draw inferences on the absolute levels of concentration in each segment. We can, however, make comparisons of concentration between each. Such comparisons show that the market for business loans to SMEs with turnover less than £2 million is more

⁹ Ulster, Bol, Danske and AIBG.

concentrated than that of business loans for SMEs with annual turnover of greater than or equal to £2 million (see Figure 14).¹⁰

Figure 14: UK GPBL market shares by size of SME in 2014

[✂]

UK GPBL market shares by size of SME in 2014

Banking group	%	
	SMEs < £2m	SMEs ≥ £2m
Barclays	[10–20]	[20–30]
Clydesdale	[0–5]	[10–20]
Co-op Bank	[0–5]	[5–10]
Danske	[0–5]	[0–5]
Handelsbanken	[5–10]	[0–5]
HSBCG	[0–5]	[10–20]
LBG	[30–40]	[10–20]
RBSG	[30–40]	[20–30]
Santander	[0–5]	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.
2. Loan data excluding residential property lending not available for LBG and Clydesdale. Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks.
3. Lending data by size of SME not available for AIB, Aldermore, BoI, Metro and TSB.

27. Figure 15 sets out the share of each banking group in the flow of UK GPBL. We find that the combined share of flow of the four largest lenders is similar whether calculated using the number or value of new loans granted and lies around 75%.¹¹ While smaller banks such as [✂] have experienced very high rates of growth in their share of new loans granted, the absolute changes in share remain very low.
28. While these figures do not include peer-to-peer lending, which is another source of GPBLs, figures from NESTA indicate that the total value of such lending in 2014 was about £1 billion,¹² around 1% of the outstanding GPBLs to SMEs from banks. We acknowledge, however, that peer-to-peer lending is growing rapidly and accounts for a larger share of the flow of new GPBLs (about 3%).

¹⁰ The HHI for the value of lending to SMEs with annual turnover of less than £2 million is around 2,700, compared to 1,680 for SMEs with turnover of greater than £2 million.

¹¹ Note that the group of the four largest lenders in terms of volume of new loans ([✂]) doesn't coincide with the group of the four largest lenders with respect to the value of new loans ([✂]). [✂].

¹² This is based on the estimated total advanced over 2012-14 (the amount advanced before 2012 was very small). The great majority of peer-to-peer lending is to SMEs.

Figure 15: UK GPBL market shares of flow



UK – All SMEs: number of new loans granted

	%				
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
AIBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Aldermore	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Barclays	[20–30]	[20–30]	[20–30]	[20–30]	[10–20]
Bol	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Clydesdale	[5–10]	[0–5]	[0–5]	[0–5]	[0–5]
Co-op	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Danske	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
HSBCG	[10–20]	[20–30]	[10–20]	[10–20]	[10–20]
LBG	[30–40]	[30–40]	[30–40]	[30–40]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[5–10]	[5–10]	[5–10]	[10–20]	[10–20]
Santander	N/A	[0–5]	[0–5]	[0–5]	[0–5]
Shawbrook	N/A	N/A	N/A	N/A	[5–10]
TSB	N/A	N/A	[0–5]	[0–5]	[0–5]

UK – All SMEs: value of new loans granted

	%				
<i>Banking group</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>
AIBG	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Aldermore	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Barclays	[20–30]	[20–30]	[20–30]	[30–40]	[20–30]
Bol	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Clydesdale	[10–20]	[10–20]	[5–10]	[5–10]	[5–10]
Co-op	[10–20]	[5–10]	[5–10]	[0–5]	[0–5]
Danske	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
Handelsbanken	[0–5]	[0–5]	[0–5]	[5–10]	[10–20]
HSBCG	[10–20]	[10–20]	[5–10]	[5–10]	[10–20]
LBG	[10–20]	[10–20]	[20–30]	[10–20]	[20–30]
Metro	[0–5]	[0–5]	[0–5]	[0–5]	[0–5]
RBSG	[20–30]	[20–30]	[20–30]	[20–30]	[5–10]
Santander	N/A	[0–5]	[0–5]	[0–5]	[0–5]
Shawbrook	N/A	N/A	N/A	N/A	[0–5]
TSB	N/A	N/A	[0–5]	[0–5]	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Figures include commercial mortgage lending and exclude residential property lending.
2. Data not available for Santander until 2012.
3. Loan data excluding residential property lending not available for LBG, Clydesdale, AIB and Bank of Ireland. Shares for these banking groups have been calculated by applying the industry average proportion of residential property lending (in total lending) to the total lending data submitted by these banks.

Invoice finance

29. Data from the Asset Based Finance Association (ABFA) show that there were approximately 42,000 SMEs with invoice finance agreements in place at the end of the first quarter of 2015, with total outstanding balances of around £9 billion.¹³ Data from the same source shows that larger SMEs account for the majority of invoice finance lending. More specifically, SMEs

¹³ These figures may include a limited number of SMEs holding import and/or export factoring, stock finance and asset-based lending facilities.

with annual turnover less than £1 million accounted for around 50% of SME invoice finance customers at the end of Q1 2015, but less than 15% of outstanding balances. This is consistent with accounts and lending data submitted by banks which show that SMEs with annual turnover less than £2 million accounted for around 45% of SME asset finance customers at the end of 2014, but only 15% of the value of outstanding balances.

30. Figure 16 sets out the market shares of UK invoice finance loan values based on the data submitted by the banks. We estimate similar levels of concentration in invoice finance to those observed for GPBL. The combined share of UK outstanding balances of the four largest providers was approximately 80% at the end of 2014 and the corresponding HHI was around 2,000.
31. We are aware, however, of invoice finance providers that are not captured in the data used to estimate these concentration measures. The ABFA membership list includes over 30 providers for which customer and balance volumes were not available to the CMA.¹⁴ We therefore consider the resultant estimates to provide upper-bound estimates of the level of concentration in the invoice finance market.
32. Furthermore, the ABFA figures do not include invoice trading on alternative finance platforms. Figures from NESTA indicate that the total value of invoice trading in 2014 was about £0.4 billion,¹⁵ around 5% of the value of conventional invoice finance. Like other types of alternative finance, invoice trading is growing rapidly.

¹⁴ For example, see the [membership list](#) on the ABFA website.

¹⁵ This is based on the estimated total advanced over 2012 to 2014 (the amount advanced before 2012 was very small). The great majority of invoice trading is in relation to SMEs.

Figure 16: UK invoice finance market shares in 2014



UK – All SMES

<i>Banking group</i>	<i>%</i>
AIBG	[0–5]
Aldermore	[0–5]
Barclays	[10–20]
Bol	[0–5]
Close Brothers	[0–5]
Clydesdale	[0–5]
Danske	[0–5]
Handelsbanken	[0–5]
Hitachi	[0–5]
HSBCG	[10–20]
LBG	[20–30]
RBSG	[30–40]
Santander	[0–5]
Shawbrook	[0–5]
Skipton	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Proxy data (loan book values) for Investec, Hitachi and Skipton sourced from respective company accounts and proxy value supplied by Close Brothers. Figures may include loans to SMEs with turnover >£25m.
2. Data not available for Metro.

Asset finance

33. Figures from the Finance & Leasing Association show that over £25 billion worth of new asset finance loans (excluding high value items)¹⁶ were granted in the 12 months to June 2015. These figures represent annual growth in asset finance lending of around 15%. This is consistent with data on the value new asset finance lending submitted by the BCA providers, which shows a similar rate of growth for 2014.
34. On the basis of the data submitted by the banks, we calculate that the majority of asset finance lending by BCA providers is to larger SMEs, and SMEs with annual turnover below £2 million account for less than 15% of the value of new loans in 2014.
35. Figure 17 sets out our estimates of the shares in the value of asset financing at the end of 2014. We find evidence that the provision of asset finance lending is less concentrated than that of GPBL. For example, the four largest asset finance providers had a combined share of around 65% of outstanding balances at the end of 2014 and the HHI was 1,550 (compared to around 1,800 for general purpose business lending).

¹⁶ Data on the value of lending specifically to SMEs is not available. We have therefore sought to proxy this using asset finance lending excluding high value items.

Figure 17: UK asset finance market shares in 2014



UK – All SMES

<i>Banking group</i>	<i>%</i>
AIBG	[0–5]
Aldermore	[10–20]
Barclays	[10–20]
Bol	[0–5]
Close Brothers	[0–5]
Clydesdale	[0–5]
Danske	[0–5]
Hitachi	[5–10]
HSBCG	[5–10]
Investec	[5–10]
LBG	[10–20]
RBSG	[30–40]
Shawbrook	[5–10]
Santander	[0–5]

Source: CMA calculations using data submitted by banks.

Notes:

1. Proxy data (loan book values) used for Investec and Hitachi sourced from respective company accounts and proxy value supplied by Close Brothers. Figures may include loans to SMEs with turnover >£25m.
2. Data not available for Metro.

Business credit cards

36. Data from the Charterhouse BS, shows that there were over 1.7 million business credit card or charge card accounts held by SMEs in GB in 2014. Smaller SMEs account for the majority of these customers with over 90% of such accounts held by SMEs with an annual turnover of less than £2 million.
37. Figure 18 sets out the share of each provider in the number of GB business credit and charge card accounts in 2014. Using data from earlier Charterhouse BBS surveys we find that estimated levels of concentration have remained constant since 2011 with HHIs of around 2,000 and the combined market share of the four largest providers equal to 87%.

Figure18: GB business credit card market shares in 2014



GB – All SMEs

<i>Banking group</i>	<i>%</i>
Barclays	[20–30]
Clydesdale	[0–5]
Co-op Bank	[0–5]
Handelsbanken	[0–5]
HSBCG	[20–30]
LBG	[10–20]
RBSG	[20–30]
Santander	[0–5]
TSB	[0–5]
Other	[5–10]

Source: CMA calculations using Charterhouse BBS.

38. Data from the Charterhouse NI BBS shows that there were approximately 44,000 business credit or charge card accounts held by NI SMEs in 2015. Smaller SMEs account for the majority of these customers, and data submitted by the banks shows that over 95% of credit card accounts in 2014 were held by SMEs with annual turnover less than £2 million.
39. Figure 19 plots the shares of each provider in the number of credit card accounts held by NI SMEs in 2015, using the Charterhouse Northern BBS. This data suggests lower levels of concentration than observed in the provision credit cards to GB SME customers. The combined market share of the four largest banking groups was around 75% in 2015, and the HHI was around 1,700.

Figure 1: NI business credit market shares in 2015

[✂]

NI – All SMEs

<i>Banking group</i>	<i>%</i>
AIBG	[10–20]
Barclays	[0–5]
Bol	[10–20]
Co-op Bank	[0–5]
Danske	[20–30]
HSBCG	[0–5]
LBG	[0–5]
RBSG	[20–30]
Santander	[5–10]
Other	[5–10]

Source: CMA calculations using Charterhouse NI BBS.

Business deposit accounts

40. Data on deposit accounts and values submitted by banks, shows that approximately 1.7 million bank business deposit accounts were held with UK BCA providers at the end of 2014. These accounts contained a total of £82 billion worth of deposits. The total number of accounts held by BCA providers has remained broadly constant since 2012, the value of deposits has risen by around 15%. Smaller SMEs account for nearly 90% of these accounts but only 50% of the value of funds deposited.¹⁷
41. We note, however, that there are a number of participants in the business deposit account market that are not also BCA providers. Accounts and deposit values held with such providers will not be captured in our market share estimates.

¹⁷ Equivalent data on a GB and NI basis is not available.

42. Figure 20 set out our estimates of market share for the sub-set of business deposit accounts held with BCA providers. We find that the combined share of the four largest providers of the value of UK deposits was approximately 85% in 2014, with a corresponding HHI of around 2,100. However, given the exclusion of a number of providers, we recognise that actual concentration figures would be lower.

Figure 20: UK business deposit account market shares in 2014

[✂]

UK – All SMEs

<i>Banking group</i>	<i>%</i>
AIBG	[0–5]
Aldermore	[0–5]
Barclays	[30–40]
Bol	[0–5]
Clydesdale	[0–5]
Co-op Bank	[0–5]
Danske	[0–5]
Handelsbanken	[0–5]
HSBCG	[10–20]
LBG	[10–20]
Metro	[0–5]
RBSG	[20–30]
Santander	[5–10]
TSB	[0–5]

Source: CMA calculations using data submitted by banks.

Appendix 7.2: SME revenues

Overview

1. This appendix sets out the results of our analysis of net revenues earned from SME banking products, including:
 - An analysis of aggregate net revenue per active BCA, segmented by size of SME customer (including comparisons across banking groups).
 - Comparisons of net revenue per active BCA across account types.
 - An analysis of aggregate revenue as a proportion of balances for SME lending products (including comparisons across banking groups).
 - An analysis of net revenue proportion of balances for business deposit accounts (including comparisons across banking groups).
2. In undertaking this analysis we have sought to gain an understanding of the primary sources of net revenue from SME banking products (and how these have evolved over time). We have also undertaken comparisons between banking groups of net revenue per customer to assess the degree of variability between banking groups.
3. The analysis in the appendix relates to banks' UK revenue, and includes results from banks operating across the UK (eg RBSG and Santander) as well as from banks whose UK operations are primarily in GB (eg Barclays, HSBCG and LBG), and banks whose UK operations are primarily in NI (AIBG, BoI and Danske). As such we consider the results are broadly applicable to both of the geographic markets we identified (GB and NI).

Analysis of BCA revenue

Summary of approach

4. Using data submitted by the banks in response to our data request¹ we have calculated net revenue from BCAs as:
 - (a) receipts from fees and interest charged on overdrafts;

¹ A data request was sent to Barclays, Clydesdale, HSBC, LBG, Santander, TSB, RBS (RBS and NatWest branded accounts), Ulster (RBSG submitted a separate return for Ulster), AIBG, BoI and Danske. As part of our targeted and proportionate approach to evidence gathering, smaller banks were sent a LITE version of the market questionnaire, which did not include revenue data.

- (b) plus receipts from other charges and sources of BCA revenue including interchange fees;
 - (c) less any interest paid to customers on credit balances together with any other payments made to customers (eg cashback); and
 - (d) plus the value that banks obtain from net credit balances (ie the value of funds from credit balances less the cost of funding overdrafts).
5. We have normalised net revenue by the number of active BCAs held so as to obtain net revenue numbers that are comparable between banks and overtime (as all else being equal, a bank with many customers will have greater revenue than one with few customers). We use active accounts as the basic unit of analysis.²
 6. To assign a meaningful interpretation to the net revenue comparisons across banks we require that differences in net revenue per account are reflective of price rather than cost differences. This will be the case if differences between banks in average customer characteristics per account do not impact materially on operating costs.
 7. We believe that net revenue per account is more likely to be reflective of price (rather than cost differences) for PCAs than BCAs. In particular, because the cost per account is more likely to be affected by factors such as the amount of advice received (eg type of relationship manager) and whether SMEs make use of overdrafts.
 8. We have attempted to mitigate these points by making separate comparisons of BCA net revenue for SMEs with turnover above and below £2 million, and by making separate comparisons for transactional net revenue per account and overdraft net revenue as a percentage of debit balances.

Aggregate revenue per active BCA

9. Table 1 shows a breakdown of revenue aggregated across the banks for which we have collected revenue and balance data. These results reflect a weighted average across BCAs. Trends over time will therefore reflect both general trends affecting all accounts as well as changes in the composition of accounts.

² Defined as an account that has had at least one customer-generated payment or transfer (including standing order and direct debit, but excluding charges and interest on the account) coming into, or leaving, the account in the last 12 months.

Table 1: Analysis of revenue (£ per active account*, 2014 prices)

Type of revenue	2011	2012	2013	2014	2014 %	Decomposition of Δ net revenue since 2012 % †
Transaction charges	138	143	124	112	15	27
Arranged overdraft	194	219	171	156	21	57
Unarranged overdraft & unpaid item fees	48	54	42	36	5	17
Interchange fees (debit card)	0	4	5	5	1	0
Monthly account fees	26	30	28	32	4	0
Other receipts (net) ‡	46	83	75	67	9	15
Total receipts from charges & interest	453	535	444	408	55	115
Interest payments to customers	-22	-23	-24	-25	-3	2
Other payments to customers	0	0	0	-3	0	3
Net value of funds §	434	334	398	356	48	-19
Net revenue	865	845	818	736	100	100

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

*Aggregate revenue is divided by average of number of active accounts at start and end of year (except for Danske data in 2013, when only number of accounts at end of year is available).

†Decomposition of change over time calculated relative to 2012, due to sensitivity of results to absence of Clydesdale from sample in 2011.

‡Other receipts consists of revenue from charges for failing to meet account criteria, revenue from occasional charges relating to cheques, revenue from occasional charges relating to payments, revenue from account management charges, other revenue from account holders and other revenue which is not from account holders.

§Banks' own assessment of value of funds from BCA credit balances less cost of funding BCA debit balances (except for Danske, where the weighted average for the other banks has been used).

Note: Excludes AIB, HSBCG and RBSG, for which a full revenue breakdown is not available. Data is not available for Clydesdale and LBG in 2011, and for Danske and Santander for 2011 and 2012.

10. Inspection of the results shows that aggregate net revenue has declined over time and the main factors behind this are:
 - a decline in revenue associated with the arrangement, renewal, extension and day-to-day use of arranged overdrafts and buffers (revenue from unarranged overdraft fees has also declined but to a lesser extent);
 - decline in revenue from transactions charges;
 - decline in revenue from other receipts (primarily as a result of a reduction in revenue from occasional charges relating to payments); and
 - decline in net value of funds on credit balances.
11. The most important sources of BCA revenue in 2014 were arranged overdraft fees (accounting for around a fifth of net revenue), transaction charges (around 15%) and the value of funds from net credit balances (accounting for about half of net revenue, or 45% if interest paid to customers is subtracted).
12. We recognise, however, that there are a number of potential issues in interpreting the data in Table 1:
 - (a) The net value of funds is an important source of BCA revenue but different banks have different transfer prices. This point is discussed further below (see paragraphs 13 to 15).

- (b) There may be differences between banks in how they have defined revenue and how/when they recognise revenue. We have also noted the overall quality of response differs between banks.
- (c) We are unable to control for the volume of transactions carried out which may impact the interpretation of changes in revenues from transaction charges over time (for example if trends over time are partly driven by an overall reduction/increase in SME activity).
- (d) Limited data is available for 2011 and 2012 (see notes to Table 1).

Value of BCA funds

13. We asked the banks to provide data on annual average credit balances and the value of funds from these balances, together with data on debit balances and the cost of funding these balances. We used this data to estimate the average transfer price for credit and debit balances, and the net value of BCA funds (ie the value of funds from credit balances less the cost of funding debit balances divided by the aggregate net credit balance).
14. Table 2 summarises this data. It also shows the average net balance per main account which is also a driver of the net value of funds in Table 1.
15. The average net balance per account varied widely between banks ranging from approximately £5,000 to £24,000 in 2014. The relative size of this range, in comparison to average net balance per PCA is likely, in part, to be reflective of greater heterogeneity between BCAs versus PCAs as the basic unit of analysis. For this reason it is difficult to draw strong inference from the difference in average net balance between banks, particularly where we suspect high or low values result from problems with the underlying data. However, at an aggregate level we find that average net balance per account has increased over time. This is accompanied by a small increase in interest payments to customers per account.

Table 2: Value and cost of funds applied to credit and debit balances of BCAs

By bank for 2014	Value of funds (credit) %	Cost of funds (debit) %	Net value of funds %	Average net balance per active account, £	Number of active accounts
AIB	[X]	[X]	[X]	[X]	[X]
Barclays	[X]	[X]	[X]	[X]	[X]
Bol	[X]	[X]	[X]	[X]	[X]
Clydesdale	[X]	[X]	[X]	[X]	[X]
Danske	[X]	[X]	[X]	[X]	[X]
HSBC	[X]	[X]	[X]	[X]	[X]
LBG	[X]	[X]	[X]	[X]	[X]
Santander	[X]	[X]	[X]	[X]	[X]
TSB	[X]	[X]	[X]	[X]	[X]
Ulster	[X]	[X]	[X]	[X]	[X]
<i>By year*</i>					
2011†			3.74		
2012‡			2.50		
2013			2.73	12,509	3,665,556
2014			2.16	14,795	3,648,750

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

*Weighted average for all banks except Danske, 2014 prices.

†Data not available for Clydesdale and Santander.

‡Data not available for Santander.

Note: The net value of funds is the absolute difference between the value and cost of funds as a percentage of net balances. So, the net value of funds is $(vB - cD)/(B - D)$ where v is value of credit funds (%), B is average credit balance over the year, c is cost of debit funds (%) and D is average debit balance over the year.

Comparisons across banking groups

16. In order to make comparisons between banking groups, we have used a standardised percentage net value of funds for each banking group. This is the weighted average across banks, ie the value shown in the lower panel of Table 2 (eg 2.16% for 2014).³

17. Table 3 shows the comparison for 2014 across banking groups:

Table 3: Analysis of net revenue per active account using standardised net value of funds, 2014

[X]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

18. Table 3 shows that average net revenue for the four largest banks is around £[X] per active account.⁴ [X] and [X] have the lowest net revenue per active account at £[X] and £[X], respectively. [X] have substantially higher

³ HSCG said that the adoption of standardised value of funds had serious limitations since it did not reflect the true economic costs of banks – the value of funds would differ by bank depending on the: institution’s capital strength; balance sheet strategy; and perspectives on the stability of funding. However, we consider differences may also simply reflect different approaches to fund valuation and, even if they do to some extent reflect underlying economic costs, it is not clear that these should be included in a comparison of net revenue.

⁴ Including Ulster but excluding RBS and NatWest branded accounts for which value of funds net average account balance data is not available.

average net revenue, though this may reflect data issues with the comparability of the underlying data.

19. In addition to the points raised in paragraph 12, there are further potential issues in making comparisons in net revenue between the banks:
 - (a) The analysis presented implicitly assumes a common cost per account across banks (such that differences in net revenue per account can be interpreted as pricing differences). However, in practice the quality of the relationship management service offered is expected to differ both across banks and between different types of accounts within a given bank. Where a higher quality relationship management service is offered, differences in net revenue per account may reflect cost rather than pricing differences.
 - (b) It is not possible to directly control for differences in costs due to losses associated with defaults on overdraft debt. This may be problematic where the average characteristics of SMEs, with respect to overdraft debt and creditworthiness differ between banks (and over time).
20. To account for point (b) above, Table 4 contains net revenue from (i) charges and interest on overdrafts, and (ii) all other receipts normalised separately, as a percentage of average debit balances and by number of active BCAs. In doing so, the intention is to control for differences in the profile of SMEs between banks in terms of the size of debit balances held (and therefore also the losses associated with defaults on overdraft debt).

Table 4: Comparison of normalised revenues by source, 2014

[✂]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

[✂]

21. As plotted in Figure 1 below, banks do not appear to consistently earn higher (or lower) net revenues across both sources of income. For example, whilst [✂] and [✂] received the lowest net revenue per active BCA from total receipts excluding those associated with overdrafts, they also earned the highest revenues on charges and interest from overdrafts (as a percentage of average debit balances).

Figure 1: Comparison of normalised revenues by source, 2014

[✂]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

Net revenue by size of SME

22. In addressing point (a) in paragraph 19 we first consider aggregate net revenue (across all banks) split by SMEs with annual turnover less than and greater than £2 million. As shown in Table 5, there are differences in the composition of net revenue per account which may, in part, reflect differences in the characteristics of SMEs in each group.
23. For example, whereas unarranged overdraft and monthly account fees account for a comparatively larger proportion of net revenue from BCAs held by SMEs with turnover below £2 million (as compared to SMEs with annual turnover above £2 million), other receipts and interest payments to customers account for a higher proportion of net revenue from SMEs with turnover above £2 million.

Table 5: Comparison of net revenue (excluding value of funds) by size of SME, 2014

Bank	SMEs with annual turnover <£2m		SMEs with annual turnover >£2m	
	£ per active account	% of net revenue per account	£ per active account	% of net revenue per account
Transaction charges	98	35%	726	35%
Arranged overdraft	93	33%	832	41%
Unarranged overdraft & unpaid item fees	35	13%	83	4%
Interchange fees (debit card)	4	1%	3	0%
Monthly account fees	37	13%	49	2%
Other receipts (net)	22	8%	599	29%
Total receipts from charges & interest	290	102%	2,292	112%
Interest payments to customers	-7	-2%	-243	-12%
Other payments to customers	-2	-1%	-9	0%
Net revenue excluding value of funds	283	100%	2,049	100%
(% average annual turnover)	0.16%	-	0.03%	-

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

Notes: Excludes HSBC for which a full revenue breakdown is not available. Breakdown by SME size not available for AIB, Danske and TSB.

24. Total net revenue per account is substantially greater for BCAs held by SMEs with turnover above £2 million. This may reflect, among other things:
- the more complex needs of larger SMEs, including the costs of providing a greater depth of relationship management service to these account holders (which are likely to be reflected in fees and charges);
 - the greater volume of transactions carried out by larger SMEs; and
 - the higher credit and debit balances held per account by larger SMEs.
25. To account for differences across banks in the size profile of SMEs served (and the consequent impact on cost and revenue per account), Table 6 and Table 7 contain a comparison of normalised net revenue between banks for

SMEs with annual turnover less than, and greater than, £2 million respectively.⁵

26. For BCAs held by SMEs with annual turnover less than £2 million, net revenue per account is around £[redacted], with the exception of [redacted] at £[redacted] and [redacted] at £[redacted]. However, when considering total net receipts from interest and charges (ie abstracting from the value of funds), [redacted] earns the lowest amount per account (£[redacted]), compared to around £[redacted] for largest four banking groups. [redacted] and [redacted] for which we have data appear to earn higher total net receipts from interest and charges (over £[redacted] per active account) than the other banks for which we have data.
27. Net revenue per active account appears much more variable across banks for SMEs with annual turnover above £2 million (see Table 7), and this may reflect differences in customer characteristics associated with the comparatively smaller number of accounts over which average revenue is being calculated.
28. The total net receipts from interest and charges component of revenue (ie excluding the net value of funds) shows less variation across banks than net revenue, with the largest four banking groups earning the lowest amount per account (around £[redacted] to £[redacted], see Table 7). Total net receipts from interest and charges per account is slightly larger for [redacted] (around £[redacted]) driven by relatively higher revenue earned from transaction charges. Total net receipts per account for [redacted] appears to be substantially higher and may definitional differences in the underlying data.

Table 6: SMEs with annual turnover <£2 million – analysis of net revenue per active account using standardised net value of funds, 2014

[redacted]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

[redacted]

Table 7: SMEs with annual turnover >£2 million – analysis of net revenue per active account using standardised net value of funds, 2014

[redacted]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

[redacted]

⁵ We note however that because some banks were unable to provide a breakdown by SME size (AIB, Danske and TSB) the sample upon which to make comparisons is smaller.

SME lending products

29. In this section we present the results of our analysis of revenue from other SME lending products. A number of issues arise in interpreting this analysis which, due to the nature of products involved, are likely to pose more serious limitations than for the equivalent analyses of PCA and BCA revenues.

General purpose business loans (including commercial mortgages)

30. Table 8 shows a breakdown of revenue aggregated across the banks. We have considered net revenue as comprising the following sources:

- interest received from SMEs;
- arrangement fee revenue; and
- any other fee revenue received from SMEs.

Table 8: Analysis of GPBL revenue (% average loan balance)

Type of revenue	2011	2012	2013	2014	2014%
Interest received from SMEs	2.55	2.62	2.70	2.57	92
Arrangement fee revenue received from SMEs	0.10	0.10	0.10	0.10	4
Other revenue (including fee received from SMEs)	0.13	0.12	0.12	0.11	4
Total revenue from interest and charges	2.78	2.84	2.92	2.78	100

Source: CMA calculations based on data submitted by banks in response to aggregate data request.
Note: Revenue data for Santander not available in 2011 and 2012.

31. We find that revenue from interest and charges as a percentage of average loan balance has largely remained unchanged over time reflecting similar trends for its components, ie interest received from SMEs and other fee revenue received from SMEs.

32. Interest from SMEs remains the most important source of revenue in 2014 (accounting for just over 90% of net revenue).

33. We note however that there are potential issues in interpreting the data in Table 8:

- There may be differences between banks in how they have defined revenue and how and/or when they recognise revenue. We have also noted differences in the overall quality of the data submitted by banks.
- We are unable to account for loan impairments and changes in the quality of banks' loan books over time, which may impact the interpretation of trends in revenues.

- Limited data is available for 2011 and 2012 (see note to Table 8).

Comparison of normalised GPBL revenue across banking groups

34. Table 9 displays the comparison of GPBL revenue from interest and charges (as a percentage of annual average loan balance) for 2014 across banking groups.

Table 9: Analysis of revenue for GPBL (% annual average loan balance) in 2014

[✂]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

[✂]

35. The data in Table 9 suggests significant variation between banks in net revenue as a percentage of annual average loan balance, which ranges from 1.46% to 4.39%.
36. There does not appear to be a consistent pattern between market share and normalised revenue, with the largest revenues being earned by a mixture of both large and small banks.⁶
37. However, as noted in paragraph 33, it is not possible to control for differences in the quality of loan books between banks or directly account for the costs of loan defaults. Differences in GPBL revenue between banks may therefore reflect differences in the risk profile of loan customers and any subsequent impairments.

Other SME lending products

38. Table 10 and Table 11 show a breakdown of revenue aggregated across the banks for asset and invoice finance products, respectively. We have considered revenue as comprising the following:
- Interest received from SMEs.
 - Arrangement fee revenue.
 - Any other fee revenue received from SMEs.
39. As with our analysis of GPBL revenue, we have not been able to subtract the cost of funds from the revenues earned from interest and other fees.

⁶ For example the five highest revenues are earned by [✂] respectively.

Table 10: Analysis of asset finance revenue (% average loan balance)

<i>Type of revenue</i>	%				
	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2014</i>
Interest received from SMEs	3.46	4.08	4.37	4.53	89
Arrangement fee revenue received from SMEs	0.22	0.24	0.22	0.20	4
Other revenue (including fee received from SMEs)	0.69	0.52	0.40	0.34	7
Total revenue from interest and charges	4.38	4.84	4.99	5.07	100

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

Note: Revenue data not available for Santander in 2011 and 2012, and Lloyds for 2011 to 2014. Revenues for Clydesdale and Ulster not included due to problems with the underlying data.

Table 11: Analysis of invoice finance revenue (% average loan balance)

<i>Type of revenue</i>	%				
	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2014</i>
Interest received from SMEs	2.98	2.92	2.89	2.77	30
Arrangement fee revenue received from SMEs	0.21	0.19	0.17	0.17	2
Other revenue (including fee received from SMEs)	6.90	6.62	6.48	6.40	68
Total revenue from interest and charges	10.09	9.74	9.55	9.34	100

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

Note: Revenue data not available for Santander in 2011 and 2012.

40. The results in Table 10 and Table 11 reflect a weighted average across loans. Trends over time will reflect both general trends affecting all loans as well as changes in the composition of banks' loan books.
41. For asset finance loans, the following points emerge from the table:
- Revenue as a percentage of average loan balance has increased over time. The main factor behind this is an increase in interest received from SMEs.
 - Interest from SMEs remains the most important source of revenue in 2014 (accounting for just under 90% of revenue). The share of revenue accounted for by arrangement and other fees has decreased from around 20% in 2011 to around 10% in 2014.
42. For invoice finance products the following points emerge from the table:
- Revenue as a percentage of average loan balance has decreased over time. The main factors behind this are a decline in other fee revenue and a decline in interest received from SMEs.
 - Non-interest revenue remains the most important source of invoice revenue in 2014 (accounting for around 70%).
43. The same potential issues in interpreting the GPBL net revenue data (as referred to in paragraph 33 also hold for the asset finance analysis.

Comparison of normalised asset and invoice finance revenue across banking groups

44. Table 12 and Table 13 show the comparison of revenue in 2014 across banking groups, for asset and invoice finance loans, respectively.
45. Similar to GPBLs there is significant variation in revenue between banks (ranging from 2.98% to 7.81% of annual average balances for asset finance and 2.4% to 14.5% for invoice finance).
46. There appears to be little evidence of a relationship between market share and revenue, with smaller banks being represented in both the highest and lowest revenue earners within the sample for both types of finance.⁷
47. However, as with GPBL, there are limits to the interpretation of this analysis due to possible differences in the risk profile of customers and impairment costs between banks. In the context of asset and invoice finance, this may be more serious a limitation than for GPBLs due to:
 - the specialisation of banks in certain types of asset (for example plant and construction machinery, marine, catering equipment etc); and
 - differences in the cost of recovering accounts receivables for invoice factoring loans (both in terms of the administrative costs of managing the accounts, and the credit risk of the accounts).⁸
48. To the extent that it is not possible to control for systematic differences in the characteristics of loans and cost of providing these services between banks, caution should be exercised in interpreting differences in revenue as pricing differences.

Table 12: Analysis of revenue for asset finance (% annual average loan balance) in 2014

[REDACTED]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

[REDACTED]

Table 13: Analysis of revenue for invoice finance (% annual average loan balance) in 2014

[REDACTED]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

⁷ While [REDACTED] earned the highest net revenue as a % annual average balances for asset and invoice finance ([REDACTED]% and [REDACTED]%, respectively), [REDACTED] earned the second lowest ([REDACTED]% and [REDACTED]%, respectively).

⁸ For example an accounts receivable with only one creditor may be less costly to manage than one with a number of creditors. Conversely, a less diversified accounts receivable may increase the overall credit risk of the loan.

Business deposit accounts

49. Table 14 shows a breakdown of business deposit account revenue aggregated across the banks. We have considered net revenue as comprising the following:

- fee revenue received from SMEs;
- the value of funds deposited; and
- **less** interest paid to SMEs.

50. The results in Table 14 reflect a weighted average across business deposit accounts. As a proxy to the value of funds held in business deposit accounts we have applied the standardised percentage value of funds for BCA credit balances to the average value of deposit account balances. Trends over time will reflect both general trends affecting all deposit accounts as well as changes in the composition of accounts over time.

Table 14: Analysis of business deposit account revenue (£ per account, 2014 prices)

Type of revenue	2011	2012	2013	2014	% in 2014
Fee revenue received	1	1	1	1	0%
Interest paid to SMEs	-226	-272	-301	-197	-26%
Net revenue from interest and charges	-226	-271	-300	-196	-26%
Standardised value of funds	1,417	944	1,112	942	126%
Net revenue*	1,191	673	812	746	100%

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

*Calculated by applying standardised % value of funds for BCA credit balances to the annual average business deposit account balance of each bank. Data for Danske excluded from calculation of standardised % cost of funding. BCA credit balances data not available for RBS, Co-op Bank, Metro and Handelsbanken.

51. Despite a reduction in interest paid to SMEs since 2011, net revenue per business deposit account in 2014 was approximately two-thirds of its 2011 value. This decline was driven primarily by a decrease in the value of funds. Nevertheless net revenue per account remains positive at around £740.
52. Table 15 shows the comparison of normalised business deposit account revenue for 2014 across banking groups. Revenue per account ranges from £280 ([~~£~~]) to £2,827 ([~~£~~]) and is likely to reflect differences in the average size of SME customers served (and therefore average size of deposit) as well as any differences in interest rates paid to SMEs.
53. To control for these differences, Table 16, provides a comparison between banks of net revenue from interest and charges expressed as a percentage of the average deposit balance. On this basis, interest paid to SMEs varied from 0.07% (for [~~£~~]) to 2.23% (for [~~£~~]). Around half of the banks made interest payments at a rate in excess of the short-term interest rate in 2014 (which

was approximately 0.5%). We do not, however, find evidence of a relationship between the rates of interest paid and market share.

Table 15: Analysis of business deposit account net revenue in 2014 (£ per account, 2014 prices)

[✂]

Source: CMA calculations using data submitted by the banks.

Table 16: Comparison of net business deposit account revenue from charges and interest in 2014 (% average balances)

[✂]

Source: CMA calculations based on data submitted by banks in response to aggregate data request.

Appendix 7.3: Profitability of small and medium-sized enterprise banking customers and products

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Overview

1. In this appendix, we consider the profitability of SME banking across different customers and products, and seek to address the following questions:
 - (a) Are BCAs profitable when considered separately from the banks'¹ wider SME banking offerings?
 - (b) Does the profitability of BCAs vary by customer usage (eg propensity to use overdraft facility) or customer type (eg the size of the business), and if so, how much do different customer groups contribute to the profitability of BCAs?
 - (c) Are the other SME banking products offered by the banks profitable when considered separately from the banks' wider SME banking offerings, and if so, how much do they contribute to the profitability of the banks' wider SME banking offerings?
2. The purpose of this appendix is to understand how and to what extent the banks assess the profitability of SME banking customers and products, and not to conduct a detailed financial analysis of SME banking customer and

¹ We focus our analysis on the SME banking activities of the five largest banks in the UK (ie Barclays; HSBCG; LBG; RBSG and Santander), as together they had a combined market share (by number of active BCAs) of over [X]% in 2015 in GB. Please see Section 7, and Appendix 7.1, Figure 3 for further information.

product profitability. Therefore, our assessment is based on financial data provided by the banks and generally reflects accounting (and not economic) profits.

3. The analysis is based on data submitted by banks in 2014, such that the figures for 2015 and 2016 presented here are forecasts.

Are BCAs profitable when considered separately from SME banking?

4. We do not have a comprehensive view of the profitability of BCAs across all of the banks, as they take different approaches in assessing the performance of BCAs, and they do not all assess the profitability of BCAs in the normal course of business:
 - (a) Barclays told us that it did not measure the profitability of BCAs in the regular course of business due to the difficulty in allocating fixed costs to multiple products² and instead, it considered the four major sources of income associated with BCAs (ie monthly fees; transactional fees; credit balances; and debit balances) and BCA-related impairment.
 - (b) HSBCG told us that it did not manage its SME banking business by reference to product profitability and instead, performance of product areas was assessed by reference to the contribution that those products made to common costs, as this approach reflected the fact that it competed in the SME banking market through a relationship banking approach that involved meeting customer needs by providing a range of products.
 - (c) LBG told us that SME banking product performance, including BCAs, was primarily assessed by reviewing revenue performance and not overall profitability, because business units in its Commercial Banking division were structured by reference to client size (as a relationship manager managed their customers' entire relationship) and therefore, financial performance was assessed and managed at total rather than product level.
 - (d) RBSG told us [REDACTED].³
 - (e) Santander told us [REDACTED].

² This is more challenging for BCAs than for PCAs, because Barclays manages PCAs through a distinct business unit, whereas it provides BCAs alongside a wider product set.

³ [REDACTED]

5. The banks' assessments of the profitability of their BCA propositions in recent years (and in future years where available) is presented in Annex A. The information provided by the banks in Annex A suggests that, over the course of a five-year period, for [X] and [X], BCAs are profitable, and for [X] and [X], SME banking, including the provision of BCAs, is profitable.
6. In addition to the information provided by the banks in Annex A, the following evidence supports the view that BCAs are profitable:
 - (a) In 2012, Barclays outlined a proposal to develop a best in class BCA proposition that intended to increase BCA profitability from £[X] per customer to £[X] per customer by 2014.
 - (b) In 2013, Barclays outlined a BCA proposition to sustainably grow current account profitability by £[X] per annum from £[X] in 2012 to £[X] in 2014. Barclays told us that this represented an increase in profitability of £[X] per customer per annum and much of the increase in profitability was a function of reduced costs and impairments rather than customers paying more for their BCA services.⁴
 - (c) In 2013, HSBCG stated that its Business Banking Mass proposition [X].

Does the profitability of BCAs vary by customer usage or customer type, and if so, how much do different customer groups contribute to the profitability of BCAs?

7. We do not have a comprehensive view of the profitability of different BCA customers across all of the banks, as they take different approaches in assessing the performance of customers, and they do not all assess the profitability of BCA customers in the normal course of business:
 - (a) Barclays told us that historically, it had not measured SME customer profitability, as it could not accurately link the behaviour of customers to its cost base, but it intended to complete the development of a customer level profitability model in 2016.
 - (b) HSBCG told us [X].
 - (c) LBG told us that it undertook profitability assessments at key strategic decision points, but it did not fully allocate costs across its SME banking

⁴ Current account profitability of £[X] was calculated by multiplying total current account income (including arranged and unarranged overdrafts) of £[X] by the same revenue to profit before tax (PBT) ratio as seen for the wider business banking business (ie [X]%). The £[X] increase in profitability was divided by the number of business banking customers at the time (ie [X]) to give an increase in profitability per customer of £[X] per annum.

business at a customer level due to the difficulties associated with cost allocation, capital allocation and the valuation of fixed and intangible assets.

(d) RBSG told us [REDACTED].

(e) Santander told us [REDACTED].

Customer usage

8. There are a number of ways in which the manner in which a customer uses their BCA impacts upon the returns that they generate for their bank:
 - (a) The level of credit balances held in BCAs are an important source of funding for the banks and a driver of net interest income (NII).
 - (b) The volume and type of transactional activity undertaken by the customer relates directly to the income generated by that customer for their bank. This is particularly the case for BCA customers, as the banks typically charge transactional fees (in addition to a monthly fee for usage of the account). The income generated by a customer for their bank is determined by their channel usage, and electronic payments tend to incur a higher fee for SMEs than cash and manual payments, although the banks incur higher processing costs in serving customers in branches). For example, Barclays told us that it made a loss on serving charities, clubs, associations and societies, because these customers were typically provided core banking services (eg BCAs and key payment services) free of charge, and had a relatively high cost to serve, as they were particularly likely to use cheques and frequently required change in mandates.
 - (c) The income generated for the banks from overdraft fees and interest is a driver of the profitability of BCAs. With the exception of [REDACTED],⁵ the income generated by the banks from BCA overdraft fees and interest appears to have declined in recent years. It is unclear as to the extent that this has been driven by a decline in overdraft usage and the changes made by a number of the banks to their overdraft propositions to increase the transparency of their charging structures.
9. We present the evidence provided by the banks to demonstrate how these features impact upon BCA profitability in Annex B.

⁵ [REDACTED]

Customer type

10. The following characteristics of BCAs customers impact upon the profits that they generate for their bank:
 - (a) The size of the SME.⁶ Larger SMEs tend to hold larger credit balances in their BCAs, thus driving greater NII for their bank. Further, larger SMEs typically have higher transaction volumes; greater and more complex financial needs (eg greater borrowing requirements); and the need for a broader range of other SME banking products and services.
 - (b) The life stage of the SME. Start-ups or new BCA customers often receive free core banking services for a limited period (typically 12 to 18 months) and therefore generate less income in the early stages of their operation. LBG told us that BCAs provided to start-ups or switchers, which were introductory products, were not expected to cover their incremental costs in the short term, but it expected these customers to make a contribution in excess of incremental costs over the lifetime of their relationship with LBG. Therefore, the provision of free banking for a limited period is effectively a cost of customer acquisition.
11. We present the evidence provided by the banks to demonstrate how these characteristics impact upon BCA profitability in Annex C.

Are the other SME banking products offered by the banks profitable when considered separately from SME banking, and if so, how much do they contribute to the profitability of SME banking?

12. We do not have a comprehensive view of the profitability of other SME banking products across all of the banks, as they take different approaches in assessing the performance of these products, and they do not all assess the profitability of these products in the normal course of business:
 - (a) Barclays told us that the profitability of loans and asset finance products was measured in terms of the return on risk weighted assets and return on equity; and the profitability of deposits accounts was measured purely in terms of PBT, because it held little capital against the deposits, and therefore, the use of a return on risk weighted assets or return on equity metric was of little practical value.
 - (b) HSBCG told us that it did not manage its SME banking business by reference to product profitability and instead, performance of product

⁶ We consider that the annual turnover of an SME is an appropriate proxy for the size of the business.

areas was assessed by reference to the contribution that those products made to common costs, as this approach reflected the fact that it competed in the SME banking market through a relationship banking approach that involved meeting customer needs by providing a range of products.

(c) LBG told us that product performance, including BCA performance, was primarily assessed by reviewing revenue performance and not overall profitability.

(d) RBSG told us [REDACTED].⁷

(e) Santander told us [REDACTED].

13. The banks' assessments of the profitability of some of their SME banking products in recent years (and likely profitability in future years where available) is presented in Annex D. The information provided by the banks in Annex D suggests that, over the course of a five-year period, the SME banking products (for which we have data) provided by [REDACTED] (mortgages, loans, deposit accounts and credit cards), [REDACTED] (term lending products, asset finance products and deposit accounts) and [REDACTED] (commercial charge cards) are profitable.⁸

⁷ [REDACTED]

⁸ The information provided by [REDACTED] and [REDACTED] did not allow us to assess whether their SME banking products are profitable.

Annex A: BCA profitability

- The differences in the information provided by the banks and presented in this annex reflects both the different information provided by each bank (ie [X] provided stand-alone profit and loss forecasts for their BCA propositions, whereas [X] provided forecasts for their SME banking businesses, which includes the provision of BCAs and other SME banking products), and the different revenue and cost allocation methods utilised by each of the banks.

Barclays

- Table 1 shows that the provision of [X] was [X] from 2012 to 2014, and [X] in 2015 and 2016.

Table 1: Barclays [X] profit and loss, 2012 to 2016

	<i>£m</i>				
	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>
Current accounts NII	[X]	[X]	[X]	[X]	[X]
Liquidity buffer (allocation)	[X]	[X]	[X]	[X]	[X]
Current accounts NII	[X]	[X]	[X]	[X]	[X]
Overdrafts NII	[X]	[X]	[X]	[X]	[X]
NII	[X]	[X]	[X]	[X]	[X]
Risk related	[X]	[X]	[X]	[X]	[X]
Money transmission	[X]	[X]	[X]	[X]	[X]
Foreign exchange	[X]	[X]	[X]	[X]	[X]
Debit card exchange trade agreement	[X]	[X]	[X]	[X]	[X]
Non-interest income	[X]	[X]	[X]	[X]	[X]
Total income	[X]	[X]	[X]	[X]	[X]
In business costs	[X]	[X]	[X]	[X]	[X]
Functional costs	[X]	[X]	[X]	[X]	[X]
Operations and technology	[X]	[X]	[X]	[X]	[X]
Head office allocations	[X]	[X]	[X]	[X]	[X]
Other	[X]	[X]	[X]	[X]	[X]
Total operating costs	[X]	[X]	[X]	[X]	[X]
Impairments	[X]	[X]	[X]	[X]	[X]
Other	[X]	[X]	[X]	[X]	[X]
PBT	[X]	[X]	[X]	[X]	[X]

Source: Barclays.

[X]

HSBCG

- Table 2 shows that [X] was [X] from 2012 to 2014 and [X] in 2015 and 2016.

Table 2: HSBCG [X] profit and loss, 2012 to 2016

	<i>£m</i>				
	2012	2013	2014	2015	2016
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>
Income	[X]	[X]	[X]	[X]	[X]
Impairments	[X]	[X]	[X]	[X]	[X]
Costs	[X]	[X]	[X]	[X]	[X]
Associates	[X]	[X]	[X]	[X]	[X]
PBT	[X]	[X]	[X]	[X]	[X]

Source: HSBCG.
[X]

4. HSBCG told us that [X]:

- (a) [X];
- (b) [X];
- (c) [X]; and
- (d) [X].

LBG

5. Table 3 shows that [X]⁹ was [X] in 2014 and [X] from 2014 to 2018.

Table 3: LBG [X] profit and loss, 2014 to 2018

	<i>£m</i>				
	2014	2015	2016	2017	2018
	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>
NII	[X]	[X]	[X]	[X]	[X]
Other operating income	[X]	[X]	[X]	[X]	[X]
Total income	[X]	[X]	[X]	[X]	[X]
Direct costs	[X]	[X]	[X]	[X]	[X]
Indirect costs	[X]	[X]	[X]	[X]	[X]
Total costs	[X]	[X]	[X]	[X]	[X]
Impairments	[X]	[X]	[X]	[X]	[X]
PBT	[X]	[X]	[X]	[X]	[X]

Source: LBG.

6. LBG told us that the key drivers of performance during this period were:

- (a) annualised customer balance growth over the period of [X]% for deposits and [X]% for lending due to customer-led investment and economic growth causing significant increases in the levels of both SME deposits and lending;

⁹ [X]

- (b) an increase in NII, reflecting the expectation of a medium term rise in the base rate;
- (c) lower growth in other operating income (in comparison with NII) due to lower growth in BCA and overdraft fee income and expected reductions in interchange fee income;
- (d) a gradual increase in direct costs, reflecting increased staff and other operating costs due to expected growth in the business;¹⁰ and
- (e) an increase in impairments due to increased lending, partially offset by reduced impairment risk as the economy improved.

7. Table 4 shows that [£m]¹¹ was [£m] from 2011 to 2014.

Table 4: LBG [£m] profit and loss, 2011 to 2014

	<i>£m</i>			
	2011	2012	2013	2014
NII	[£m]	[£m]	[£m]	[£m]
Other operating income	[£m]	[£m]	[£m]	[£m]
Total income	[£m]	[£m]	[£m]	[£m]
Operating expenses	[£m]	[£m]	[£m]	[£m]
Impairments	[£m]	[£m]	[£m]	[£m]
Fair value unwind	[£m]	[£m]	[£m]	[£m]
PBT	[£m]	[£m]	[£m]	[£m]

Source: LBG.

8. Table 5 shows the income and margins generated and the balances held by LBG's [£m] from 2012 to 2014, and forecasts for 2015 to 2017.

¹⁰ The majority of costs are indirect shared costs, which are allocated to the business using appropriate cost drivers, and do not have a direct relationship with the volume or characteristics of customers.

¹¹ Commercial Banking includes the provision of BCAs to SMEs with turnover between £1 million and £25 million.

Table 5: LBG [redacted] income, margins and balances 2012 to 2017

	£m					
	2012	2013	2014	2015	2016	2017
	Actual	Actual	Actual	Forecast	Forecast	Forecast
Non-interest bearing current account (NIBCA) NII	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Interest-bearing current account (IBCA) NII	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Overdraft income	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Other operating income	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total income	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
NIBCA margin	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
IBCA margin	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Overdraft margin	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
NIBCA balances	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
IBCA balances	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Overdraft balances	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Source: LBG.
[redacted]

9. LBG told us that the key drivers of performance over this period were:

- (a) an increase in credit balances due to SMEs investing less in working capital, reflecting the uncertainty caused by the recent economic environment, and an increase in customers (eg [redacted]% of the deposit growth in 2014 was due to the recruitment of new customers in the current or previous year);
- (b) a fall in overdraft balances due to a reduced demand for overdraft facilities;
- (c) a lower growth in NII relative to balance growth due to a reduction in deposit and lending margins; and
- (d) an increase in other operating income due to customers choosing to transact through lower cost digital channels.

RBSG

10. Table 6 shows that [redacted], was [redacted] and is [redacted]. RBSG told us that [redacted] in 2013 was [redacted]:

- (a) [redacted];
- (b) [redacted];
- (c) [redacted]; and
- (d) [redacted].

Table 6: RBSG [X] profit and loss, 2013 to 2015

	<i>£m</i>		
	<i>2013</i>	<i>2014</i>	<i>2015</i>
	<i>Actual</i>	<i>Actual</i>	<i>Forecast</i>
NII	[X]	[X]	[X]
Treasury allocations*	[X]	[X]	[X]
Other income	[X]	[X]	[X]
Total income	[X]	[X]	[X]
Staff costs	[X]	[X]	[X]
Other costs	[X]	[X]	[X]
Total direct costs	[X]	[X]	[X]
Services†	[X]	[X]	[X]
Functions‡	[X]	[X]	[X]
Indirect restructuring costs	[X]	[X]	[X]
Total indirect costs§	[X]	[X]	[X]
Total costs	[X]	[X]	[X]
Operating profit before impairments	[X]	[X]	[X]
Impairments	[X]	[X]	[X]
Operating profit	[X]	[X]	[X]

Source: RBSG.

*Treasury allocations represent treasury costs allocated to the business based on appropriate product drivers and funding mechanisms.

†Indirect services costs include allocated costs for bank centre; technology services; payment and cash services; fraud operations; change and transformation; international operations; bankline, Bacs, trade operations; and lending operations.

‡Indirect functions costs include allocated costs for Legal, Group Internal Audit, Risk, Restructuring, Secretariat, Share Based Payments, Compliance, Corporate, Finance, HR, Marketing and Communications, Product and Bank Levy.

§All indirect allocated costs are based on appropriate cost drivers (eg dedicated or semi-dedicated full time equivalents or underlying transaction volumes).

Notes:

[X]

11. Table 7 shows that [X].

Table 7: RBSG [X] profit and loss, 2013 to 2017

	<i>£m</i>				
	<i>2013</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>	<i>2017</i>
	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>
Asset NII	[X]	[X]	[X]	[X]	[X]
Deposit NII	[X]	[X]	[X]	[X]	[X]
NII	[X]	[X]	[X]	[X]	[X]
Non-interest income	[X]	[X]	[X]	[X]	[X]
Total income	[X]	[X]	[X]	[X]	[X]
Treasury allocation	[X]	[X]	[X]	[X]	[X]
Total income including treasury allocation	[X]	[X]	[X]	[X]	[X]
Staff costs	[X]	[X]	[X]	[X]	[X]
Other costs	[X]	[X]	[X]	[X]	[X]
Total direct costs†	[X]	[X]	[X]	[X]	[X]
Indirect costs‡	[X]	[X]	[X]	[X]	[X]
Total costs	[X]	[X]	[X]	[X]	[X]
Profit before impairment loss	[X]	[X]	[X]	[X]	[X]
Impairment loss	[X]	[X]	[X]	[X]	[X]
Operating contribution fully allocated	[X]	[X]	[X]	[X]	[X]

Source: RBSG.

*Treasury allocations represent treasury costs allocated to the business based on appropriate product drivers and funding mechanisms.

†Direct costs include costs of front business and management teams.

‡Indirect services costs include allocated costs for bank centre; technology services; payment and cash services; fraud operations; change and transformation; international operations; bankline, Bacs, trade operations; and lending operations.

Indirect functions costs include allocated costs for Legal, Group Internal Audit, Risk, Restructuring, Secretariat, Share Based Payments, Compliance, Corporate, Finance, HR, Marketing and Communications, Product and Bank Levy. All indirect allocated costs are based on appropriate cost drivers (eg dedicated or semi-dedicated full time equivalents or underlying transaction volumes).

[X]

14. Santander told us that the main drivers of financial performance of its SME banking business (including BCAs) were:
- (a) NII, which was driven by the mix and size of balances that were in credit and overdrawn, and the interest paid to the customer;
 - (b) non-interest income, which was mainly driven by the number of customers using their overdraft facility; the transactions performed by customers (eg ATM and debit card usage); and the use of ancillary services (eg cash handling and payment services such as CHAPS);
 - (c) provisions and impairments, which were mainly driven by the value of write offs, non-performing loans and fraud costs; and
 - (d) costs relevant to the provision of the SME banking business (eg employment costs, general and third party costs and depreciation).

Annex B: BCA profitability by customer usage

Transactional activity

1. The income generated by a customer for their bank is determined by their transactional method. For example:
 - (a) Barclays told us that the near exclusive use of online payments would give rise to lower income generated from some customers, while the frequent paying-in of cash would give rise to higher income generated from others.
 - (b) [X] told us that retail and leisure businesses tended to be heavier users of cash and manual payments, and these payments drove higher income, but also cost more to process.¹³

Overdraft usage

2. Barclays told us that overdraft usage drove the income generated by an SME for the bank as follows:
 - (a) There was an annual fee relative to the size of the overdraft limit on the account (irrespective of the level of usage of the facility) and interest payable when a customer used their arranged overdraft. The varying size of overdraft limits across SMEs reflected the varying requirements for working capital (eg very few charities had overdraft facilities, but they were commonly used among agricultural businesses to manage the frequent fluctuations in cash flow in that industry).
 - (b) When a customer used an unarranged overdraft (ie where the overdraft balance exceeded their agreed or arranged overdraft limit):
 - (i) they were charged a higher interest rate than that applied to the use of their arranged overdraft facility;
 - (ii) they were charged a paid referral fee of £30 where Barclays elected to process a payment that took the customer more than £30 over their agreed limit (this fee was capped at one per day); and

¹³ [X] told us that income from manual payments had fallen in recent years as customers migrated to automated payment methods (eg standing orders, direct debits, faster payments and card payments), and that the rate of income decline was faster in the higher turnover businesses, reflecting speed of adoption of the available payment methods and volume.

- (iii) they were charged an unpaid fee of £35 where Barclays declined a payment (this fee was capped at one per day).
- 3. Barclays told us that overdraft income (including risk fees) generated by SMEs had fallen from £[redacted] in 2012 to £[redacted] in 2014. Barclays also told us that there had been a decline in overdraft balances, as the sharp fall in the base rate to a record low and uncertainty surrounding the strength of the economic recovery had encouraged SMEs to retain additional credit balances in their BCAs.
- 4. HSBCG told us that overdraft income generated by SMEs had [redacted], because:
 - (a) on average, customer use of overdraft facilities [redacted] (eg in 2014, HSBCG provided [redacted] overdraft facilities to its circa [redacted] SME customers (which represented a product penetration ratio of [redacted]%), and the average debit balance was £[redacted] (which represented an average overdraft facility utilisation of [redacted]%);
 - (b) there were competitive alternatives to overdraft facilities (eg invoice finance; credit cards; trade credit; alternative finance; and PCA credit balances); and
 - (c) it had made the following changes to its SME banking unarranged overdraft proposition (all of which came into effect on 1 December 2014):
 - (i) A reduction in the overdraft interest rate from 29.5% to 19.5%.
 - (ii) A reduction in the charge for unpaid items from £25 to £15 for cheques, direct debits and standing orders.
 - (iii) The creation of a debt balance buffer of £10.
- [redacted]
- 5. Table 1 shows that the income that LBG generated from BCA overdrafts declined from 2012 to 2014, and, at the time of our provisional findings, was forecast to continue to decline from 2015 to 2017, driven by declining overdraft balances and margins.

Table 1: LBG BCA overdraft income, 2012 to 2017

	<i>£m</i>					
	<i>2012</i>	<i>2013</i>	<i>2014</i>	<i>2015</i>	<i>2016</i>	<i>2017</i>
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Forecast</i>	<i>Forecast</i>	<i>Forecast</i>
Overdraft income	[X]	[X]	[X]	[X]	[X]	[X]
Overdraft balances	[X]	[X]	[X]	[X]	[X]	[X]
Overdraft margin (%)*	[X]	[X]	[X]	[X]	[X]	[X]

Source: LBG.

*Margin is calculated by dividing NII by spot balances.

6. RBSG told us that overdraft usage among SMEs had declined by [X]% from [X] to [X], as demand for working capital facilities had weakened in the economic downturn, resulting in a reduction in overdraft income from £[X] in [X] to £[X] in [X].

7. Table 2 shows the BCA income generated by Santander from overdraft fees and interest from 2010 to 2014. [X].

Table 2: Santander BCA overdraft income, 2012 to 2014

	<i>£m</i>				
	<i>2010</i>	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
[X]					
[X]	[X]	[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]	[X]	[X]
[X]	[X]	[X]	[X]	[X]	[X]

Source: Santander.

Annex C: BCA profitability by customer type

Size

1. Barclays told us that larger customers held larger balances in their BCAs and had higher transaction volumes and therefore, paid higher money transmission charges, and as a result, the average BCA income generated from SMEs with turnover above £1 million was more than [REDACTED] the income generated from SMEs with turnover of less than £100,000.
2. Table 1 shows that [REDACTED].¹⁴ HSBCG told us that [REDACTED]. Further, HSBCG told us that [REDACTED].

Table 1: HSBCG [REDACTED] revenue per customer, 2012 to 2014

[REDACTED]

Source: HSBCG.
[REDACTED]

3. Figure 1 shows that high turnover businesses (those businesses with turnover between £500,000 and £1 million) and mid-turnover businesses (turnover between £100,000 and £500,000) generated a disproportionate amount of LBG's [REDACTED] income when compared to the income generated by low turnover businesses (less than £100,000 turnover).¹⁵

Figure 1: [REDACTED]

[REDACTED]

Source: [REDACTED].

4. LBG told us that SMEs with higher turnover generated greater income for LBG, because those SMEs:
 - (a) typically had greater borrowing requirements (both in terms of amount and frequency); higher deposit balances; and a greater volume of transactions;
 - (b) benefited from additional products designed specifically to meet the more complex needs of such businesses (eg international services); and
 - (c) did not receive free banking services (whereas start-ups received free banking services for a limited period, which temporarily reduced the income that they generated for LBG, but income increased over time as

¹⁴ [REDACTED]

¹⁵ [REDACTED]

the business became more established, increased its turnover and/or started to use a wider range of products.

5. Table 2 shows that [REDACTED].

Table 2: RBSG [REDACTED], 2011 to 2014

	£			
	<i>Average income per account</i>			
<i>SME turnover</i>	2011	2012	2013	2014
Less than £2 million	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
£2 million to £25 million	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: RBSG.
[REDACTED]

6. Santander told us that larger SME customers with more complex businesses generally generated larger revenues.

Life stage

7. Barclays told us that:

- (a) start-ups did not pay standard account fees or money transmission charges (usually for the first 12 months of their relationship with Barclays); and
- (b) the average income it generated from a start-up was around [REDACTED] of the average income it generated from all SME customers.

8. LBG told us that BCAs provided to start-ups or switchers, which were introductory products, were not expected to cover their incremental costs in the short term, but it expected these customers to make a contribution in excess of incremental costs over the lifetime of their relationship with LBG.

9. RBSG told us that it offered start-ups a fee-free overdraft of £500 for the first 12 months and no annual fee on commercial credit cards for the first 12 months.

Annex D: Profitability of other SME banking products

Barclays

- Table 1 shows the NII and margins generated and the balances held by Barclays [REDACTED] in 2013 and 2014 (and equivalent information for the forecast period from 2015 to 2018).

Table 1: Barclays [REDACTED] income, margins and balances, 2013 to 2018

	£m					
	2013	2014	2015	2016	2017	2018
	Actual	Actual	Forecast	Forecast	Forecast	Forecast
Asset NII						
Income						
Overdrafts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Mortgages	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Loans	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Average balances						
Overdrafts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Mortgages	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Loans	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Margin						
Overdrafts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Mortgages	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Loans	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Liability NII						
Income						
Current accounts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Savings	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Average balances						
Current accounts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Savings	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Margin						
Current accounts	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Savings	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: Barclays.
[REDACTED]

- Barclays told us that the key drivers of the profitability of its debt products were borrowing demand, the level of impairment and margins. Barclays told us that in recent years, it had witnessed:
 - limited borrowing demand, which had resulted in limited balance growth;
 - a significant decrease in the level of impairments due to improved underwriting techniques, improving economic conditions and rising underlying asset prices; and

- (c) a downward pressure on margins due its participation in government lending schemes, which had often provided greater benefits for banks with weaker credit scores.
3. Barclays told us that the key drivers of the profitability of its deposits business were the level of balances held and margins. Barclays told us that in recent years it had witnessed:
- (a) significant growth in deposit balances due to:
- (i) continued economic uncertainty, causing businesses to delay major capital investment projects; and
- (ii) a growth in its SME customer base;
- (b) margin compression (due to the very low base rate environments), which had significantly reduced the profitability of its deposits business; and
- (c) the emergence of liquidity buffer charges as a new cost.
4. Table 2 shows the profitability of Barclaycard’s small business segment from 2010 to 2014. Barclays told us that the key drivers of Barclaycard profitability were the number of accounts; customer churn; the level of balances; and the level of interest-earning balances.

Table 2: Barclaycard small business profitability, 2010 to 2014

	£m
	PBT
2010	[REDACTED]
2011	[REDACTED]
2012	[REDACTED]
2013	[REDACTED]
2014	[REDACTED]

Source: Barclays.

Notes:

1. Barclaycard views its small business customers (ie those customers with turnover of up to £5 million) as one book and measures profitability at this level.

2. PBT is calculated as net income (ie net interest plus interchange and other fees) less impairment and costs.

LBG

5. Table 3 shows the NII and margins generated and the balances held by LBG’s [REDACTED] from 2012 to 2014 (and equivalent information for the forecast period from 2015 to 2017).

Table 3: LBG [X] income, margins and balances, 2012 to 2017

	<i>£m</i>					
	<i>2012 Actual</i>	<i>2013 Actual</i>	<i>2014 Actual</i>	<i>2015 Forecast</i>	<i>2016 Forecast</i>	<i>2017 Forecast</i>
Term lending*						
Income	[X]	[X]	[X]	[X]	[X]	[X]
Margin	[X]	[X]	[X]	[X]	[X]	[X]
Balances	[X]	[X]	[X]	[X]	[X]	[X]
Deposit accounts†						
Income	[X]	[X]	[X]	[X]	[X]	[X]
Margin	[X]	[X]	[X]	[X]	[X]	[X]
Balances	[X]	[X]	[X]	[X]	[X]	[X]
Asset finance‡						
Income	[X]	[X]	[X]	[X]	[X]	[X]
Margin	[X]	[X]	[X]	[X]	[X]	[X]
Balances	[X]	[X]	[X]	[X]	[X]	[X]

Source: LBG.

*Term lending represents business loans. LBG is unable to accurately distinguish between business loans and commercial mortgages.

†Deposit accounts represents instant access accounts and term deposits.

‡Asset finance represents invoice finance and hire purchase.

Notes:

1. Margin is calculated as NII divided by spot balances.
2. Balances are spot balances as at 31 December.

RBSG

6. RBSG told us that the lifetime value for SME commercial charge cards was estimated at £[X] per customer.¹⁶

¹⁶ [X]

Appendix 7.4: BCA pricing analysis

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Overview

1. This appendix sets out the results of our analysis of BCA prices.
2. We compared the monthly cost of BCAs for a number of different customer profiles, using January 2015 published prices.
3. We asked the five largest banks to submit five representative BCA customer profiles together with weightings showing the proportion of their BCAs that these profiles reflected.
4. The following sections cover: BCA pricing, representative customer profiles, our methodology for making comparisons, our results and a discussion of the interpretation of our results.

BCA prices

5. BCAs provide the following services to SMEs: payment transactions, store of value, and borrowing facilities (overdrafts). However, not all BCA customers have an overdraft facility.
6. BCAs often include charges for transactional services and for use of overdraft facilities. Some BCAs pay interest on in-credit balances. Annex A sets out information available on overdraft charges and credit interest rates.

7. Our analysis covers charges for transactional services (including any monthly charges)¹ and focuses on BCAs identified by the banks in response to the market questionnaire. We excluded BCAs aimed at a particular type of enterprise, such as charities, clubs and societies as these account for a relatively small proportion of all BCAs. Our analysis is also limited to current BCA tariffs and excludes legacy tariffs. Many banks offer incentives to new customers, which often differ between start-ups and switchers – details of these incentives are set out in Annex A. Switching incentives are excluded from our analysis.
8. Business banking transactions used in our analysis can be divided into electronic transactions – such as auto credits and direct debits – and branch transactions – such as depositing or withdrawing cash over the branch counter. The analysis includes the most important transactions for which pricing data was readily available.
9. We included the following electronic transactions:
 - (a) auto credit – an electronic credit paid into the account;
 - (b) bill payment – a bill payment which is debited to the account via telephone or internet banking service and credited to a recipient;
 - (c) debit card – a debit to the account following a business debit card payment;
 - (d) direct debit – a direct debit payment made from or returned to the account; and
 - (e) standing order – a standing order payment made from the account.
10. We also included the following branch/other transactions:
 - (a) branch paying-in – credits paid in over the branch counter (containing cash and/or cheques);
 - (b) branch withdrawal – cash withdrawal over the branch counter (ie when cashing a cheque);
 - (c) branch cash-in – a charge in addition to the branch paying-in charge for cash paid in at branch (as a percentage of the value deposited);

¹ As can be seen in Appendix 7.2, Table 5, transactional charges and monthly account fees make up just under 50% of the charges on BCAs for businesses with a turnover of less than £2 million. A large proportion of the remaining revenue is from overdraft charges. So the results here should be considered alongside the information on overdraft charges in Annex A.

- (d) branch cash-out – a charge in addition to the branch withdrawal charge for cash withdrawal over branch counter (as percentage of the value withdrawn);
- (e) ATM cash-out – charge for debit associated with a cash withdrawal from self-service machine (one debit per withdrawal) and an additional charge for cash amount withdrawn from self-service machine (as a percentage of the value withdrawn);
- (f) cheques paid-in – a charge in addition to the branch paying-in charge for cheques paid in at branch; and
- (g) cheques issued – cheques written.

11. We used pricing data published on the Business Moneyfacts website in January 2015.²

Customer profiles

12. We asked the five largest banks in GB³ to submit five transactional profiles⁴ which were broadly representative of their SME BCA customers on standard tariffs, together with weightings showing the proportion of BCAs that these profiles reflected.
13. We asked the banks to exclude SMEs with an annual turnover larger than £2 million as published prices may be less relevant to this segment if they negotiate their prices.
14. According to one bank ([X]), approximately [X]% of all transactions (by volume) were covered by those included in the analysis (see paragraphs 9 and 10 above). The remaining less common transactions include: first party transfers, bank initiated charges, unpaid and paid referral fees, branch bill payments, CHAPS and unallocated transactions. Excluding these transactions is unlikely to have a major effect on the results.
15. We received five transactional profiles from Barclays and four usable transactional profiles from HSBCG, RBSG, and Santander.⁵ These can be found at Annex B. LBG did not submit any profiles as it did not believe that meaningful representative customer profiles could be provided given SMEs'

² BBA Moneyfacts presents BCA tariffs for around 130 different BCAs. Pricing data for Handelsbanken is not available from the Business Moneyfacts website. We obtained its pricing data separately from Handelsbanken.

³ Barclays, HSBCG, LBG, RBSG and Santander.

⁴ By transactional profile, we mean the number of transactions set out above that a representative customer would make.

⁵ Of HSBCG's five profiles, one was simply the aggregate of the other four. In the case of RBSG and Santander, we excluded one profile as it related to SMEs with turnover in excess of £2 million.

diversity in cost to serve, risk, average and range of balances, transaction volumes, channel preference and need for relationship support.⁶ One NI bank ([X]) said it believed that we would not be able to draw any reliable conclusions because of limitations in the profiles.

16. Table 1 below shows an illustrative set of transactional profiles.

Table 1: An illustrative set of transactional profiles

Weighting	50%	20%	15%	10%	5%
Description	£0–150k	£150–500k <i>light branch user</i>	£1500–500k <i>heavy branch user</i>	£500k–2m <i>light branch user</i>	£500k–2m <i>heavy branch user</i>
Transaction	Profile 1	Profile 2	Profile 3	Profile 4	Profile 5
<i>Electronic</i>					
Auto credit	1	6	2	15	5
Bill payment	0	0	0	0	0
Debit card	2	7	3	6	4
Direct debit	1	2	1	3	5
Standing order	0	6	1	15	1
<i>Branch/other</i>					
Branch paying-in	0	0	5	2	8
Branch withdrawal	0	0	0	0	1
Branch cash-in	£20	£70	£1,520	£315	£4,300
Branch cash-out	£20	£30	£275	£50	£470
ATM cash-out	£15	£55	£130	£65	£70
Cheques paid-in	0	1	5	1	11
Cheques issued	1	1	3	2	8

Source: CMA analysis.

Methodology

17. For each profile, we calculated the monthly cost for each relevant tariff of each bank by multiplying the number of transactions by the price per transaction. Where monetary values were submitted, such as on cash deposited and withdrawn, we divided the amount by 100 and rounded it up to the nearest whole number to account for parts of £100 deposited or withdrawn. We then multiplied this number by the fee applied to each £100 deposited/withdrawn.
18. Banks may have more than one relevant tariff, for example one tariff aimed at SMEs with mainly electronic transactions and one aimed at those with more branch transactions. Where this was the case, we took the tariff with the lowest monthly cost overall. This assumes that SMEs choose the cheapest

⁶ LBG considered that we should carry out analysis for BCAs using transactions data, similar to that for PCAs (see Appendix 5.4). However in contrast to PCAs we did not already have transactions data and we considered the costs of obtaining such data would not be proportionate to the potential benefits, given also that we had obtained representative profiles together with weightings from four banks.

tariff available for their pattern of transactions.⁷ While this may not be true in every case, we considered it more plausible than alternative assumptions, for example assuming that SMEs choose at random (ie taking a simple average across relevant tariffs).

19. When banks submitted their transactional profiles, in some cases they specified the SME turnover band to which each profile related.⁸ Banks' tariffs also sometimes have a turnover restriction (for example, the January 2015 TSB tariffs apply to SMEs with a maximum turnover of £0.5 million).⁹ We only included tariffs which applied within the turnover band of the profile.¹⁰
20. Barclays offers discounts on monthly charges according to the length of time its customers have been with Barclays. These discounts range from 5% to 30% and depend on the customer's turnover and on the length of its relationship with Barclays. We calculated the weighted average discount rate for each profile and applied it to Barclays' monthly prices.¹¹
21. We then calculated a weighted average monthly BCA price for each bank and banking group by applying the weightings to the profiles.¹²

Results

22. As shown in Table 2, there is significant variation between banks' charges. The variation in monthly charges across banks is illustrated for one set of profiles in Annex C.

⁷ One bank ([redacted]) stated that it 'reviews each customer's price plan on an annual basis. Where it considers that a customer will be better off on a different payments plan, it will notify the customer and move them onto that price plan.'

⁸ See Annex B.

⁹ TSB now opens accounts for businesses with turnovers up to £2 million.

¹⁰ As the TSB tariffs had a maximum turnover of £0.5 million, this meant we could not calculate a TSB price for profiles applying to SMEs with turnover above £0.5 million. As a consequence, TSB was excluded from some results.

¹¹ We weighted discount rates in each turnover and tenure category by the number of customers in this category.

¹² We calculated a weighted average price for LBG and RBSG using the proportion of these groups' active BCAs in Scotland (from these groups' responses to the market questionnaire) as a proxy for the number of accounts at BoS and RBS respectively. The prices for Clydesdale and Yorkshire Bank were the same, so we did not need to calculate a weighted average for the Clydesdale Group.

Table 2: Variation between highest and lowest monthly cost (highest as % of lowest)

	%			
	<i>Profiles provided by:</i>			
<i>Profiles</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>
<i>GB</i>				
Profile 1	223	189	169	199
Profile 2	216	316	214	360
Profile 3	233	190	279	138
Profile 4	268	145	167	136
Profile 5	319	n/a	n/a	n/a
<i>NI</i>				
Profile 1	251	248	161	204
Profile 2	279	329	252	401
Profile 3	308	168	342	148
Profile 4	335	138	150	138
Profile 5	357	n/a	n/a	n/a

Source: CMA analysis.

23. We also estimated for each profile the difference between each bank's charge and the charge for the cheapest product. We then weighted this using the weightings for each profile to give an average monthly gain for each bank. We then estimated the weighted average difference across all banks using the number of each bank's BCAs as weights. The results for the profiles sets are shown in Table 3. Taking a simple average across the four groups of profiles, the average difference is about £6 per month, though it is somewhat higher for the NI analysis.

Table 3: Average difference between monthly cost of BCA and cost of cheapest BCA

	<i>Profiles sets</i>				<i>Average of all profiles</i>
	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	
GB £ per BCA*	£8	£5	£6	£6	£6
GB %†	104%	56%	78%	75%	79%
NI £ per BCA*	£12	£9	£8	£10	£9
NI %†	136%	101%	91%	119%	112%
UK £ per BCA*	£9	£5	£6	£6	£7
UK %†	105%	57%	79%	77%	80%

Source: CMA analysis.

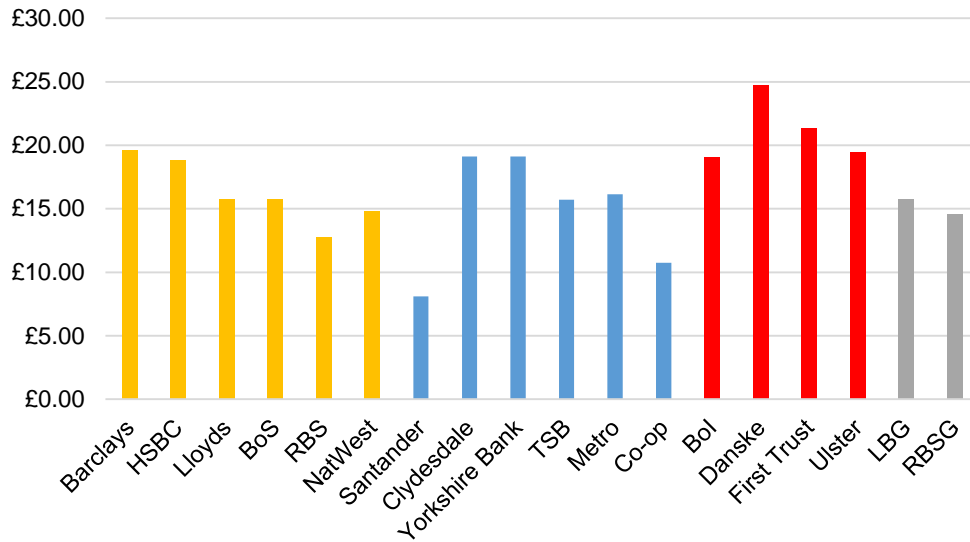
*Weighted average across banks and profiles.

†% of charge for cheapest BCA (weighted average across banks and profiles).

24. Figures 1 to 4 below show each bank's weighted average prices calculated by weighting the individual profiles. Four banks provided profiles; hence, there are four sets of profiles and four sets of results.¹³

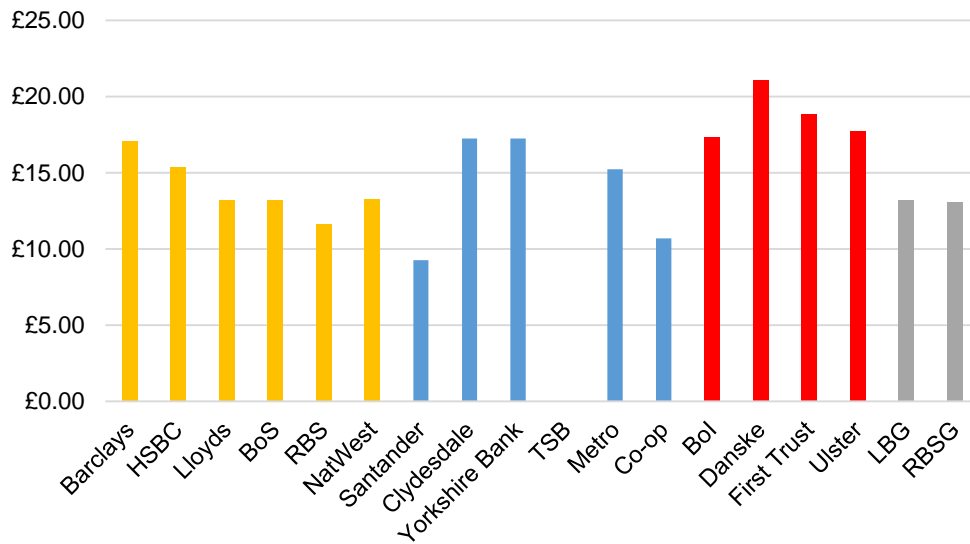
¹³ Yellow bars show larger banks, blue bars show smaller banks, red bars show NI banks and grey bars show weighted averages for the two banking groups whose constituent banks have different weighted average prices. TSB is excluded from some results since we were not able to calculate a weighted average price for TSB where at least one profile related to SMEs with turnover in excess of £500,000.

Figure 1: Weighted average prices by bank based on set A



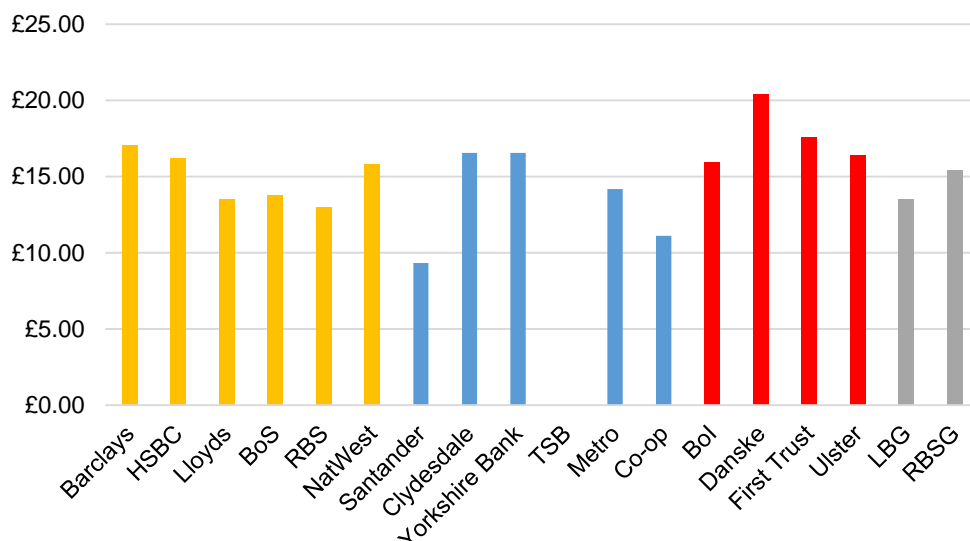
Source: CMA analysis.

Figure 2: Weighted average prices by bank based on set B



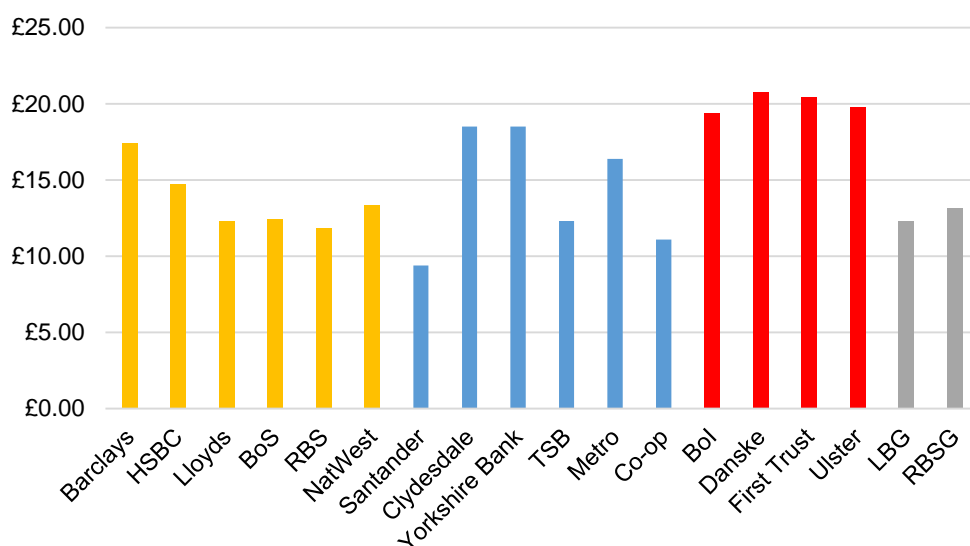
Source: CMA analysis.

Figure 3: Weighted average prices by bank based on set C



Source: CMA analysis.

Figure 4: Weighted average prices by bank based on set D



Source: CMA analysis.

25. We note that the relative prices are broadly similar for all four sets of results.
26. Handelsbanken was not included in the above analysis as its prices are not published. Handelsbanken provided us with its guide prices and we used these to calculate indicative weighted average prices on a similar basis to the other banks. Based on these guide prices, Handelsbanken's prices are above those of the other banks.¹⁴

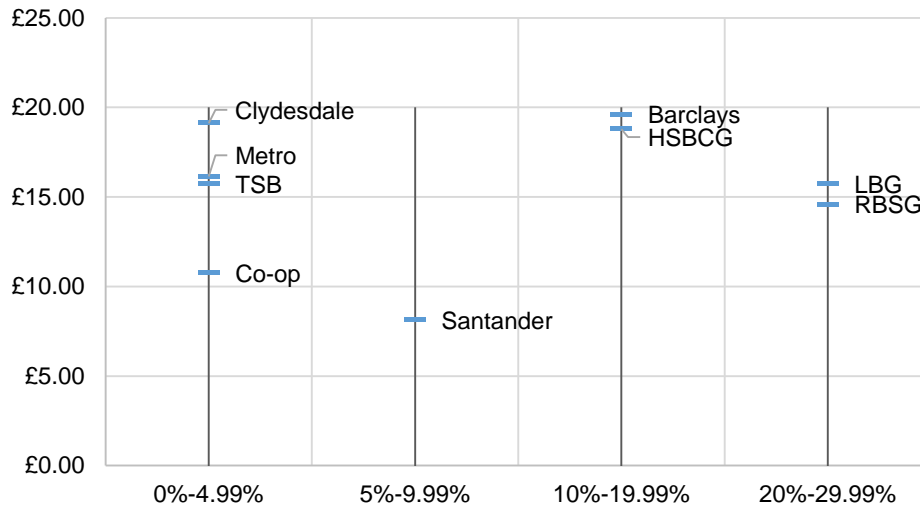
¹⁴ This reflects in particular Handelsbanken's indicative monthly charge of £50, but this is a guide price only and its branch managers can set their own prices for bespoke products and services.

27. In its response to our [provisional findings](#), RBSG said that the percentage difference between the lowest and highest priced BCAs (as set out in Table 2) was a volatile measure of price dispersion which ignored all other prices in between.¹⁵ We note that we have also calculated the average deviation between the price of each BCA and the price of the cheapest BCA (see Table 3). This measure, which is dependent on the price of the lowest cost BCA as well as the price of each other BCA, shows that the average deviation in prices from the lowest cost BCA is nearly 80%.
28. RBSG also stated that some degree of price dispersion was expected, even in a well-functioning market and we had not set out a benchmark level of price dispersion against which to make comparisons.¹⁶ While we agree that a realistic well-functioning market would not necessarily imply uniform pricing, we consider that the existence of price differentials in excess of 200% would be accompanied by a non-trivial customer response (all other factors held constant). We undertake this assessment of the evidence on customer response to variations in BCA pricing and quality variations in Section 7.
29. One of the questions we are seeking to address with our pricing analysis is whether banks with a higher market share tend to charge higher prices than smaller banks. Figures 5 to 8 below show the weighted average price against market share in GB. These do not show any clear association between price and market share, though Santander's prices are consistently amongst the lowest. Annex D shows weighted average price against market share in NI and these similarly do not show any clear association between price and market share.

¹⁵ [RBSG response to provisional findings](#), p7.

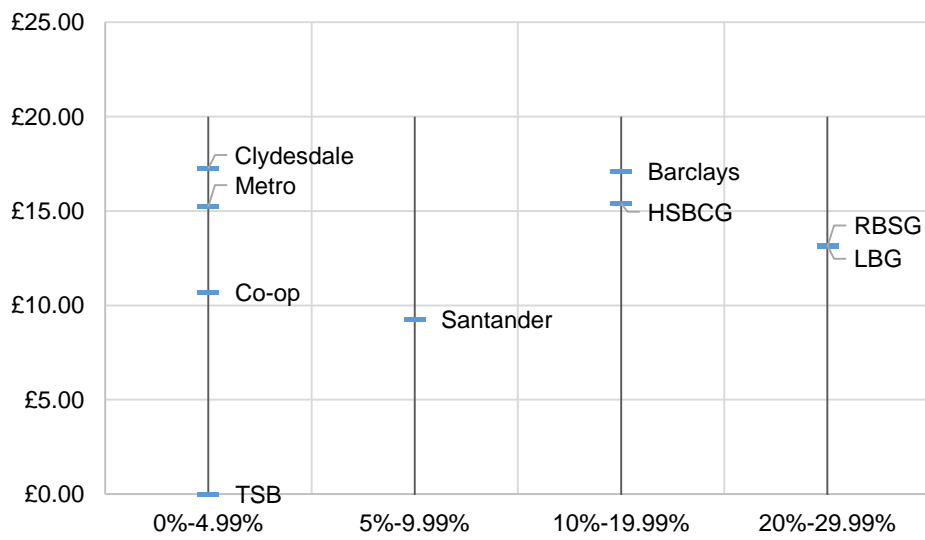
¹⁶ *ibid*, pp7 & 8.

Figure 5: Weighted average monthly BCA price in GB, set A



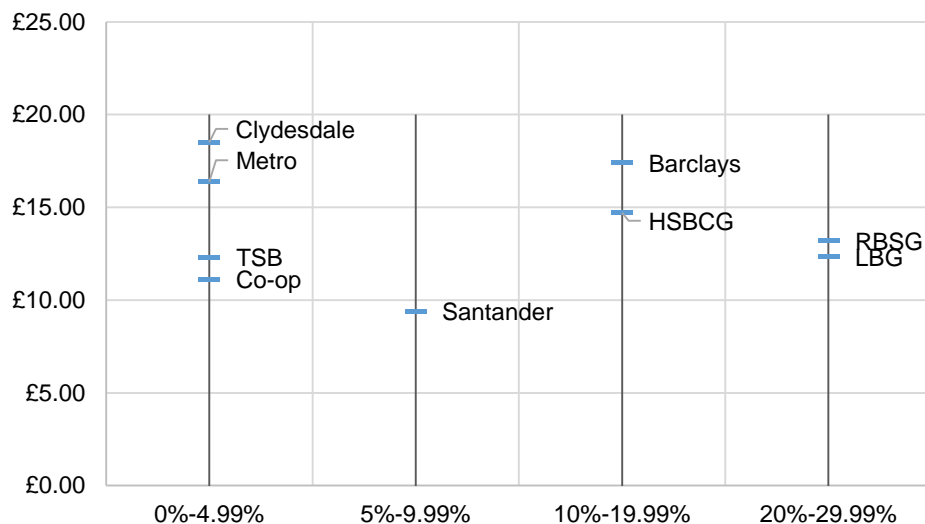
Source: CMA analysis.

Figure 6: Weighted average monthly BCA price in GB, set B



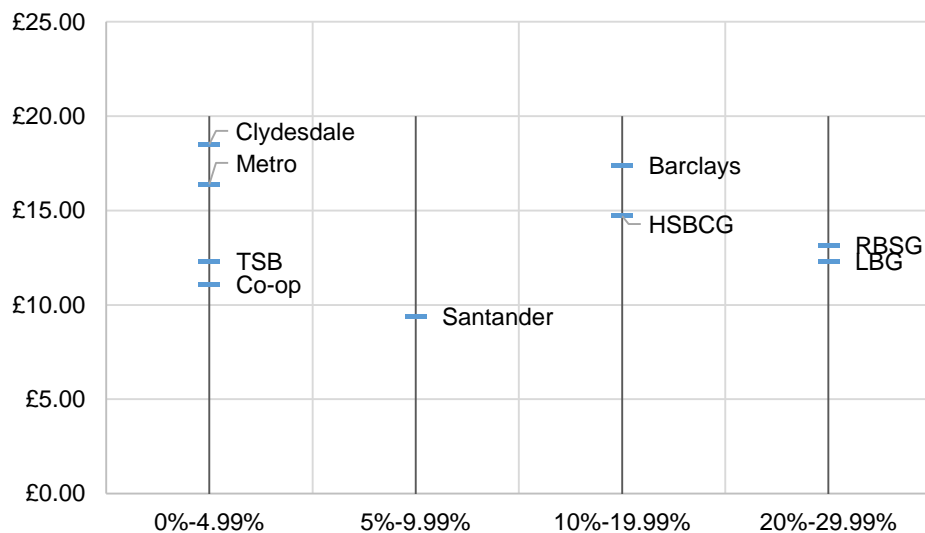
Source: CMA analysis.

Figure 7: Weighted average monthly BCA price in GB, set C



Source: CMA analysis.

Figure 8: Weighted average monthly BCA price in GB, set D



Source: CMA analysis.

Interpretation of the analysis

30. Interpretation of the results is subject to limitations:

- (a) There are a number of pricing dimensions which are not taken into account such as overdraft charges, interest on credit balances and other incentives. In its response to our [provisional findings](#), RBSG said that in not including these dimensions of pricing, the results were not representative of the real charges that an SME customer would actually

pay.¹⁷ Annex A contains information on posted charges for these dimensions of price and a discussion of the expected impact on our analysis of not being able to directly incorporate them.

- (b) The analysis is limited to SMEs with annual turnover less than £2 million and even within this segment customer profiles may not be fully representative of the diversity of SMEs' BCA usage. RBSG said that SMEs were a diverse customer group and designing representative user profiles was a particularly difficult challenge.¹⁸ [X] all raised concerns about the representativeness of the profiles we had used. RBSG also submitted that the analysis did not account for the fact that different banks may target SMEs with different banking needs and therefore may not offer tariffs that were designed to be cost effective for all SME user profiles in the market.¹⁹ Nevertheless, we note the similarity in results (in terms of relative prices) across the range of customer profiles submitted by the banks and have weighted the customer types using the actual proportion of customer accounts in each category. The analysis is also based on the assumption that SMEs are on the lowest priced available tariff (see paragraph 18). It also does not take account of any negotiation of prices (though this is less prevalent for SMEs under £2 million turnover).
- (c) Differences in banks' prices may reflect differences in the quality of service provided to SME customers (which we are unable to directly control for in our pricing analysis).²⁰ RBSG said that the relationship and service components were typically more valued by SME customers and the particular service given to SMEs was tailored to the particular needs of the business, which will be determined by its size, the sector in which it is active and the nature of the SME business.²¹ Similarly, Barclays said that any pricing analysis needed to also take into account differences in quality of service.²² Appendix 7.5 looks at data on quality of service, and differences in quality of service will need to be borne in mind when considering any price differences. We do not consider that the value to consumers of quality of service differences can be calculated with sufficient accuracy to calculate prices adjusted for quality of service. Therefore, the results of pricing and quality of service comparisons will need to be considered together.

¹⁷ *ibid*, p7.

¹⁸ [RBSG response to updated issues statement](#), section 3.1.3.

¹⁹ [RBSG response to provisional findings](#), p7.

²⁰ See Appendix 7.5.

²¹ [RBSG response to updated issues statement](#), section 3.2.2 ii) b).

²² [Barclays response to updated issues statement](#), paragraph 4.5.4.

31. Any differences in average prices between providers may have a number of explanations, including growth strategy (an expanding bank may have lower prices because it has more active and fewer inactive customers) and balance sheet strategy.

Annex A: BCA credit interest rates, overdraft charges and customer incentives

Interest rates on credit balances

- As noted in paragraph 6 of the main appendix, some banks offer interest on credit balances. Eight out of 32 tariffs used in our analysis offer interest on in-credit balances. The interest rate (AER) for these eight tariffs varied from 0.05% to 0.28%, see Table 1 below. We were not able to include interest on credit balances in our weighted average prices as we did not have average credit balances for the profiles obtained from the four banks.²³ This means that actual prices for interest paying accounts will be slightly lower than shown in this analysis, for SMEs that have credit balances. This is because the interest paid will offset some of the charges they face. Given that credit interest rates are low, this is unlikely to have a major effect on the overall results.

Table 1: Interest rates offered on credit balances

Bank	Tariff	%						
		Balances <£999	Balances £1,000– £4,999	Balances £5,000– £9,999	Balances £10,000– £24,999	Balances £25,000– £99,999	Balances £100,000– £249,999	Balances >£250,000
RBS	Business Plus	0.05	0.05	0.05	0.05	0.05	0.05	0.05
RBS	Royalties	0.05	0.05	0.05	0.05	0.05	0.05	0.05
NatWest	Business Plus	0.05	0.05	0.05	0.05	0.05	0.05	0.05
NatWest	Advantage	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Santander	Business Current	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Santander	Corporate Current	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Santander	Corporate Current +	0.15	0.15	0.15	0.15	0.15	0.15	0.15
Co-op Bank*	Business Direct Plus	0	0.12	0.15	0.18	0.21	0.25	0.28

Source: Business Moneyfacts.

*New rates and tiers were introduced in July 2015.

Overdrafts

- BCAs may include a facility to apply for arranged overdrafts and this is a significant source of revenue for banks.²⁴ Survey evidence suggests around 43% of SMEs have overdrafts.²⁵ As with PCAs, banks may allow SMEs to make payments even when this would take them beyond their borrowing limit, but such unarranged overdrafts are a less important source of revenue for

²³ Metro does not pay interest on credit balances but offers a reduction in fees for accounts with a balance which stays above £5,000 for the whole month. For accounts which meet this condition, the monthly fee is waived and they are entitled to 50 free day to day transactions. As we do not have credit balances, this waiver has been excluded from our calculations.

²⁴ See Appendix 7.2, Table 5.

²⁵ Charterhouse BBS 2014.

BCAs than PCAs.²⁶ Table 2 shows published prices on overdrafts from Business Moneyfacts.

3. We were not able to include overdrafts in our weighted average prices as published prices for arranged overdrafts are in many cases unavailable (see Table 2).

²⁶ See Appendix 7.2, Table 5.

Table 2: Overdraft charges

	Arranged			Unarranged		
	%pm	%*	Arrangement fee	%pm	%*	Extra fee
Barclays	Negotiable	Negotiable	Negotiable	n/a	29.5%	Negotiable
HSBC	Negotiable	Negotiable	Tiered/varies	1.63%	21.34%	£4 per working day debit balance is over existing formally arranged overdraft or £8 per working day account is overdrawn with no formally arranged overdraft limit in place
Lloyds†	0.88%	10.56%	Negotiable	2.20%	26.4%	£15 per day if overdraft increases by £50 or more
RBS/NatWest	Negotiable	Negotiable	Tiered/varies	n/a	29.5% APR‡	£30 per day capped at £120 per month
Santander	n/a	5% ABR§	1% (subject to minimum charge of £50)	n/a	25% ABR§	Nil
Clydesdale	Negotiable	Negotiable	Negotiable	n/a	33.51%	£25 per day
TSB	0.88%	10.56%	1.5% (Min £100)	2.20%	26.4%	£15 per day if overdraft increases by £50 or more
Metro¶	0.80%	10%	1.75% (Min £50)	1.88%	25%	Nil
Co-op Bank#	Negotiable	Negotiable	Negotiable	1.92%	25.6%	£20 per day if overdraft increases or £20 per month if overdraft occurs
Bol	Negotiable	Negotiable	Tiered/varies	Negotiable	Negotiable	Nil
Danske	Negotiable	Negotiable	Negotiable	Negotiable	Negotiable	Nil
First Trust	Negotiable	Negotiable	Tiered/varies	1.50% (subject to a minimum charge of £2/month)	Base rate plus 12%	Nil
Ulster	Negotiable	Negotiable	Negotiable	n/a	17%	Nil

Source: Business Moneyfacts.

*Effective annual rate unless otherwise specified.

†Rates are for Tracker overdrafts. Base rate overdrafts are individually negotiated and are typically below the Tracker overdraft rate.

‡Annual percentage rate.

§Above base rate.

¶Rates are for overdraft with a limit of up to £25,000. For amounts over £25,000, a fixed or variable margin over the Metro base rate (currently 0.50%) and an arrangement fee of 1.25% of the limit.

#These are the overdraft terms for the Co-op Bank's standard current account, not those of Co-op Bank's other BCAs such as Business Direct.

Incentives offered to new customers

- As illustrated in Table 3 below, banks typically offer incentives to new customers. The impact of such incentives on the average price paid by SMEs depends on how long the customer continues to hold the account with the bank concerned. We have not included such incentives in this analysis. We noted that, in principle, this could be done by calculating total cost over different periods of holding a BCA (eg two years, five years, ten years) but we considered it would make the analysis excessively complex. The exclusion of incentives means that our analysis tends to overstate the relative prices of

banks offering the most generous incentives, such as Clydesdale, RBSG and, in respect of FSB members, Co-op Bank. The exclusion of switching and some other incentives means that our assessment of the difference between each bank's price and the cheapest price (see paragraph 23) tends to understate the savings SMEs could make from switching to the cheapest bank.

Table 3: BCA incentives offered by banks to start-ups and switchers, January 2015

<i>BCA incentives</i>		
<i>Bank</i>	<i>Start-ups* (period with no monthly/standard transaction charges)</i>	<i>Switchers (period with no monthly/standard transaction charges or cash payment)</i>
Barclays	12 months	†
HSBC	18 months‡	6 months§
Lloyds	18 months¶	6 months¶
BoS	18 months	6 months
RBS, NatWest	24 months#	£150–£250~
Santander	12 months★	
Clydesdale	24 months◆	18 months◆
Yorkshire Bank	24 months◆	18 months◆
TSB	18 months	6 months▲
Metro	-	-
Co-op Bank	Special offer to members of FSB*	
Bol	No transaction charges for 12 months and a 50% discount for a further 12 months^	
Danske	12 months◇	6 months□
First Trust	For those with certain loan types, 12 months free banking	
Ulster	24 months	

Source: Data provided by banks (January 2015), supplemented by bank websites.

*Typically businesses in first year of business, setting up their first BCA.

†[⌘]

‡£2 million turnover or below (start-ups with annual turnover above £2 million are offered bespoke terms that are negotiated with their relationship manager and may include a period of free banking).

§Turnover up to £0.5 million (now increased to 12 months). Switchers with turnover of £0.5 million to £2 million may be offered a period of free banking following a discussion with their relationship manager and those with annual turnover above £2 million are offered bespoke terms that are negotiated with their relationship manager and may include a period of free banking.

¶Also offers fee-free overdrafts.

#Up to £1 million turnover. Also offers a fee free overdraft facility of £500 for the first 12 months.

~For customers with turnover of up to £2 million, accounts are credited £150 (or £250 if the customer also switches an overdraft) by the end of the fourth full month after account opening.

★Additional six months if customer has PCA with Santander, or switches to it.

◆Increase to 25 months for start-ups and switchers with effect from 4 May 2015.

▲ Changed from 6 to 18 months effective from 15 June 2015.

*Co-op Bank offers FSB Business Banking Account customers free banking, £25 annual loyalty reward and a fee free overdraft.

^ Except for cash deposits greater than £10,000 per quarter.

■ No free banking offer for switchers, but a three year package for growing businesses.

◇ Extended to 24 months if the business owners/directors have/switch to a PCA with Danske.

□ Extended to 12 months if the business owners/directors have/switch to a PCA with Danske. Also offers 12 months free Business e-Banking (payments module) and no arrangement fees on certain products during the first 12 months.

Annex B: BCA customer profiles

Table 1: Barclays transactional profiles

[✂]

Source: Barclays.

[✂]

Table 2: HSBCG transactional profiles

[✂]

Source: HSBCG.

Table 3: RBS/NatWest transactional profiles*

[✂]

Source: RBSG.

*[✂]

Table 4: Santander transactional profiles

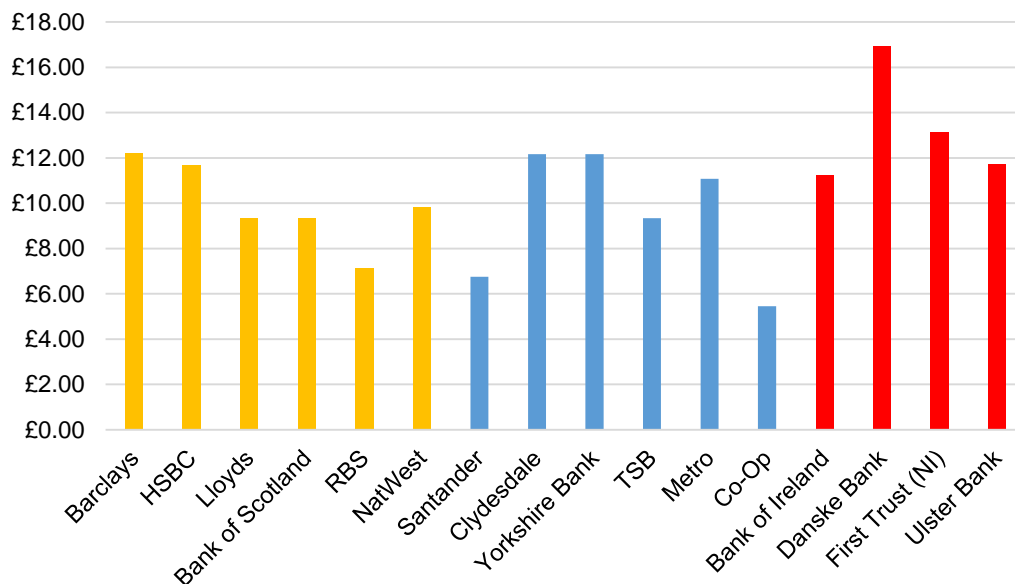
[✂]

Source: Santander.

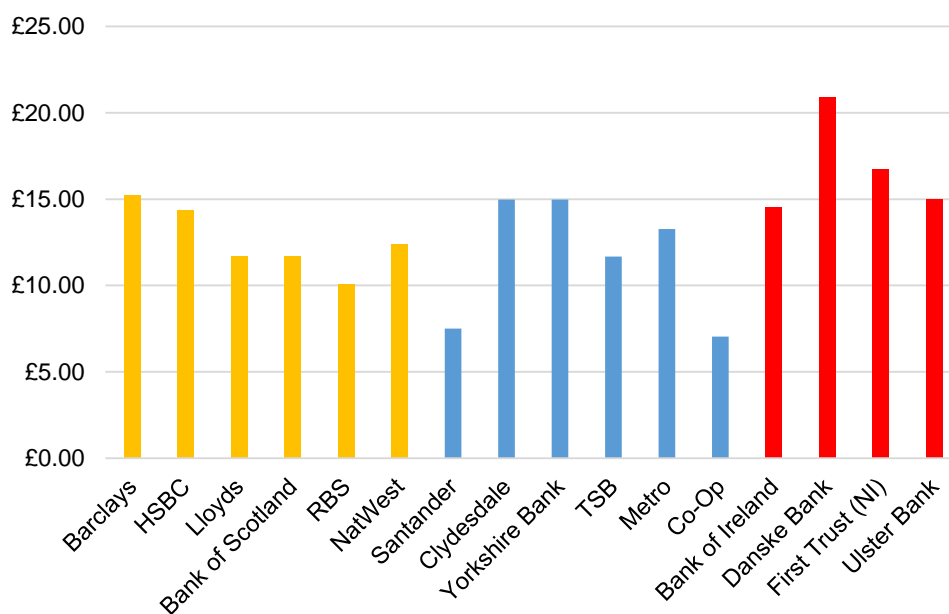
Annex C: Figures by profile for the BCA monthly charge

The figures below are based on the profiles submitted by Barclays (set A).

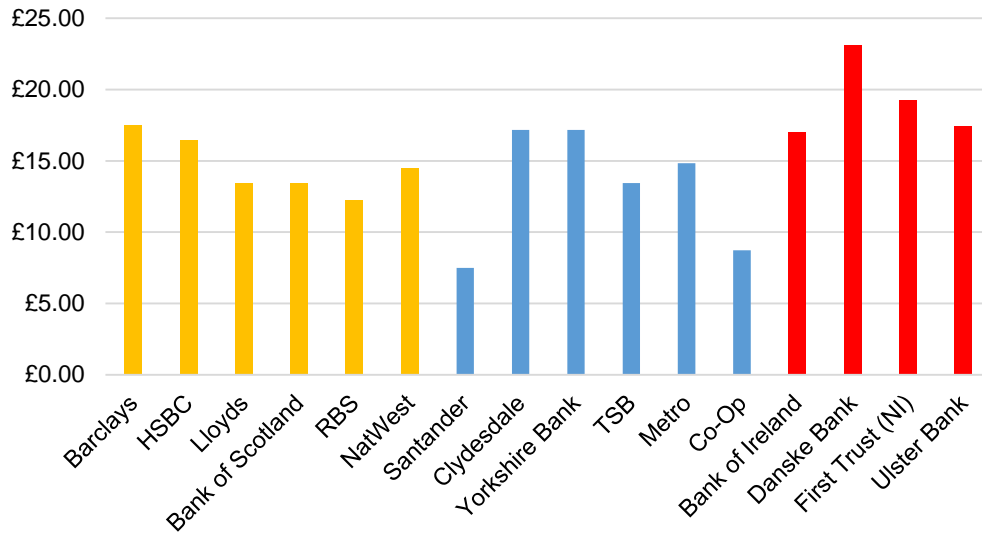
Profile 1



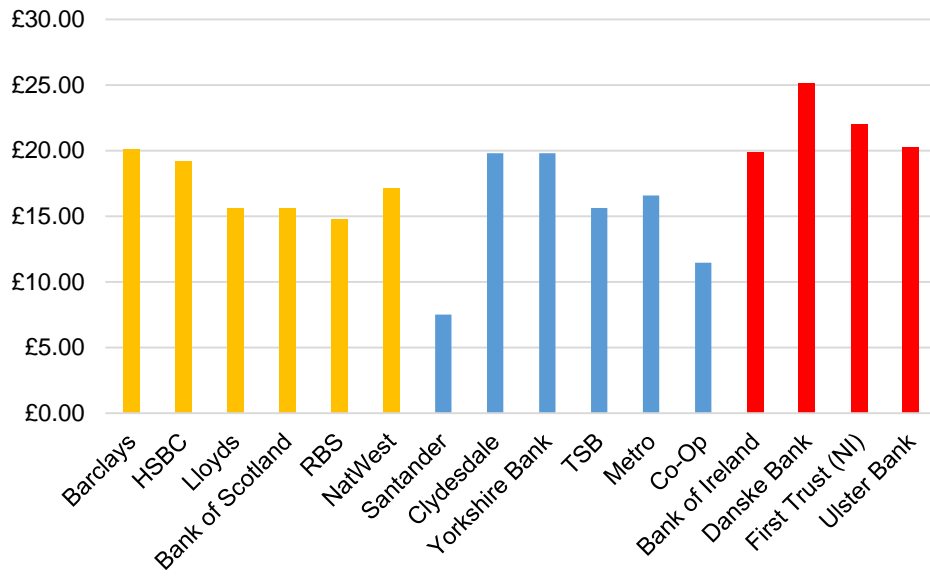
Profile 2



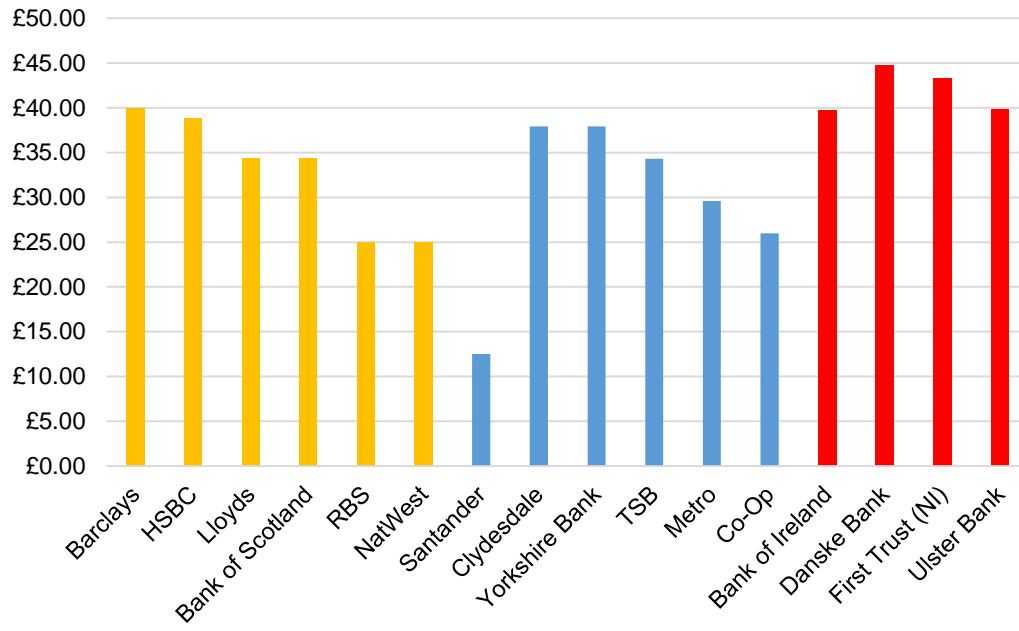
Profile 3



Profile 4



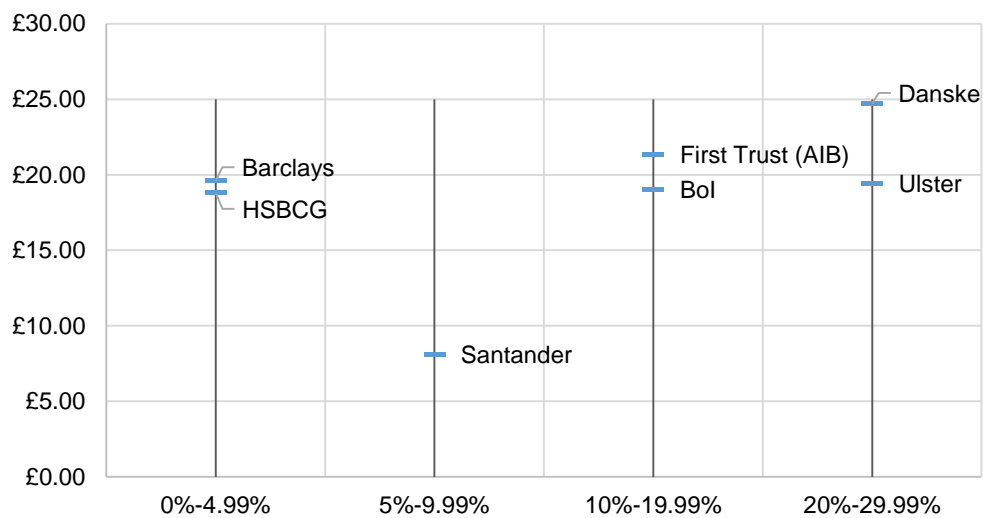
Profile 5



Source: CMA analysis.

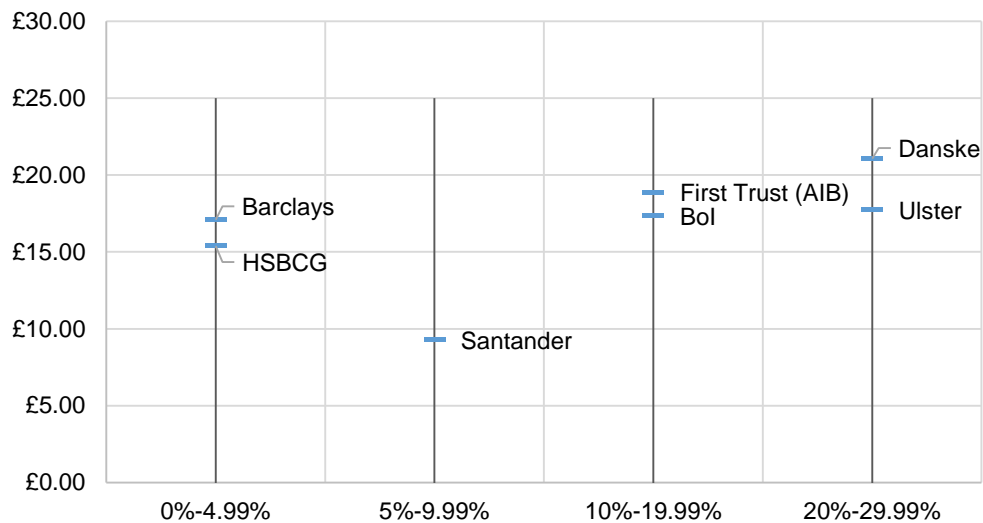
Annex D: Weighted average BCA price in NI

Figure 1: Weighted average monthly BCA price in NI, based on the profiles submitted by Barclays



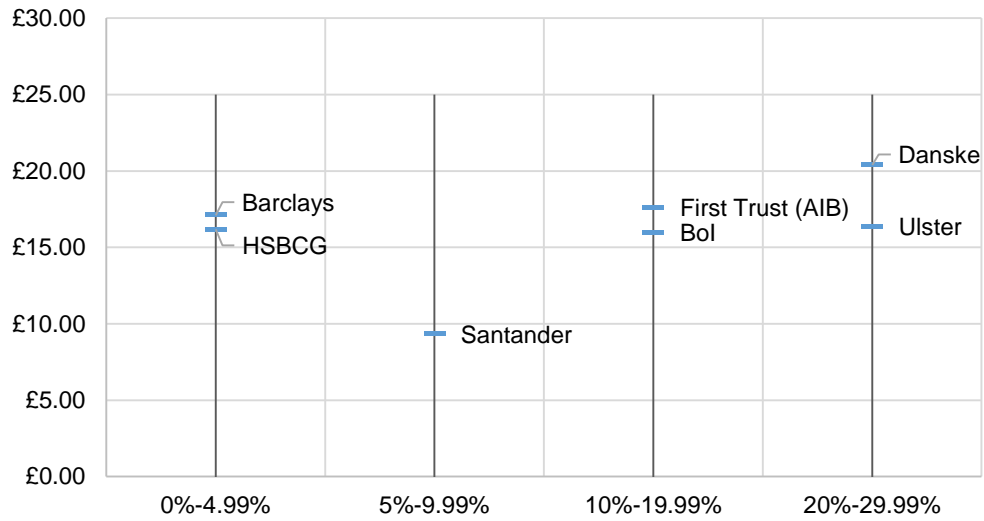
Source: CMA analysis.

Figure 2: Weighted average monthly BCA price in NI, based on the profiles submitted by HSBCG



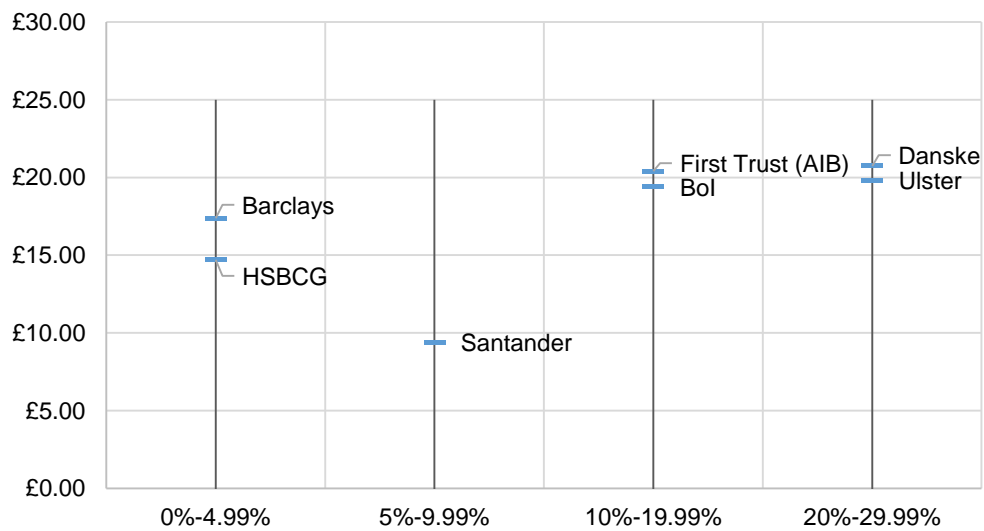
Source: CMA analysis.

Figure 3: Weighted average monthly BCA price in NI, based on the profiles submitted by RBSG



Source: CMA analysis.

Figure 4: Weighted average monthly BCA price in NI, based on the profiles submitted by Santander



Source: CMA analysis.

Appendix 7.5: SME banking quality

Overview

1. This appendix sets out our analysis of the evidence on SME banking quality outcomes.
2. In undertaking these comparisons we have sought to identify (a) whether there is a relationship between market structure and quality outcomes and (b) how and to what extent customers have responded to variations in quality outcomes.
3. According to the Charterhouse BBS, the reason most frequently cited by switchers for selecting their current main banking provider was 'good or better' overall service. The second most frequently cited factor was having access to a convenient/local branch. Similarly, overall poor service and concerns regarding the quality of relationship management were the most frequently cited reasons by switchers for moving away from their previous account.
4. Our approach to assessing the quality of SME banking providers is therefore to use indicators of:
 - overall service quality (such as customer satisfaction and NPS);
 - convenience of branch access (using branch and business centre opening hours); and
 - quality of relationship management (customer satisfaction with relationship managers and proportion of customers with relationship managers).
5. As with the corresponding analysis of PCA service quality (presented in Appendix 5.5), the indicators used here will not act as perfect proxies for the relevant dimensions of quality. Furthermore, the results should be interpreted alongside that of the pricing and revenue work streams, particularly where observed differences in prices reflect differences in quality, and vice versa.
6. A summary of the comparisons by banking group for each indicator is provided in Annex A.

Analysis of overall quality of service

7. Customer experience metrics such as customer satisfaction and advocacy ratings, can be useful indicators of the overall quality of service received by customers.

8. We recognise that there are limitations to the use of these measures as a proxy for quality outcomes, and for this reason the results of such analysis should be interpreted carefully, especially when considering absolute levels of satisfaction. In particular, ratings are likely to reflect customers' expectations of quality, which may be bound by the range of services offered by current market participants. It is also possible that perceived quality does not coincide with the actual quality of the service delivered, for example if the service is not well understood by the customer or due to brand taint effects.¹
9. However customer experience metrics have the benefit over alternatives indicators (such as operational performance measures) of measuring service outcomes as perceived by customers, as opposed to single inputs or components of the overall quality outcome. In this way they will reflect the implicit weighting attached by customers to the various attributes of service.
10. Customer-reported indicators of service quality are also the most appropriate measures to use in assessing the strength of competitive dynamics in the market, and in particular, how customers responded to perceived variations in service quality between banks.
11. We therefore consider customer satisfaction and advocacy measures to be a primary indicator of service quality outcomes, particularly when making comparisons between banks or across geographic markets.

Customer satisfaction

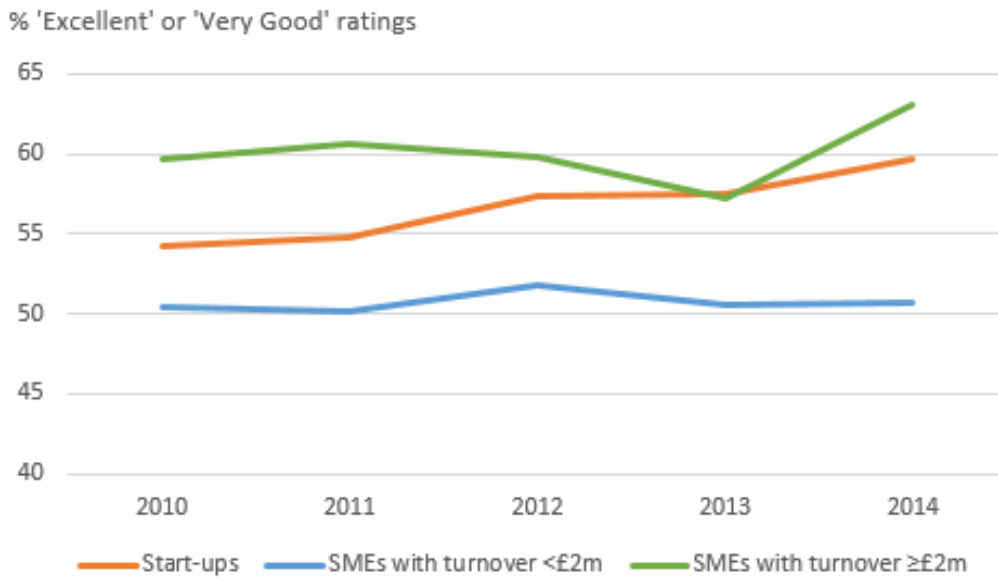
12. Customer satisfaction data is available from the Charterhouse BBS (for GB only) and the Charterhouse NI BBS, in the form of a rating of the overall quality of service over the past year (on a five point scale from 'poor' to 'excellent'). Satisfaction by size of SME, in terms of the proportion of customers reporting 'excellent' or 'very good' ratings is plotted in Figure 1 below.² The following points may be drawn from the chart:

¹ In particular a customer's reported NPS and satisfaction ratings may be impacted by positive or negative publicity surrounding a bank over issues that are not relevant to the provision of the product. For example in its submission on measuring consumer outcomes in retail banking, RBSG notes the divergence in NPS scores received by its NatWest and RBS brands (despite the similarity of their service offerings). RBSG considers this might be a result of the RBS brand being more readily associated by customers with the negative media coverage received by RBSG during and after the financial crisis.

² Respondents to the Charterhouse BBS were asked to select a rating on a five point scale of 'excellent', 'very good', 'good', 'fair' or 'poor'. The analysis presented in this appendix follows the interpretation adopted in the phase 1 market study which considers a rating of 'excellent' or 'very good' to indicate that banks are satisfying their SME customers; a rating of 'fair' or 'poor' as indicating that SMEs are dissatisfied; and a rating of 'good' (ie the midpoint on the five point scale) as neutral.

- (a) Satisfaction appears to be U-shaped over size of customer, with SMEs with annual turnover below £2 million reporting a lower proportion of positive ratings than larger SMEs and start-ups.
- (b) The proportion of positive ratings reported by start-ups over the period has increased by around five percentage points (or 10%) from 2010 to 2014.
- (c) In contrast, satisfaction for SMEs with turnover below £2 million, has remained broadly constant over the period.

Figure 1: Rating of overall quality of service for main bank, by size of SME



Source: Charterhouse BBS.

Notes:

- 1. Data not available for NI.
- 2. Data refer to quality of main banking provider.

- 13. We have undertaken comparisons across banking groups of various quality indicators to examine the strength of customer response to quality variations, and to determine whether there is evidence of a relationship between quality outcomes and concentration.
- 14. Figure 2 plots the proportion of GB customers reporting a positive rating, by banking group in 2014.

Figure 2: Rating of GB overall quality of service of main bank in 2014

[X]

Source: Charterhouse BBS and CMA calculations using data submitted by banks.

[X]

15. We find that the score of the four largest groups is very similar at about [X]. [X] and [X], have similar scores to the four largest groups. The other three banks have higher satisfaction scores, in particular [X]. [X].
16. Equivalent data for SME banking customers in NI is presented in Figure 3 below. Due to small sample sizes for some banks it is not possible to calculate a satisfaction rating for all NI market participants. It is also more difficult to interpret the results of the analysis. Notwithstanding these limitations, the relationship between market share and the indicators of overall service quality appears relatively flat.

Figure 3: Rating of NI overall quality of service of main bank in 2014

[X]

Source: Charterhouse NI BBS and CMA calculations using data submitted by banks.

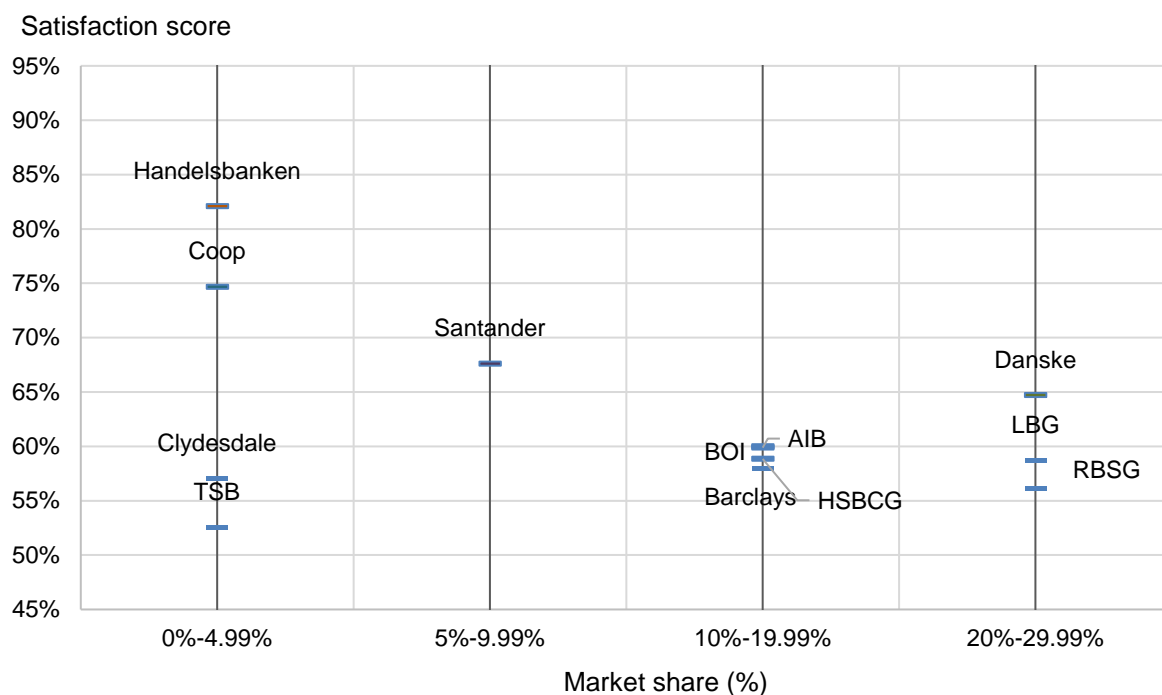
Notes:

[X]

17. The BBI survey provides an alternative indicator of satisfaction. The BBI survey is a biannual telephone survey of BCA-holding SMEs which is sponsored by the FSB and BCC. Respondents to the survey are asked to state their overall satisfaction with their BCA (on a scale of 1 to 10) and also for specific service attributes.
18. While the survey is still in its infancy, (to date results are only available for 2014 and sample sizes are relatively small),³ it is expected to be of increasing utility as additional waves are carried out and the number of surveyed SMEs increases.
19. The BCA satisfaction scores for the 2014 BBI are plotted in Figure 4. There is a strong correspondence between the BBI and Charterhouse BBS satisfaction measures (the coefficient of correlation between the two sets of scores is [X]).

³ In its [response to our provisional findings](#), Barclays said that it was unclear why the CMA chose to use the BBI data rather than other sources given these caveats. We note that we have also used the Charterhouse BBS as a complementary source and the high correlation in satisfaction scores between the two, corroborates the results of the BBI.

Figure 4: Comparison of satisfaction with BCA provider in 2014



Source: BBI 2014 and CMA calculations using data submitted by banks.

Notes:

1. Data for Metro not displayed as sample < 30 respondents.
2. Market shares relate to NI for AIB, BoI and Danske, and GB for all other banking groups.
3. Satisfaction score calculated as weighted average of the overall satisfaction score for each SME size segment.

Willingness to recommend

20. As discussed in the corresponding analysis of PCA quality (see Appendix 5.3), NPS is a customer loyalty metric widely used by banks as part of their quality monitoring process. The metric provides an indication of customer's willingness to recommend their supplier and, whilst not a direct measure of customer experience, may be useful for making comparisons across firms and products.
21. Figure 5 plots the NPS by banking group using the Charterhouse BBS in 2014. The results are broadly similar to those for satisfaction.
22. In general we find that there is little variation in the performance of the four largest banking groups in GB. Some banking groups such as Handelsbanken and Co-op Bank appear to deliver considerably higher levels of satisfaction than the rest of the banks. While Handelsbanken has experienced an increase in market share, which is consistent with customers responding to this variation in service quality, the rate of gain has been relatively low in absolute terms ([✂] since 2012). Furthermore, Co-op Bank in comparison has experienced a slight reduction in market share over the same period.

23. We do not find evidence of a clear relationship between market share and NPS. While we observe that [redacted] and [redacted] (banking groups which each have less than a [redacted]% share of GB active BCAs) receive above average scores, the relationship between satisfaction and market share in the remainder of the sample is relatively flat.
24. The equivalent scores for NI SME banking customers are presented in Figure 6. Due to small sample sizes for some banks it is more difficult to interpret the results of the analysis. Notwithstanding these limitations, the results show that although the largest and smallest banking groups in the sample ([redacted] and [redacted]) receive the [redacted] and [redacted] NPS scores, respectively, once the scores for the other banking groups are taken into account, the relationship between market share and NPS appears relatively flat.

Figure 5: Comparison of GB NPS by banking group in 2014

[redacted]

Source: Charterhouse BBS and CMA calculations using data submitted by banks.

[redacted]

Figure 6: Comparison of NI NPS by banking group in 2015

[redacted]

Source: Charterhouse NI BBS and CMA calculations using data submitted by banks.

[redacted]

Convenient access to branches

25. The results of the Charterhouse BBS show that convenient access to branches is one of the primary factors for SME customers in selecting a new BCA provider.⁴ We have undertaken comparisons of branch and business centre opening hours and weekend access, as an indicator of this dimension of service quality (see Figure 7 and Figure 8). We recognise that the comparison does not take into account customers' travel time to nearest branch, which is an important additional measure of convenience.
26. With regards to average weekly opening hours, we find that the performance of the four largest banking groups in GB is similar. There is more variation in the performance of banks with smaller market shares. For example, whereas the average opening hours of Metro branches is over 70 per week, the equivalent figures for Clydesdale and Co-op Bank are around 40. We

⁴ When asked about the most important reasons for choosing their current main bank, a convenient/local branch accounted for 15% of all responses from SME switchers. As a factor for selecting a new bank, this made it second only to good/better service in 2014.

therefore do not find strong evidence of a clear association between convenience of branch/business centre access and market share.

Figure 7: Comparison of GB average weekly opening hours by banking group in January 2015

[X]

Source: CMA calculations using data submitted by banks.

[X]

27. To evaluate the strength of customer response to variations in convenience of branch access we have considered whether banks with the best comparative performance have experienced growth in market share at the expense of banks with comparatively worse performance.
28. While Metro and Santander, the two banks with above average performance, experienced growth in market share, the size of these gains relative to the size of the market has been relatively limited ([X] and [X] percentage points in 2014). Furthermore, some of the worst performing banks on this metric (BoI and Barclays) also experienced similar rates of growth ([X] and [X] percentage points in 2014).
29. There is more variation in the proportion of branches with weekend opening (see Figure 8). While all of Metro and Co-op Bank branches centres have weekend opening, less than two-thirds of HSBCG and LBG, and less than half of RBSG, Clydesdale and Barclays branches/business centres offer weekend opening.

Figure 8: Comparison of GB proportion of branches with weekend opening by banking group in January 2015

[X]

Source: CMA calculations using data submitted by banks.

[X]

30. An equivalent analysis for NI can be found in Figure 9 and Figure 10. We find that the evidence for an association between market share and convenience of branch access appears mixed. For example, HSBCG and Santander had the highest proportion of branches/business centres with weekend opening (around 100% and 77% respectively). However, Barclays (the smallest banking group in NI) offered weekend opening at only 13% of its branches/business centres. This compares to over [X]% of branches for the two largest banking groups ([X] and [X]). Average weekly opening hours appear to be similar across all banking groups (between 33 and 43 hours per week), regardless of market share.

Figure 9: Comparison of NI average weekly opening hours by banking group in January 2015

[REDACTED]

Source: CMA calculations using data submitted by banks.

[REDACTED]

Figure 10: Comparison of NI proportion of branches with weekend opening by banking group in January 2015

[REDACTED]

Source: CMA calculations using data submitted by banks.

[REDACTED]

Quality of relationship management

31. The results of the Charterhouse BBS show that concerns with the quality of relationship management service are one of the primary reasons cited by SME switchers for moving away from their previous BCA provider. Measures of the provision of and satisfaction with this service are therefore important indicators of the quality of SME banking provision.
32. Figure 11 and Figure 12 plot a comparison, by size of SME, of relationship management coverage for BCA customers. The following points emerge from these charts:
 - (a) For SMEs with annual turnover below £2 million, the relationship between relationship management and market share is ambiguous. While [REDACTED] has an above average proportion of relationship managed customers, the opposite is true for [REDACTED],⁵ and [REDACTED] does not offer a face-to-face relationship management service to any customers.
 - (b) The proportion of customers with a relationship manager is close to 100% across all banks for SMEs with an annual turnover of or above £2 million, with the exception of [REDACTED].⁶
33. We recognise the difficulties in interpreting such comparisons as observed differences between banks reflect differences in the customer base of the banks. For example, banks with a higher proportion of smaller SME customers (and therefore with less complex needs) may have lower rates of relationship management. Differences in the definition of a relationship manager, and the number of customers each relationship manager is assigned, also limit our ability to compare between banks.

⁵ [REDACTED]

⁶ [REDACTED]

Figure 11: Proportion of GB BCA customers (annual turnover below £2 million) with relationship manager

[✂]

Source: CMA calculations using data submitted by banks.

[✂]

Figure 12: Proportion of GB BCA customers (annual turnover of or above £2 million) with relationship manager

[✂]

Source: CMA calculations using data submitted by banks.

[✂]

34. Figure 13 and Figure 14 plot the corresponding comparisons for NI BCAs. Similar to the GB analysis, the relationship between market share and relationship management coverage is ambiguous for SMEs with turnover below £2 million. The provision of relationship management to larger SMEs is universal for all banking groups except [✂] and [✂].

Figure 13: Proportion of NI BCA customers (annual turnover below £2 million) with relationship manager

[✂]

Source: CMA calculations using data submitted by banks.

[✂]

Figure 14: Proportion of NI BCA customers (annual turnover of or above £2 million) with relationship manager

[✂]

Source: CMA calculations using data submitted by banks.

[✂]

35. Figure 15 below plots GB customers' reported satisfaction with their relationship manager in the form of a rating on a five point scale from 'excellent' to 'poor'. As with relationship manager coverage, we do not see any clear association between market share and satisfaction with relationship managers.

Figure 15: GB satisfaction with relationship manager in 2014

[✂]

Source: Charterhouse BBS and CMA calculations using data submitted by banks.

[✂]

36. An equivalent analysis for NI SME banking customers is presented in Figure 16. Whilst an inverse relationship between the quality of relationship management and size of banking provider is more apparent in the NI ratings, the reduced number of banking groups for which data is available means we must be more cautious in inferring such a result. We also note that even

within our sample, [X] receives higher satisfaction ratings than a simple inverse relationship between market share and satisfaction would suggest.

Figure 16: NI satisfaction with relationship manager in 2015

[X]

Source: Charterhouse NI BBS and CMA calculations using data submitted by banks.

[X]

Strength of customer response

37. To examine the strength of customer response to variations in quality we have compared customer satisfaction ratings and NPS for each banking group against the respective change in market share (see Figures 17, 18 and 19).
38. On the basis of this analysis it is not clear that SME customers are responding to variations in the quality of service provided. For example we find that a number of banks with below average satisfaction and/or negative NPS scores (such as [X] and [X]) have increased their market share. At the same time [X] has experienced a slight reduction in market share despite achieving positive and above average satisfaction scores.
39. Although there are banks with above average performance that have experienced an increase in market share (ie [X] and [X]) the strength of this customer response appears low, with the size of the gains limited to less than [X] percentage points.

Figure 17: Comparison of NPS and change in market share in 2014

[X]

Source: Charterhouse BBS, Charterhouse NI BBS, and CMA calculations using data submitted by banks.

[X]

Figure 18: Comparison of BBI satisfaction ratings and change in market share in 2014

[X]

Source: BBI survey and CMA calculations using data submitted by banks.

[X]

Figure 19: Comparison of Charterhouse BBS satisfaction ratings and change in market share in 2014

[X]

Source: Charterhouse BBS, Charterhouse NI BBS, and CMA calculations using data submitted by banks.

[X]

Annex A: Comparison of quality indicators by bank

Service attribute	Overall quality of service			Convenience of location and opening times of branches		Quality of relationship management		
Quality indicator	Positive ratings % Charterhouse BBS	Satisfaction % BBI	NPS Charterhouse BBS	Weekend opening (% business centres & branches offering business services)	Opening hours (average per week)	Relationship manager coverage (SMEs <£2m)	Relationship manager coverage % (SMEs ≥£2m)	Positive ratings % Charterhouse BBS
AIB	[X]	60	[X]	0	34	[X]	[X]	[X]
Barclays	[X]	58	[X]	36	36	[X]	[X]	[X]
Bol	[X]	60	[X]	0	35	[X]	[X]	[X]
Clydesdale	[X]	57	[X]	41	41	[X]	[X]	[X]
Co-op Bank	[X]	75	[X]	100	41	[X]	[X]	[X]
Danske	[X]	65	[X]	48	37	[X]	[X]	[X]
Handelsbanken	[X]	82	[X]	n/a	n/a	[X]	[X]	[X]
HSBCG	[X]	59	[X]	61	39	[X]	[X]	[X]
LBG	[X]	59	[X]	61	40	[X]	[X]	[X]
Metro	[X]	n/a	[X]	100	76	[X]	[X]	[X]
RBSG	[X]	56	[X]	49	42	[X]	[X]	[X]
Santander	[X]	68	[X]	74	44	[X]	[X]	[X]
TSB	[X]	53	[X]	n/a	n/a	[X]	[X]	[X]

Source: CMA calculations using (1) Charterhouse BBS/NI BBS, (2) BBI survey 2014, and (3) data submitted by banks.

[X]

Appendix 7.6: Innovation in SME banking

Overview

1. In this appendix, we consider the following types of innovation in the SME banking markets in the UK:¹
 - (a) product innovation;
 - (b) service innovation (including the use of new or enhanced distribution models, such as mobile banking); and
 - (c) new business models.^{2,3}
2. We explain how and why the type and scale of innovation is a useful indicator of the level of competition in the market when considering innovation in the PCA market. See Appendix 5.6 for further information. This is also relevant in relation to the SME banking market.
3. We have considered a number of innovations referred to in this appendix when assessing innovation in the PCA market (see Appendix 5.4). Where this is the case, we do not provide a detailed explanation of these innovations here, and instead, focus solely on their impact on the SME banking market.

Product innovation

4. Recent product development in the PCA market has primarily taken the form of rewards accounts. There does not appear to have been a similar level of product innovation in the SME banking market, where recent activity has reflected price competition rather than product innovation. For example:
 - (a) All of the largest banks in the UK (ie Barclays, HSBCG, LBG, RBSG and Santander) offer free banking⁴ to start-ups for a limited period, and some of the banks also offer switchers free banking for a limited period. They also run short-term campaigns or offers, whereby they extend the period

¹ To the extent that there are any differences relating to specific innovations in the geographic markets across the UK, we will consider the implications of this when assessing the impact of any such innovations on the retail banking market.

² We do not consider directly the extent of any innovation in operational processes, but note that the use of new or enhanced distribution models, particularly where this is based on the increasing digitalisation of banking, is likely to lead to cost efficiencies.

³ We also consider, where relevant, the implications for the UK market of international innovations in retail banking, with reference to the [Deloitte innovation report](#).

⁴ Free banking typically means that eligible customers are not charged for standard transactions (eg most payments and receipts, as well as automated transactions through telephone and internet banking, cheque transactions, cash handling and paper or online statement services), but charges can apply for non-standard transactions (eg returned/stopped cheques, international payments and duplicate statements).

of free banking, in order to attract new customers. For example, HSBCG told us that switchers with annual turnover above £500,000 but no greater than £2 million may be offered a period of free banking following a discussion with their Relationship Manager, but, for a period of three months between September and November 2014, Relationship Managers were given greater autonomy and the ability to approve free banking of up to six months for switchers.

The prevalence of the free banking offer reflects both the importance that SMEs attach to it when considering their choice of BCA provider (eg the Charterhouse follow-up surveys found that the most important factor for start-ups when choosing their BCA was the offer of free banking);⁵ and the high level of customer turnover within SME banking and the need to recruit new customers to maintain account volumes (eg HSBCG told us that [redacted] customers in its Business Banking portfolio-managed segment⁶ [redacted] and the average length of a portfolio-managed relationship was [redacted]).

- (b) A number of banks have recently introduced BCA tariffs that reflect the increasing use of digital banking channels by SMEs. For example:
- (i) HSBCG's eBanking Tariff is available to business customers with a turnover up to £500,000 and is designed for customers with simpler banking needs, who predominantly conduct their banking via remote channels. HSBCG told us that the introduction of the eBanking Tariff was triggered by its monitoring of competitor and new entrant offerings by Santander, Metro and Handelsbanken.
 - (ii) Barclays' e-Payments Plan is designed for businesses that receive electronic payments and make payments mainly through online banking and debit cards. The e-Payments Plan offers a loyalty reward, where the customer is paid back a percentage of their monthly current account charges based on the length of their relationship with Barclays and level of credit turnover.

5. Innovation in other SME banking product areas tends to take the form of cashback and the waiving of fees. For example:

- (a) HSBCG currently waives the annual fee of £32 for the first year that a customer holds a commercial credit card.

⁵ See [Charterhouse follow-up survey](#), p7.

⁶ [redacted]

- (b) LBG's [redacted]⁷ offers to waive switchers' arrangement fees and standard security fees when they acquire invoice financing products. Since December 2014, LBG's [redacted]⁸ has waived switchers' lending arrangement and security fees associated with new term loans and overdrafts, and for new and existing business customers signing up for new term loans, LBG frequently provides special waived arrangement fee offers, in addition to an interest rate discount for the full term of the loan.

Service innovation

Internet banking

6. Internet banking functionality has been offered by the established banks in the UK for some time. Increasing customer access to broadband and high-speed connections, coupled with an increased uptake in the general use of the internet, has resulted in the development of internet banking into a significant distribution channel.
7. We consider below the impact of the development of internet banking and the wider digitalisation of banking in the context of the increasing adoption of mobile banking.

Mobile banking

8. Mobile banking was first developed in the PCA market and then expanded into SME banking. The channel has grown considerably in recent years. For example:
- (a) LBG told us that its SME banking customers who used mobile banking logged in to their mobile banking application around [redacted] times per month, compared to [redacted] times per month by customers logging into internet banking using a desktop.
- (b) Santander told us that, for Business Banking customers during 2014, there was a steady adoption of online banking, with [redacted]% growth, but there was a more dramatic uplift in its mobile channel, with users increasing [redacted] in a year and an increase of more than [redacted] in mobile transactions.
9. However, the adoption of mobile banking in the SME banking market has not yet reach the levels observed in the PCA market. For example, LBG launched

⁷ [redacted]
⁸ [redacted]

its mobile banking service for business customers in March 2014, and it currently attracts [x] % to [x] % of its SME internet banking base. LBG told us that it expected the service to follow a similar path to personal banking, albeit with the shift to mobile being at a slightly slower pace, reflecting different customer demographics and needs.

10. Table 1 compares the functionality of the BCA banking applications of a selection of UK banks, and suggests that, while providing similar basic services, there is some differentiation in the applications of the main banks. Most banks offer separate applications for PCAs and BCAs, but some (eg Barclays) offer a dual application, which allows users to access both their PCA and their BCA in the same place. Some banks (eg TSB) do not currently offer a mobile banking application for their BCA customers.

Table 1: Functionality of BCA mobile banking applications as at June 2015

	<i>Check balance</i>	<i>Make payment to new recipient</i>	<i>Send money to a mobile number (Paym)</i>	<i>Branch/ATM locator</i>	<i>Touch ID support</i>
Lloyds, Halifax and BoS	Yes	Yes		Yes	No
NatWest/RBS	Yes	No	Yes – have to be NatWest customer	Yes	Yes
Barclays	Yes	No	Yes (via Pingit)	Yes	No
Nationwide	Yes	No		Yes	No
HSBC	Yes	No	No – only receive payments	Yes	No
Santander	Yes	No	No – only receive payments	Yes	No
Metro	Yes	No		No	Yes

Source: [Deloitte innovation report](#).

11. The take-up of digital banking in the SME banking market is reflected in the decline in the branch as the main channel for a significant proportion of SMEs – according to survey data from Charterhouse, the proportion of SMEs reporting to use branches as their main banking channel has fallen every year over the past four years, decreasing from 41% of SMEs in 2010 to 26% in 2014. Nevertheless, for some SME customers, branches remain important for paying in cash or cheques, despite the rise in digital banking and electronic forms of payment, and for banks, branches remain an important channel for customer acquisition and retention.
12. As mobile banking adoption is largely driven by smartphone adoption, which is greater among the younger population, this suggests that both smartphone and mobile banking adoption is likely to increase over time. Increased mobile banking adoption is likely to be further enhanced by the greater functionality and broader integration of banking services within the mobile application. However, given the pattern of mobile banking development to date, it is likely that any such innovation and the resulting increase in mobile banking adoption will first take place in the PCA market and then be observed in the SME banking market at a later date.

13. Therefore, as is the case in the PCA market, digital banking has not replaced traditional forms of banking, and instead, a multi-distribution banking model, combining both digital and traditional channels, is now present.

Other digital innovations

14. The increasing digitalisation of banking, and particularly the rising adoption of mobile banking, has led to other service innovations in the SME banking market. However, many of these innovations, such as Paym; cheque imaging; video banking; and online account opening, have first been initiated in personal banking and then developed later in the SME banking market.
15. One innovation that has particularly benefited SME banking customers is the pre-assessment of lending limits to customers. This allows customers to quickly and easily see, through their online banking account, the amount of borrowing available to them without having to go through a more traditional lending application process. For example, since the end of 2013, a significant proportion of business customers managed by Barclays' small business segment have been able to see, via online banking, the amount of unsecured borrowing Barclays has pre-assessed to extend to them (initially up to £25,000 and rising to £50,000 by the end of 2015); select whether this is in the form of an overdraft limit or loan; and then quickly access these funds (usually within 24 hours). Barclays told us that whilst this new service was principally driven through customer feedback, it was also the result of competitive pressure both from new lending platforms and from competitor banks.

Aggregators

16. The use of account aggregation services in connection with SME banking in the UK is limited. See Section 8 for further information.
17. There has been a greater development in other countries:
 - (a) Commonwealth Bank in Australia recently launched Daily IQ, a first-of-its-kind mobile application that gives its business customers access to insights about their cash flow, sales and the market they operate in, presented in easy to understand visuals to enable business owners to better understand the financials of their business.
 - (b) A similar service is provided by Xero's mobile app, which had obtained 80,000 customers in New Zealand as at 2013. However, in contrast to Daily IQ, the service is not provided by a bank, but rather by an established provider of accounting software. This service is more focused

on business accounting and enables SMEs to manage their business accounts from a mobile, reconcile data from different sources, manage invoices online and obtain a real-time view of their cash flow. Xero can also serve as a platform for other applications, including tools for additional analysis of transaction data.⁹

- (c) Bode Tree, a US company, provides specific financial services, such as forecasting, access to a network of banks and alternative bank lenders, on top of general account aggregation.¹⁰

Big data

18. When considering the uses of big data in the PCA market (see Appendix 5.4), we found that finance providers could make use of data from a wider variety of sources, in order to assess potential borrowers and the risks of default associated with loans. This could be particularly relevant to the SME banking market, where new entrants could use big data to reduce the informational asymmetry between them and the established banks, which could potentially facilitate new entry into SME lending, thereby improving customer access to credit.
19. Although lending to SMEs is generally based on traditional credit assessment checks, there are international examples of the use of big data in this area, particularly by non-banks. For example, Kabbage, an SME lender with operations in both the UK and the USA,¹¹ applies 'big data' analysis techniques to data from both social media pages and online market places, such as eBay, to determine the credit score of a small business.¹² Similarly, LendingClub and ZestFinance, both US financial technology start-ups, are also building their businesses on credit assessment that depend on big data.¹³

New business models

20. The rise of digital banks underlines the importance of technological innovation in facilitating entry into the market. However, some of the digital-only banks still provide counter services to their customers through agency banking relationships; Inter-Bank Agency Agreements; use of the Post Office network; and/or cash collection and delivery services agreements. Further, the entry of banks with more traditional distribution models, such as Metro, suggest that

⁹ See [Deloitte innovation report](#), p42.

¹⁰ *ibid*, p76.

¹¹ Kabbage launched in the UK in 2013 and remains relatively small scale. In the USA, where it has operated since 2009, it was lending \$1 billion per annum within four years of launch.

¹² See [Deloitte innovation report](#), p52.

¹³ *ibid*, p53.

branch-based banking has not been fully replaced by digital banking, and is unlikely to be in the short to medium term. Please see Section 9 for further information on recent entry and expansion in the SME banking market.

Entry by firms with ancillary financial services products

21. In contrast to the PCA market, where a number of firms with an established presence in retail and other areas have recently entered (eg the Post Office,¹⁴ M&S Bank¹⁵ and Tesco Bank), there has not been any similar type of entry into the BCA market.

Online entry

22. A number of prospective entrants are planning to enter the SME banking market with innovative business models, perhaps most notably with no (or very limited) branch presence and adoption of the latest technology:
- (a) Atom was authorised in June 2015 as the UK's first full-service digital-only bank, and will serve both personal and SME customers. Atom launched its first products (savings) in April 2016.
 - (b) On 7 June 2016 CivilisedBank submitted its banking licence application. It believes that advances in IT and changes to the authorisation process have created an opportunity for it to make a successful entrance into the market. It told us that it intends to bring back a 'traditional, relationship-led' style of banking for SMEs, led by highly autonomous Relationship Managers. CivilisedBank plans to offer a BCA (with overdraft facility), asset-based lending and other loan products, and potentially invoice discounting subject to customer demand. It does not plan to have a formal physical presence, except for some offices that Relationship Managers may use if and when required. Its model will rely upon Relationship Managers travelling to visit customers from regional hubs.
 - (c) OakNorth initially plans to offer short-term business loans (between two and twelve months) and property development finance. Its distribution model will be a hybrid of financial technology alternative finance provider and traditional banking services.

¹⁴ The Post Office offers retail banking services under Bol's banking licence.

¹⁵ M&S Bank is a wholly owned subsidiary of HSBCG.

Alternative finance

23. In addition to online entry, the global financial crisis and resulting de-risking of balance sheets undertaken by the largest UK banks coincided with the growth of the alternative finance market. According to recent research, the alternative finance market in the UK, which includes crowdfunding¹⁶ and peer-to-peer lending,¹⁷ is substantially more advanced than the rest of Europe and growing.
24. However, awareness and interest in alternative finance among UK SMEs is currently low (see Appendix 8.2) Further, alternative finance remains a very small part of the SME lending market in the UK (eg in 2014, alternative finance accounted for less than 2% of bank-led funding).¹⁸

Bank in a Box

25. When considering the impact of Bank in a Box (BiaB) technology on the PCA market (see Appendix 5.4), there were a number of instances of banks entering and planning to enter both the personal and SME banking markets on BiaB platforms (eg Metro, Lintel Bank and Fidor).
26. A further example of effective use of BiaB technology, but solely in the SME banking market, is Holvi, a Finnish online bank, which entered SME banking in 2011, targeting small businesses and entrepreneurs. Holvi's aim was to simplify banking services for sole traders, for which current banking systems were not well suited and often resulted in lost revenues and business, as it took considerable time to open a bank account. Instead of building its own banking infrastructure, Holvi focused on building the customer interface and used partnerships for other functions. The transaction banking infrastructure and the APIs required to connect the front end to the customer interface are provided by Nordea, while GB Group, an identity intelligence specialist, provides document verification services to support the boarding process. As a result, sole traders and small SMEs can open an account with Holvi in under a minute without having to go to a branch with documents.¹⁹
27. It is not just new entrants that can benefit from lower cost IT solutions. For example, [X]. [X] told us that it recognised the need to invest significantly in

¹⁶ Crowdfunding is the practice of funding a project or venture by raising monetary contributions from a large number of people, typically via the internet.

¹⁷ Peer-to-peer lending is the lending of money to unrelated individuals without the use of a traditional financial intermediary, such as a bank.

¹⁸ BBB, *Small Business Finance Markets 2014*, p53.

¹⁹ See [Deloitte innovation report](#), p67.

its digital capabilities and systems, in order to give it the necessary agility to compete with smaller banks, new entrants and non-bank providers.

Digital wallets

28. Digital wallets do not currently represent a complete substitute for PCAs or BCAs, because they require customers to have an underlying payment vehicle, which is often a current account. However, digital wallets do appear to be allowing non-banks to provide some financial services to SMEs that are traditionally provided by banks. For example:
- (a) In June 2010, Alibaba launched Alipay Financial, a microcredit company based in Hangzhou, to offer loans to existing SME users of its e-commerce services. Within the first two years of launch, Alipay Financial had made loans worth RMB13 billion (\$2.09 billion).²⁰
 - (b) PayPal, through its Working Capital service, which was launched in 2013, provides cash in advance to businesses based on PayPal payments history. Since 2013, it has provided more than \$500 million in capital, and as at 31 December, the outstanding balance of merchant loans was approximately \$99 million.²¹
 - (c) Amazon Lending was launched on 1 July 2015 in the UK. It has been in operation in the USA since 2011, and has lent approximately \$1 billion of capital to tens of thousands of small US traders.²²

²⁰ *ibid*, p74.

²¹ *ibid*, p74.

²² *ibid*, p74.

Appendix 8.1: BCAs – further evidence

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Introduction

1. This appendix provides supporting evidence for Section 8. It covers the following topics:
 - (a) Sources of evidence.
 - (b) Background information on SMEs.
 - (c) Transparency and comparability.
 - (d) Levels of customer engagement.
 - (e) Motivations for switching.
 - (f) Barriers to switching.
 - (g) Developments in pricing and quality of BCAs.
 - (h) Customer acquisition strategies and cross-selling.

Sources of evidence

2. Throughout Section 8 we use a number of different sources, primarily:
 - (a) Charterhouse BBS (including Charterhouse NI BBS in 2015).
 - (b) Charterhouse follow-up surveys covering:

- (i) Finance.
 - (ii) Start-ups.
 - (iii) Two- to five-year old business.
- (c) SME Finance Monitor.
- (d) The HSBCG survey 2014 and HSBCG survey 2015.
- (e) Research Works qualitative research for CMA.
- (f) Optimisa qualitative survey for FCA.
3. The main source of quantitative research we used was the Charterhouse BBS and follow-up surveys. These surveys provide a number of insights into SME behaviour. The Charterhouse BBS is a robust large continuous telephone survey which is drawn from a representative sample of the SME population using BCAs. The survey is weighted by turnover rather than employee numbers, which is in line with how banks segment their customers. We report figures from both the Charterhouse BBS (which covers GB) and the Charterhouse NI BBS (where sample sizes allow).¹
 4. The Charterhouse follow-up surveys are much smaller telephone surveys, but cover specific areas of interest. Results of these surveys are representative of the UK,² and can be found on the [CMA webpages](#).
 5. The SME Finance Monitor is a large continuous telephone survey run by BDRC Continental, mainly focused on access to finance issues. Where we have results from both the SME Finance Monitor and Charterhouse BBS we have tended to use the Charterhouse BBS, partly because it samples from SMEs using BCAs, rather than the population of all SMEs, and also because it is weighted by turnover, rather than employee numbers (as is the case with the SME Finance Monitor). This results in the SME Finance Monitor having a much larger proportion of small businesses (particularly sole traders), with some not using SME banking products. Appendix 8.2 expands on the comparisons between Charterhouse BBS and the SME Finance Monitor.
 6. HSBCG has commissioned two surveys, the HSBCG 2014 survey³ and the HSBCG 2015 survey,⁴ both conducted by BDRC Continental. Both these surveys provided helpful insights into SME behaviour. However, we have

¹ [X]

² Due to the small number of interviews in NI we do not analyse NI and GB separately.

³ This was commissioned during the CMA and FCA market study into banking services to SMEs.

⁴ This was commissioned during this market investigation.

concerns about the sampling and methodology used as both are sampled from online panels. This is likely to result in a biased sample, especially where questions about the degree of digital engagement are concerned. While we recognise that internet penetration may be high among SMEs, we also note that the types of individuals that take part in online panels tend to be different from the average internet user. Therefore, where we refer to these surveys, we note the insight they bring but do not place undue weight on the findings. Where the results contradict Charterhouse BBS we place more weight on the Charterhouse BBS results.

Background information on SMEs

7. Demand for SME banking services is affected by the demographics of the SME population. For instance microbusinesses tend to have simpler banking needs than larger SMEs who may trade from more than one site and even internationally. This section describes recent trends in SMEs across the UK, including growth of SMEs, changes in the proportion of different SMEs, and entry and exit.
8. The terms of reference for the market investigation defines an SME as a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) not exceeding £25 million.
9. There are several alternative definitions of SMEs that are commonly used. Most commonly, an SME is defined as a business with 250 employees or fewer.⁵ The Companies Act 2006⁶ defines a business as an SME if two or more of the following requirements are satisfied, in both the current and preceding financial year:
 - (a) Number of employees – not more than 250 employees.
 - (b) Turnover – not more than £25.9 million net (or £31.1 million gross).
 - (c) Balance sheet total – not more than £12.9 million net (or £15.5 million gross).⁷

⁵ National statistics from ONS and BIS tend to use this definition.

⁶ See [section 465, Companies Act 2006](#).

⁷ The European Commission (under [Recommendation 2003/361/EC](#)) defines SMEs as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million.

10. SMEs currently account for over 99% of all businesses and produce 47% of all UK turnover (see Table 1).⁸

Table 1: Number of businesses in the UK private sector and their associated employment and turnover by size of business, start of 2015

	<i>Businesses</i>	<i>Employment (000s)</i>	<i>Turnover*(£)</i>
All businesses	5,389,450	25,871	3,710,278
SMEs (0–249 employees)	5,382,485	15,611	1,753,870
<i>Of which</i>			
With no employees†	4,077,590	4,451	237,190
1–9	1,068,815	4,010	435,624
10–49	203,525	3,967	543,058
50–249	32,555	3,183	537,997

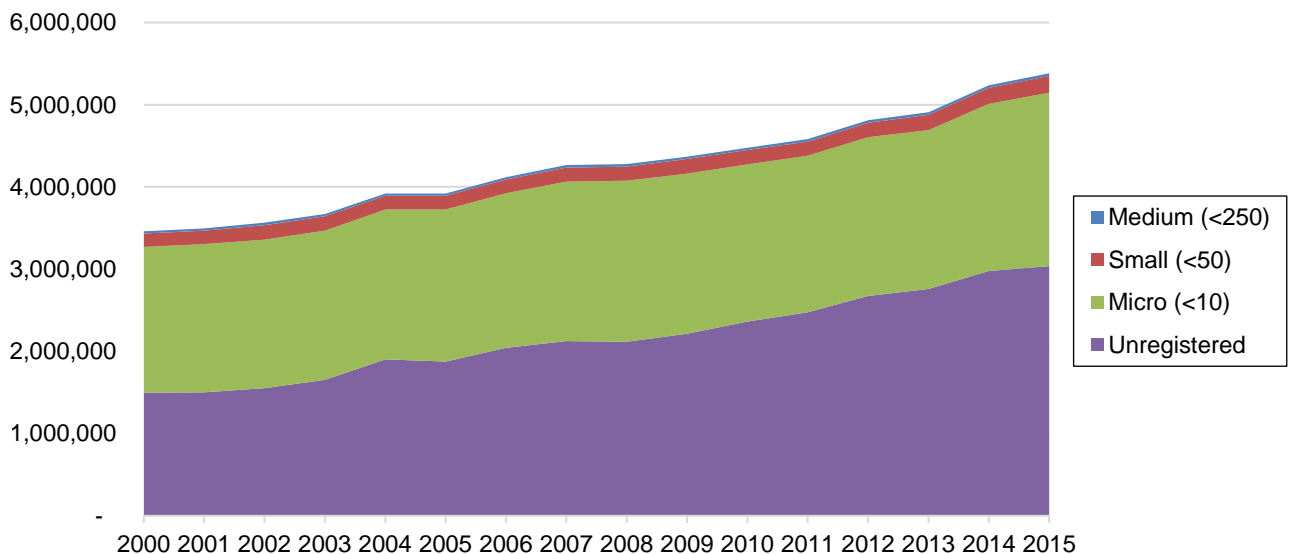
Source: Business Population estimates 2015, BIS.

*Total turnover figures exclude Section K (financial and insurance activities) where turnover is not available on a comparable basis.

†'With no employees' comprises sole proprietorships and partnerships comprising only the self-employed owner-manager(s), and companies comprising only an employee director.

11. Since the recession in 2008 there has been a rise in the number of SMEs, up from approximately 4.3 million in 2008 to 5.4 million in 2015.

Figure 1: Growth in SMEs by employee numbers (UK), 2000–2014

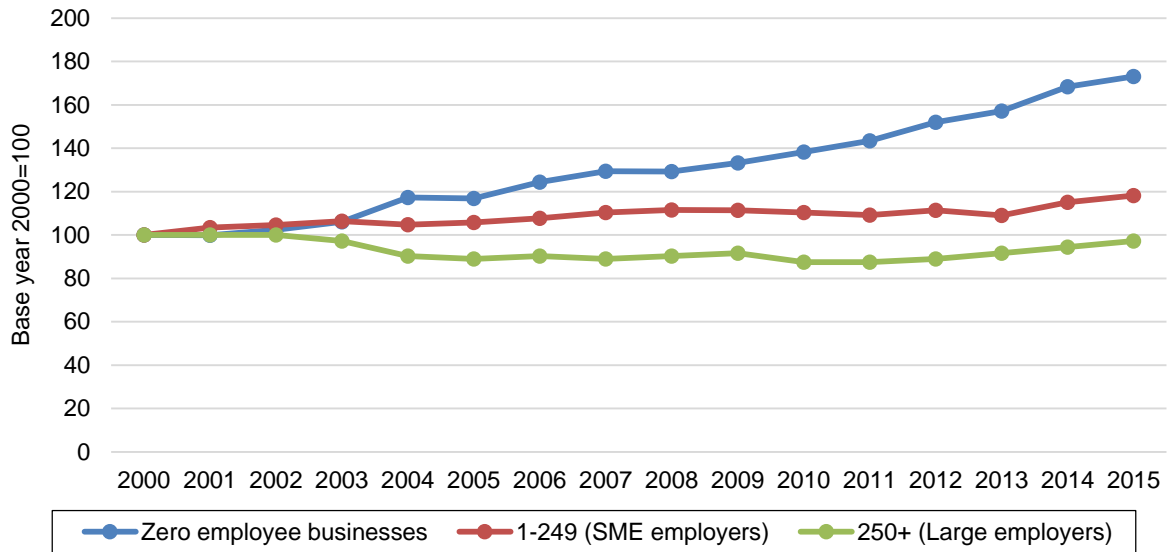


Source: Business Population estimates 2014, BIS.

12. Much of this growth has been among SMEs with zero employees. Since 2008, the number of zero employee businesses has grown by 34%. The growth rate has been much slower among SMEs with at least one employee, with just 6% more in 2015 compared to 2008 (see Figure 2). Zero employee businesses will tend to have simpler banking needs than larger SMEs.

⁸ See BIS, [Business population estimates 2015](#), Table 26.

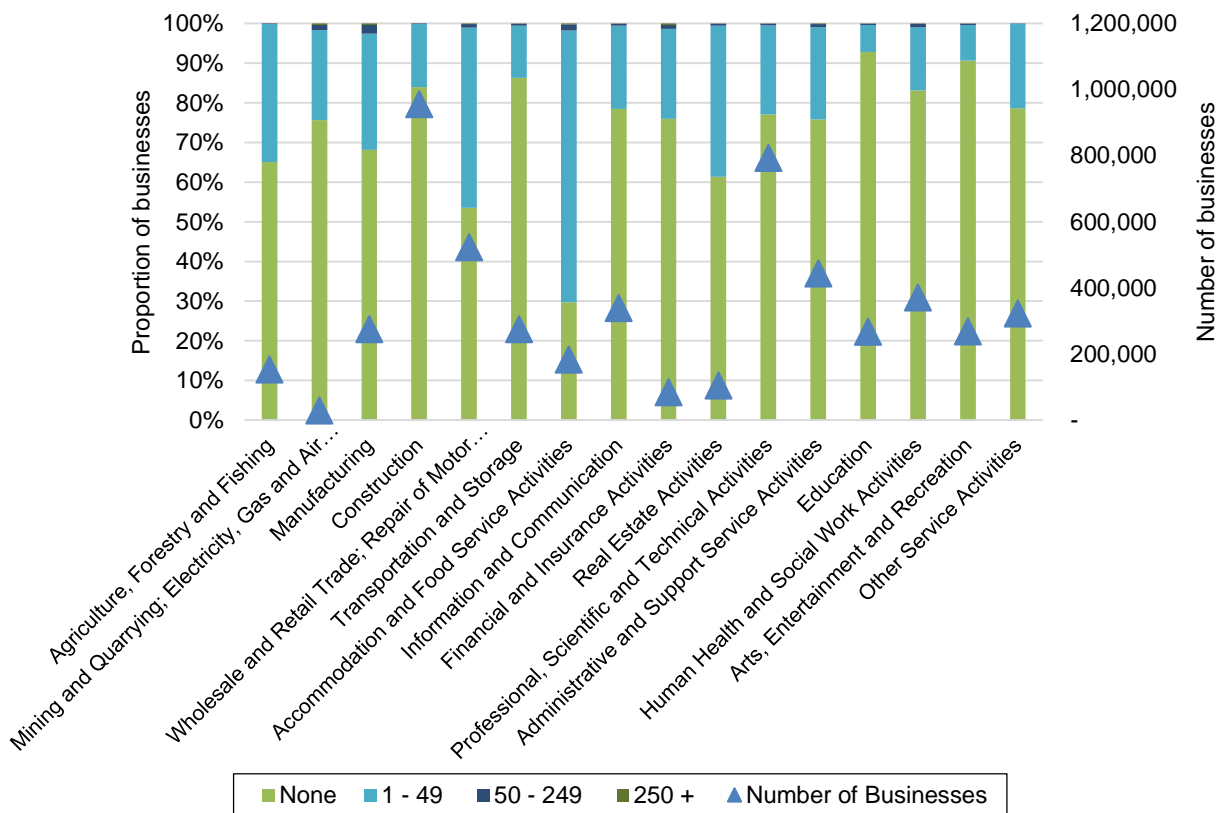
Figure 2: Growth of UK business numbers (2000–2015)



Source: Business Population estimates 2015, BIS.

- SMEs are also active in every sector of the economy across the UK the construction and the professional, scientific and technical sectors having the highest proportion of SMEs.

Figure 3: Number and proportion of UK businesses in each sector (2015)

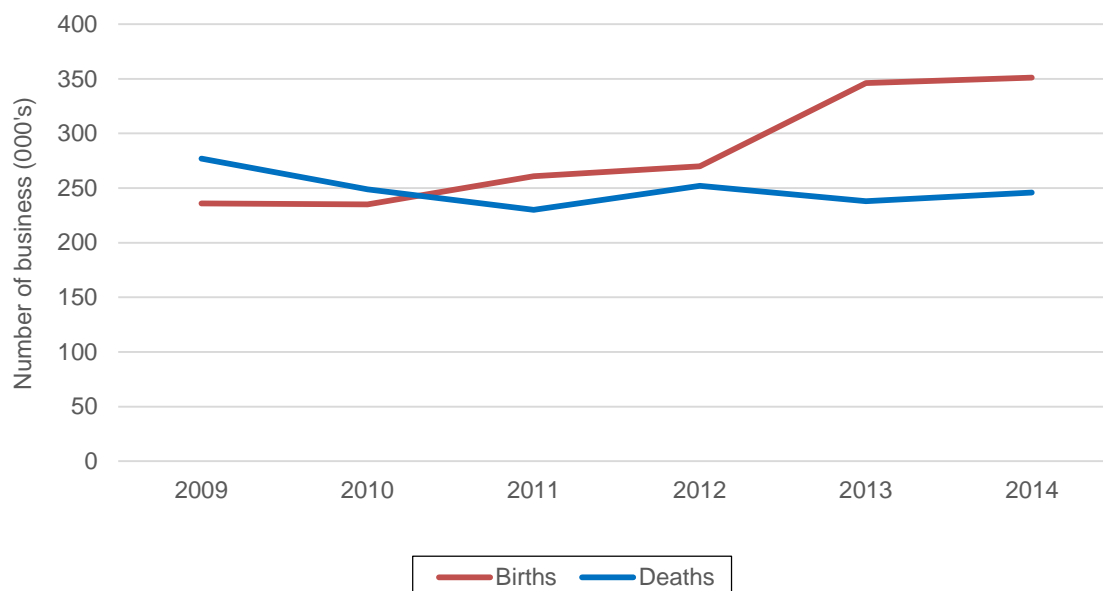


Source: Business Population estimates 2015, BIS.

Note: The second column is 'Mining, Quarry and Utilities', and the fifth column is 'Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles'

14. Whilst Figure 1 shows how many SMEs there are, this number hides the dynamism in the number of SMEs. Each year new businesses start trading (births) and stop trading (deaths).⁹ Figure 4 shows the number of business births and deaths between 2009 and 2014.

Figure 4: UK Business births and deaths (2009–2014)



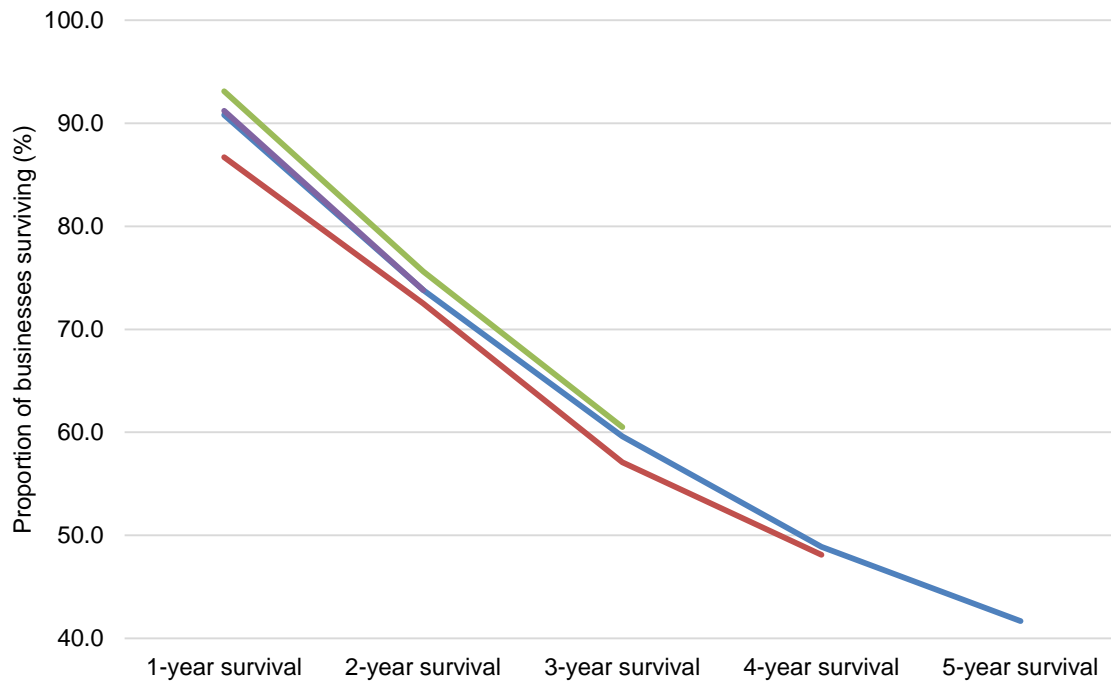
Source: ONS Business Demography, 2014.

Note: This only includes businesses that are registered and does not take account of the whole of the business population. However, registered businesses are the ones most likely to have a BCA.

15. In 2014 there were approximately 351,000 new businesses (business births), which equates to around 14% of the business population. For most of this period, births have been above deaths, reflecting a growing number of businesses and SMEs. However, in 2009/10 the number of business deaths increased and business births decreased. This coincided with the recession in this period.
16. After the first year of a business being born, survival rates are above 90%. However, by year 3 this has dropped to 60%, and by year 5 less than half (around 40%) survive. This degree of churn is reflected in the degree of churn in BCAs.

⁹ In addition, businesses can expand beyond the size of an SME.

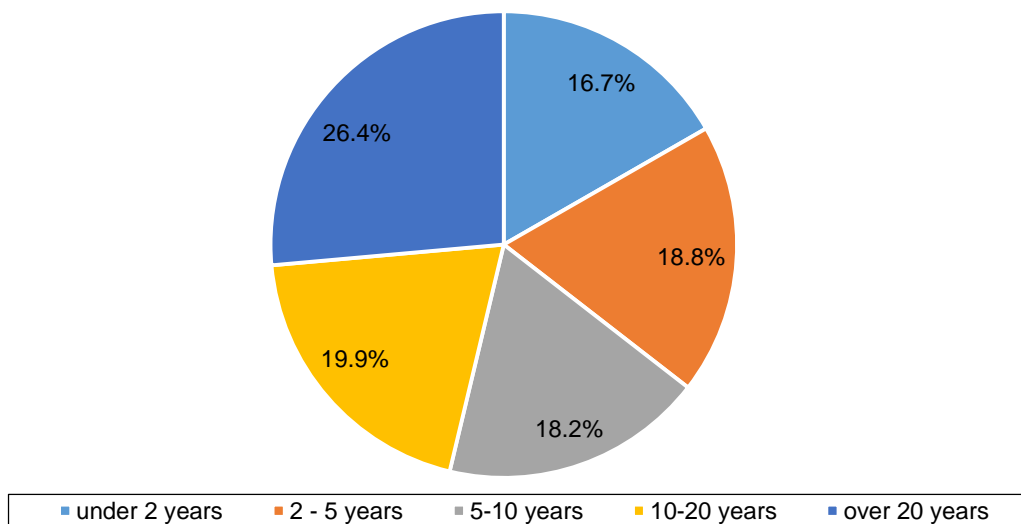
Figure 5: UK Yearly business survival rates (2009–2013)



Source: ONS Business Demography, 2014.

17. While there is considerable churn with younger businesses, this drops as businesses grow older. 26% of SMEs are over 20 years old, and 46% over ten years old, while 36% are under five years old.

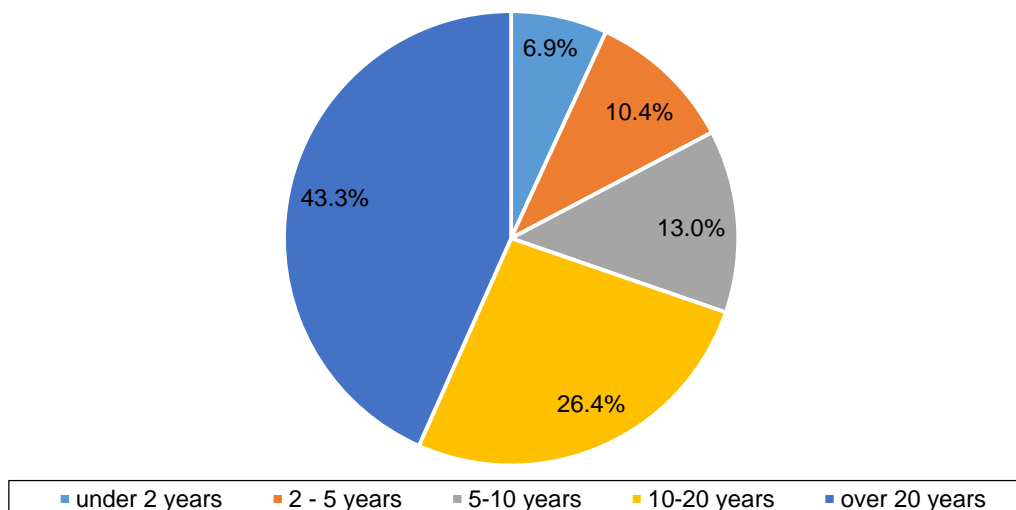
Figure 6: Age of SMEs in GB



Source: Charterhouse BBS.
Base: All SMEs (14,239).

18. The age profile of SMEs in NI is quite different from the profile in GB, with a greater proportion of older SMEs.

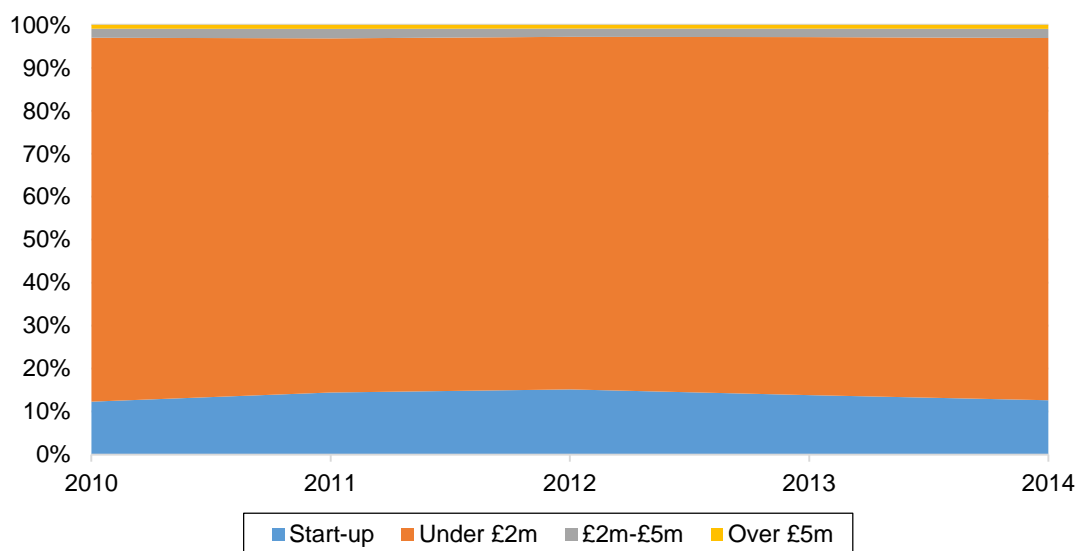
Figure 7: Age of SMEs in NI



Source: Charterhouse NI BBS, 2015.
Base: All SMEs (808).

19. The proportion of start-ups and established SMEs holding a BCA has remained relatively stable over time.

Figure 8: Turnover profile of SMEs in GB over time (2010–2014)



Source: Charterhouse BBS 2010–2014.
Base: All SMEs 2010 (15,883), 2011 (16,188), 2012 (15,746), 2013 (15,838), 2014 (14,239).
Note: Some SMEs use a PCA rather than a BCA so the number of businesses may be higher. However the Charterhouse BBS only asks about SMEs with a BCA account.

Differences between SME banking and personal banking

20. Whilst there are many similarities between PCAs and BCAs, there are some key differences.

(a) *Payments in and out:* In a PCA, there tends to be one main payment in (salary) with a number of payments, including direct debit and standing

orders, out of the account. However, with a BCA, there can be payments in from a number of different customers and sources.

- (b) *Arranged overdrafts*: The majority (64%) of PCA customers have an arranged overdraft facility with their PCA.¹⁰ They will only pay for this facility when they use it. For SMEs, 43% have an arranged overdraft facility.¹¹ This has to be arranged yearly and an arrangement fee is generally charged by the banks, as well as the usage charges.
- (c) *Free banking*: Many PCAs are operated on a FIIC basis. This means that account maintenance fees and core transaction fees are zero. Most BCAs, except for the initial free banking periods for start-ups and switchers, are paid through account maintenance fees, transaction fees, or both.
- (d) *Relationship banking*: Relationship banking is a more prominent feature of SME banking than for personal banking. For most PCA customers,¹² contact with the bank is primarily through digital channels, with branch staff, or with telephone operators. As set out in Table 2, larger SME customers will generally have a dedicated relationship manager. Smaller SMEs will generally have access to dedicated business centre support, but not an individual relationship manager. Larger SME customers may use their bank for a wider range of services and expect advice from their bank through relationship managers.

21. Figure 9 shows that in GB just over 50% of SMEs open a BCA with their PCA provider.¹³ [🔗]¹⁴

¹⁰ See Appendix 6.4.

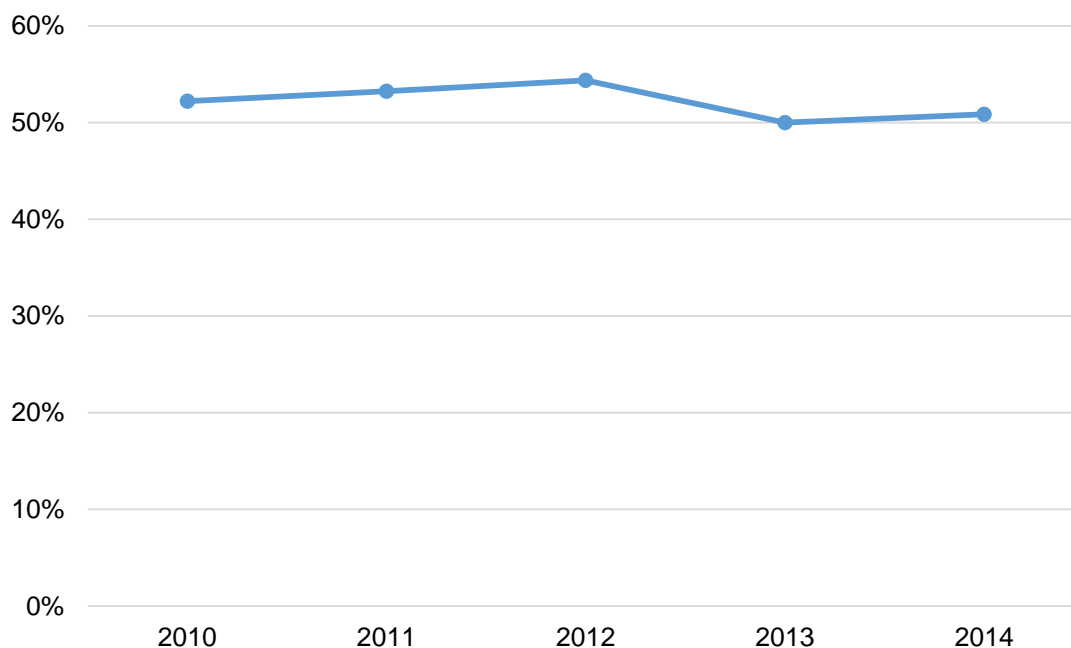
¹¹ Charterhouse BBS 2014.

¹² The main exception is private banking for wealthy personal customers.

¹³ Charterhouse BBS 2014.

¹⁴ [🔗]

Figure 9: Proportion of start-up SMEs in GB opening a BCA with their PCA provider (2010–2014)



Source: Charterhouse BBS 2010–2014.

Base: All start-ups: 2010 (3,711), 2011 (4,227), 2012 (3,933), 2013 (3,908), 2014 (2,556).

Note: This chart displays the proportion of all start-up SMEs that opened their BCA with their PCA provider.

Segmentation

22. The variety of needs of SMEs is also reflected in the way in which banks segment customers based on the size of the business. This segmentation influences the products available and the degree of negotiation on tariffs, as well as the level of support and the quality of the relationship. The five largest banks generally serve SMEs across two business units: business banking and commercial banking.

(a) Business banking covers around 95% of SMEs and is generally for smaller businesses with turnover up to around £2 million (see Table 2 below).¹⁵ These SMEs, particularly those at lower turnovers, will tend to have simple banking needs, often requiring a transactional relationship with their banks (eg making payments, cash handling). Some of these SMEs will get access to relationship managers, albeit as part of a large portfolio. Start-ups will tend to get a period of free banking.

(b) Commercial banking serves the remaining businesses (around 5%) and generally includes SMEs with turnover above £2 million. These SMEs will often have a greater degree of financial sophistication (including

¹⁵ Names of organisational units and exact turnover splits vary by bank (see Tables 2 and 3).

employing specialist financial management staff) and are more likely to require a wider range of products and services than those required by smaller SMEs. SMEs with turnover greater than £2 million will generally also be provided with a relationship manager by their bank. These customers will tend to generate more revenue for banks (see Table 5 in Appendix 7.2).

Table 2: Turnover segmentation by five largest UK banks

Bank	<£250k	£250k– £500k	£500k– £1m	£1m–£2m	£2m–£5m	£5m–£10m	£10m– £25m
Barclays*	[REDACTED]						
	[REDACTED]						
HSBC	Business Banking [REDACTED]					Mid-Market Enterprise [REDACTED]	
	Portfolio managed		RM managed [REDACTED]		RM managed [REDACTED]	RM managed [REDACTED]	
Lloyds	Retail Business Banking			SME Banking			
	Multi-channel model			[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
RBS/ NatWest†	Personal & Business Banking				Commercial & Private Banking		
	[REDACTED]	RM Hub [REDACTED]	Dedicated RM [REDACTED]		Dedicated RM [REDACTED]		
Santander‡	Business Banking	Commercial Banking					
	Direct model with local business manager support	RM support (£250k–£2.5m) [REDACTED]			Relationship director (£2.5m+) [REDACTED]		

Source: Banks' data.

*[REDACTED]

†[REDACTED]

‡[REDACTED]

23. However Table 2 hides some nuances about how banks approach segmentation.

- (a) *Borrowing requirements:* both LBG and RBSG also use borrowing thresholds to segment customers. This means that business banking customers with larger borrowing requirements will be dealt with by the commercial banking segment.
- (b) *Community/charity accounts:* Many banks provide accounts for charities, clubs or societies. Barclays, HSBCG and LBG also have accounts for schools and other educational establishments. Such accounts are generally provided free for in credit customers.

(c) *Sector focus:* Some banks (most notably LBG, RBSG and Santander) have a focus on certain sectors including agriculture, healthcare, property and professional services. In addition, LBG has specialists in the manufacturing sector, whilst Santander has specialists in the renewable energy sector. HSBCG also has a banking division for real estate SMEs.

24. Both LBG and HSBCG have reviewed their way of segmenting SMEs and have sought to align services on a needs basis. This has resulted in greater provision of relationship managers for larger (and more complex) SMEs and a more multi-channel approach in both provision of relationship managers and other channels for smaller SMEs. For instance LBG told us that:

It was recognised that LBG's smaller SME customers had simpler needs that could be better served through dedicated propositions with a particular focus on simplicity, transparency and accessibility, as well as demonstrating good value for money. The SME proposition focuses on building relationships with SMEs and communities, providing access to experts in banking and supporting clients' business goals. The new operating model, therefore, delivers two complementary approaches within a single bank: a Relationship Manager (and support team) model for larger SMEs (and those with more complex needs) focused on smaller portfolios and involving frequent contact with LBG staff; and a multi-channel banking model in retail business banking for smaller SMEs (with more straightforward needs) with access to business specialists when required.

25. In addition Santander has now moved to 'needs based' segmentation where SMEs grouped by the services and the support they required, regardless of their turnover. Banks' relationship management strategies and how these have changed over time, are considered further in paragraph 66.
26. Whilst the large banks primarily segmented their customers based on turnover, the smaller banks used a variety of approaches, including turnover, borrowing requirements and tailored approaches. For instance, both [redacted] and Ulster segmented customers based on turnover (below £2 million and above £2 million), although they also focused on some specific sectors. Clydesdale uses borrowing requirements to segment customers.
27. Some of the other banks appeared to have less prescriptive segmentation. TSB stated that it had no particular sectors it targeted, although there were some sectors it would not provide a BCA. Co-op Bank told us that it targeted customers that met its risk and ethical criteria. Handelsbanken said that it did

not segment either by size or sector and its services and products were tailored to the needs and requirements of the individual customer.

28. In NI, segmentation by banks was generally borrowing based rather than turnover based (see Table 3). However, both [X] and Ulster also used turnover as well as borrowing to determine which part of the bank a customer was serviced by.

Table 3: Bank segmentation of SMEs in NI

<i>Bank (borrowing)</i>	<i><£25k</i>	<i>£25k–£150k</i>	<i>£150k–£250k</i>	<i>£250k–£1m</i>	<i>£1m–£20m</i>
AIB	[X]				
Bol	[X]				
Danske	Business plus and Branches [X]	Finance centres [X]		Finance centres [X]	
Ulster	[X]			[X]	

Source: Banks data.

Transparency and comparability

29. Transparency and comparability of information is important to enable SMEs to make effective choices. In this section we present further evidence on:¹⁶
- (a) sources of information;
 - (b) financial sophistication; and
 - (c) comparison tools.

Sources of information

30. Banks told us that information about product prices and charges were available from multiple sources. First, the banks noted that the providers themselves are a main source of information and SMEs could find out about prices and charges:¹⁷

- online: on provider websites, via webchat, or through some online tariff calculators;

¹⁶ Further analysis on the availability and comparability of information on quality is set out in Appendix 13.2.

¹⁷ Webchat and tariff calculators were specifically mentioned by HSBCG.

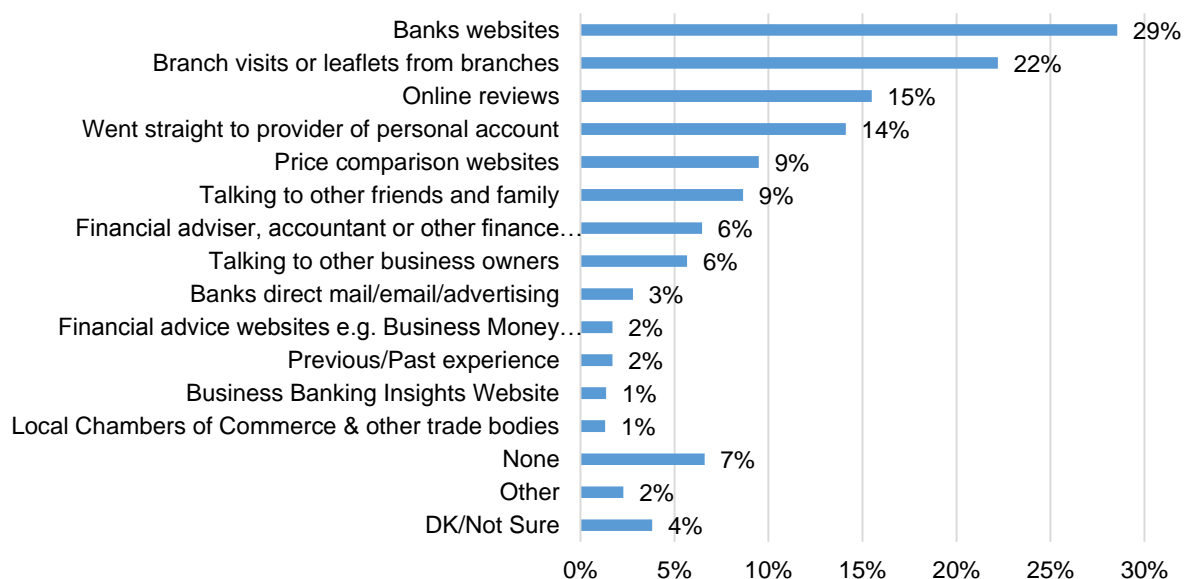
- in branches: in leaflets and brochures, or by speaking to branch based relationship or business managers;
 - over the telephone with relationship or business managers; and
 - by arranging an appointment with a relationship manager.¹⁸
31. Second, the banks said that PCWs contained information on product prices and charges.
32. Third, LBG told us that many start-ups retained formation agents to manage the company process which, in many cases, included advice in relation to acquiring banking services. RBSG noted that partner blog sites will feature some of their details on start-up products.¹⁹ We note that some of these websites will have a link to a particular bank offering a discount (cashback) when opening their BCA, although the amount of information they provide about the BCA is limited.
33. Other sources of information include brokers and professional advisers such as financial advisers, accountants and lawyers. Similarly, trade associations and organisations such as the FSB and the British Chambers of Commerce provide advice and information to their members.
34. In the Charterhouse follow-up survey of start-up SMEs the most common source of information mentioned by SMEs was the bank's own website (29%), visiting a branch (22%) and using online reviews (15%) (see Figure 10).²⁰

¹⁸ These may occur at the customers' premises.

¹⁹ Examples of these formation, start-up and blog sites are: Startups.co.uk, Smarta.co.uk, theformationscompany.com, although there are many others.

²⁰ See page 9 of SME follow up survey results.

Figure 10: Sources of information considered when choosing a BCA bank, UK



Source: Charterhouse follow-up survey of Start-ups, Question B5 (multicode).
Base: All (252).

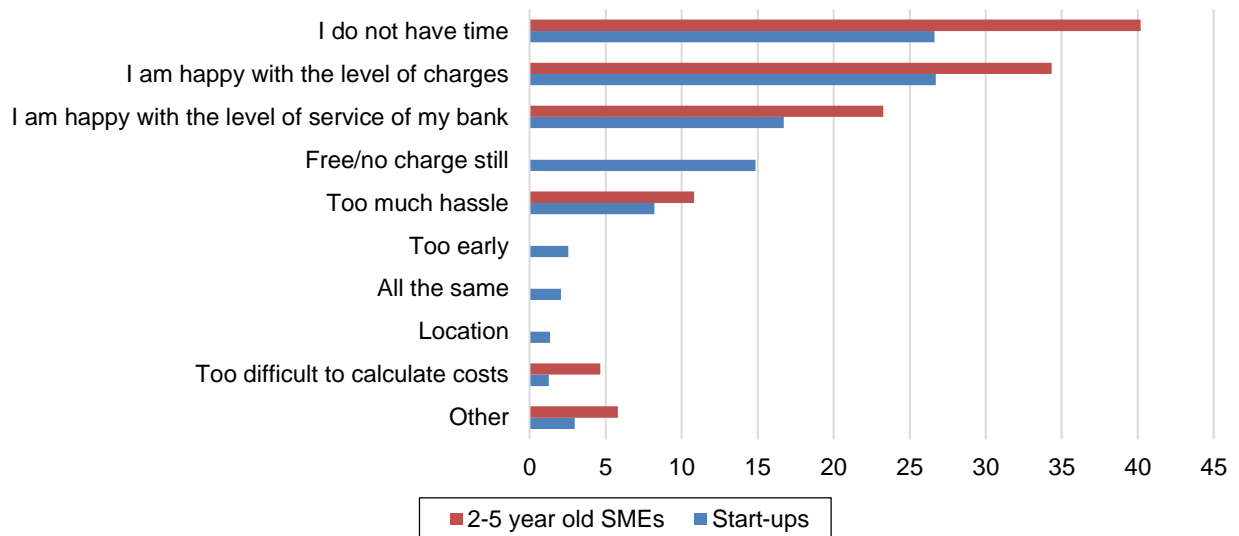
35. The HSBCG survey 2015 found that searching online was a quicker method of searching than visiting a branch or phoning a bank and online searching required lower effort. However, 40% who used branches said they definitely had enough information to make a decision, compared to 26% for those searching online or phoning a bank.²¹

Reasons for not comparing BCA costs

36. Figure 11 shows that for both start-ups and 2- to 5-year-old SMEs, the main two reasons for not comparing costs were 'I do not have the time' and 'I am happy with the level of charges'.

²¹ HSBCG survey 2015.

Figure 11: Why SMEs do not compare costs (UK)

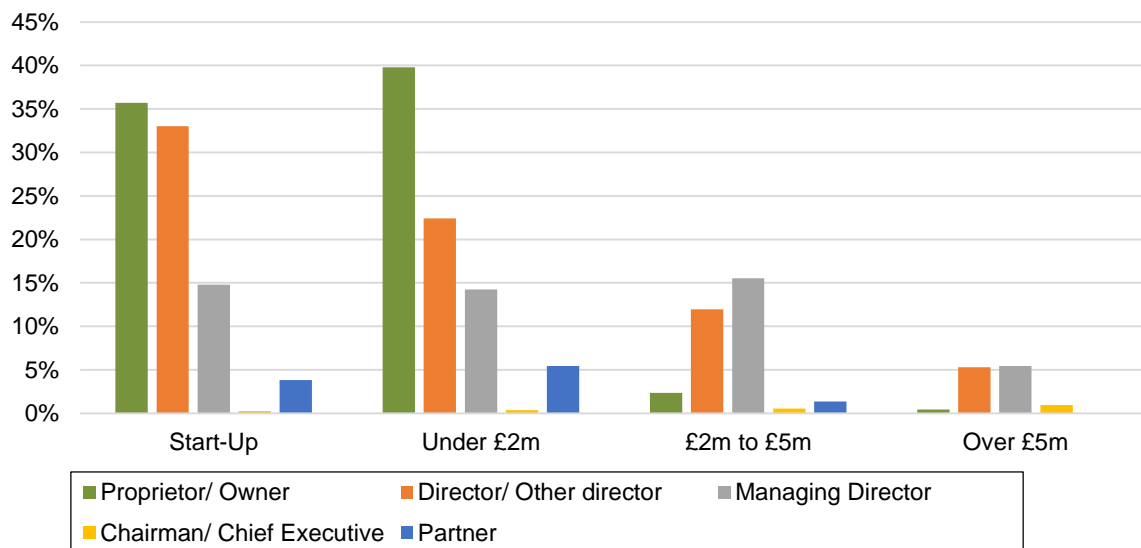


Source: Charterhouse follow-up surveys (start-ups – E5 and 2–5 year olds – E4).
 Base: All SMEs who do not compare costs with other BCA providers; survey of start-ups (211), survey of 2–5 year olds (185).

Financial sophistication

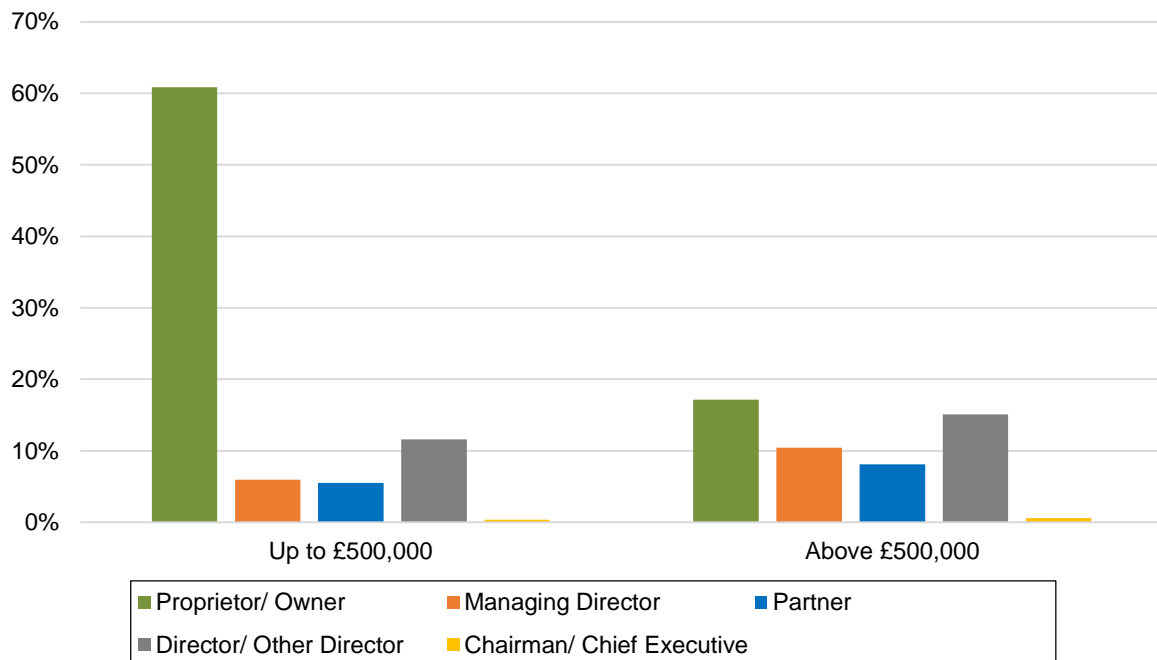
37. Figure 12 shows that smaller SMEs are substantially more likely to have the owner or director responsible for finance matters. This is not perhaps surprising, given many of these SMEs will be zero employee business with just one owner/director.

Figure 12: Job title of person responsible for finance decisions, GB (owner/leadership positions)



Source: Charterhouse BBS 2014, Qa2b.
 Base: All SMEs: start-ups (2,920), under £2 million (8,938), £2 million to £5 million (967), over £5 million (1,414).

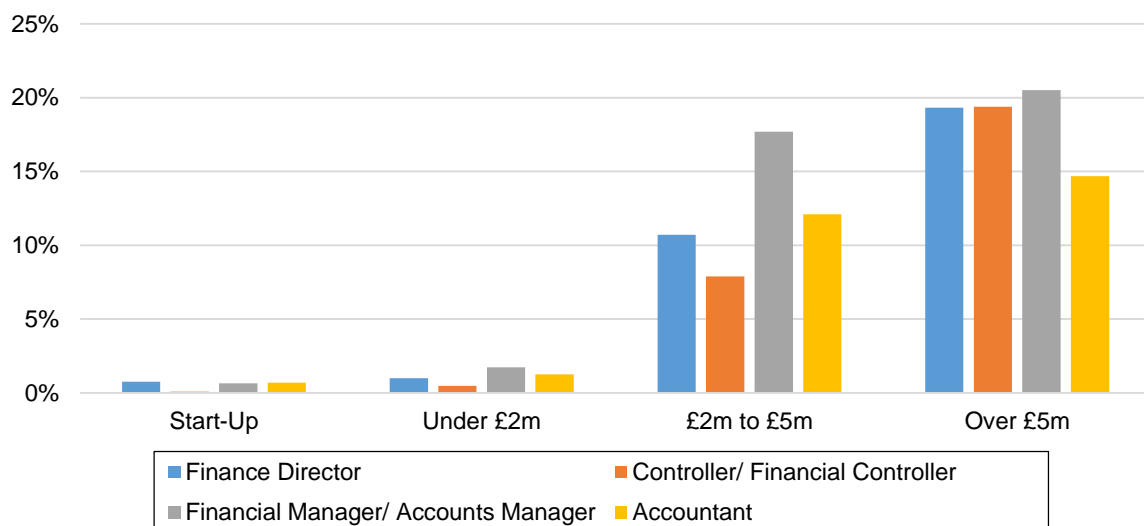
Figure 13: Job title of person responsible for finance decisions, NI (owner/leadership positions)



Source: Charterhouse NI BBS, 2015.
 Base: All SMEs: up to £500,000 (658), above £500,000 (150).
 Note: Due to the smaller sample size in NI it was only possible to make comparisons by size for SMEs over and under £500,000 turnover.

38. By contrast, large SMEs are substantially more likely to have someone finance related responsible for finance decisions (see Figure 14).²²

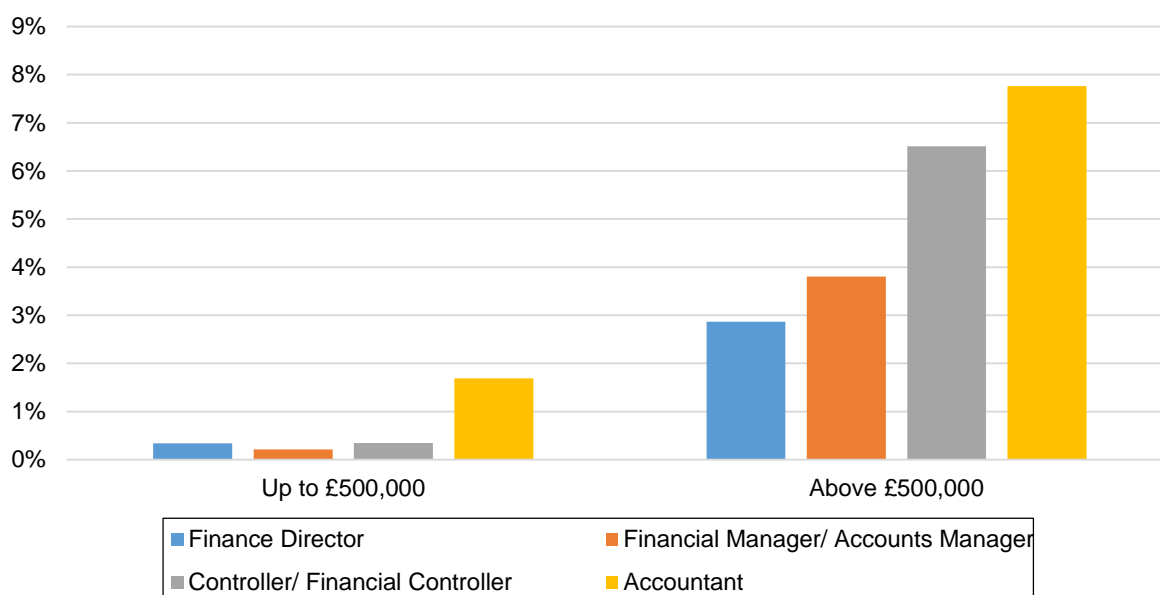
Figure 14: Job title of person responsible for finance decisions, GB (financial and other positions)



Source: Charterhouse BBS 2014
 Base: All SMEs: start-ups (2,920), under £2 million (8,938), £2 million to £5 million (967), over £5 million (1,414).
 Note: Non-financial positions not shown.

²² This appears less true in NI, although this can be partly explained by the sample having a lack of larger SMEs.

Figure 15: Job title of person responsible for finance decisions, NI (financial and other positions)



Source: Charterhouse NI BBS.

Base: All SMEs: up to £500,000 (658), above £500,000 (150).

Note: Non-financial positions not shown.

Note: Due to the smaller sample size in NI it was only possible to make comparisons by size for SMEs over and under £500,000 turnover.

Price Comparison Websites

39. We discuss PCW’s functionality and financial viability below.

PCW functionality

40. We are aware of five different PCWs covering BCAs.

- Business Moneyfacts covers BCAs, deposit accounts and loans but only offers best buy tables, rather than the ability to search the comprehensive list of accounts it holds data on.
- Business Account Finder uses data on product characteristics and charges from Business Money Facts.²³
- Knowyourmoney.co.uk compares accounts for a number of different providers.
- Money.co.uk provides comparisons on a range of SME targeted products including loans and current and deposit accounts. Comparisons are based on basic charges such as monthly account fee, interest paid and eligibility

²³ See Section 8 for information on the Business Account Finder.

for the account. SMEs can click through to the banks' websites to find out more about the detailed transaction charges, although money.co.uk told us that it was developing tools to enhance the comparison experience.²⁴

- Moneysupermarket.com also provides comparisons on a range of SME targeted products including loans and current and deposit accounts. Comparisons are based on basic charges such as monthly account fee, interest paid, and eligibility for the account. It also allows comparisons for overdrafts. Moneysupermarket.com provides more detailed information on some charges when individual BCAs are selected, but it is not possible to search by these criteria or compare on one screen.

Financial viability of PCWs

41. For PCWs to be financially viable, we would expect there would need to be sufficient demand for their services and for them to be able to monetise the demand. PCWs typically are financed by advertising revenues and click-through and sales agreements whereby the PCW receives payment for each account that is clicked on its search/comparison page (Cost Per Click (CPC) sales) and/or a larger amount for each accepted application to the bank (Cost Per Acquisition (CPA) sales).
42. [REDACTED]. Appendix 6.3 includes a comparison of revenues and visits for energy and motor insurance comparison pages with PCAs from Confused.com. [REDACTED].
43. Table 4 shows that while there has been an increase in the number of visits, the number of click-throughs and revenues has remained static.

Table 4: PCW visits, click-throughs, and revenues 2013 and 2014

	Visits		Click-throughs		Revenues	
	2013	2014	2013	2014	2013	2014
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: CMA analysis of Business Money Facts and money.co.uk responses to PCW questionnaire.

44. Table 4 also shows that the number of visits in 2014 is [REDACTED], which compares to 4.8 million active BCAs. This suggests current usage of PCWs has been low among SMEs.

²⁴ [REDACTED]

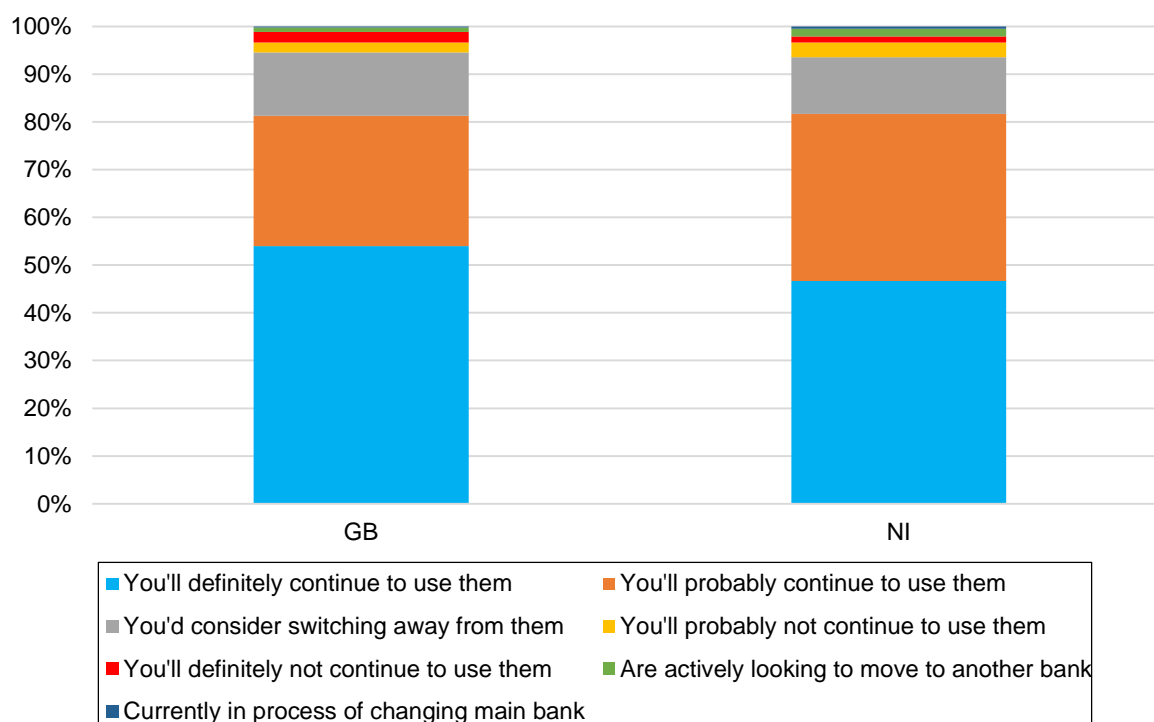
Levels of customer engagement

45. In this section we look at the degree to which customers consider switching, switching levels, multi-banking and other indicators of customer engagement.

Consideration of switching

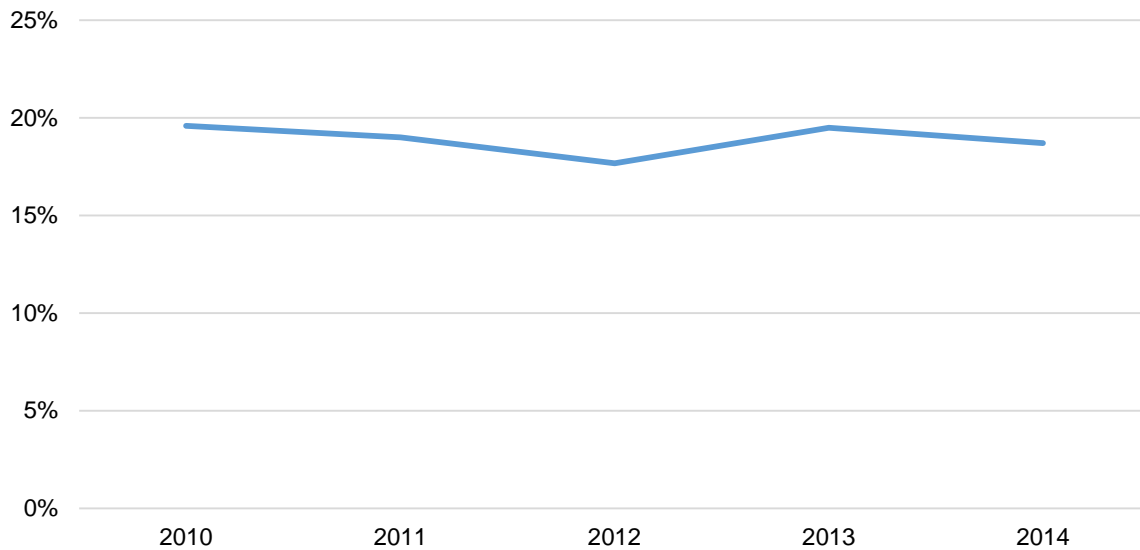
46. Figure 16 shows the number of SMEs that are considering switching away from their current bank in the coming year, in both GB and NI, while Figure 17 displays the proportion over time for GB only.

Figure 16: Whether SMEs would consider switching in the coming year, GB and NI



Source: Charterhouse BBS 2014 and Charterhouse NI BBS, P3.
 Base: All SMEs asked: GB (10,132), NI (808).

Figure 17: Whether SMEs would consider switching in the coming year over time, GB



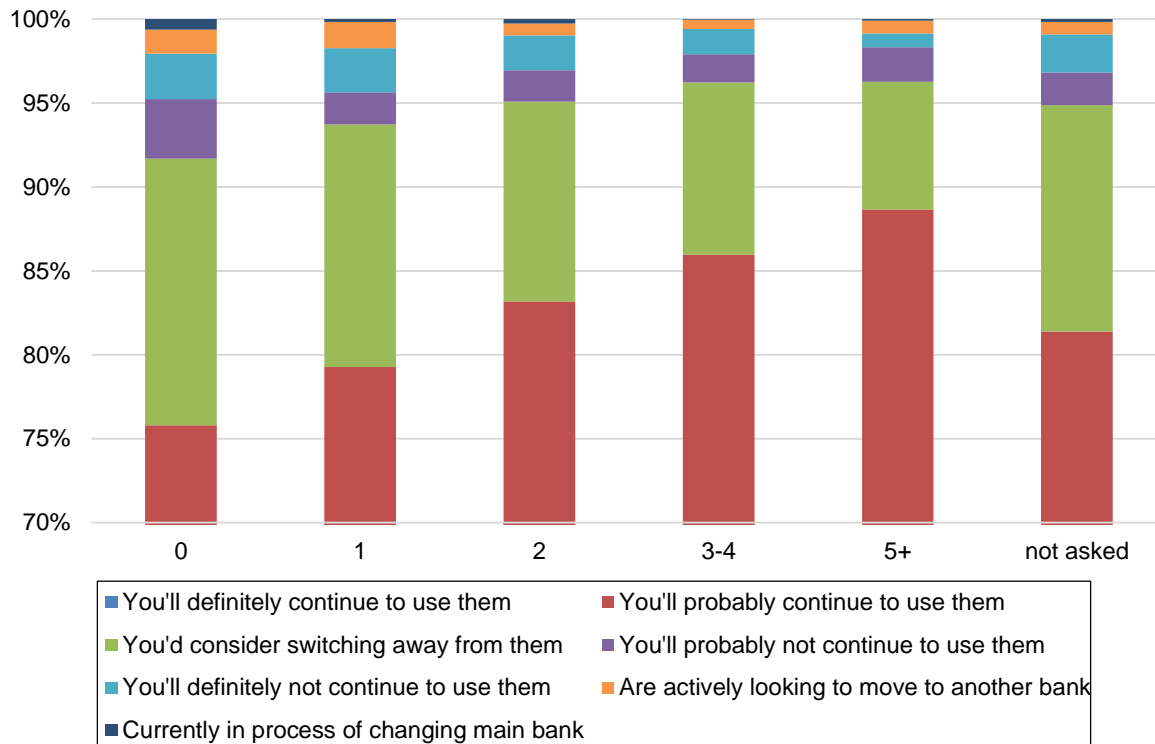
Source: Charterhouse BBS 2014.

Base: All SMEs asked: 2014 (10,132), 2013 (11,274), 2012 (11,277), 2011 (11,705), 2010 (10,827).

Note: Consider switching is all those who said they were currently in the process of switching, actively looking to move bank, definitely would not continue to use their current bank, would probably not continue to use their current bank, and were considering switching away at question P3.

47. The HSBCG survey 2015 found that 32% of SMEs have considered switching BCA in the last 2 years. Consideration of switching in the last two years was higher amongst the £500k-£2m and £2m-£25m groups compared to the <£500k group, although lower consideration of switching was found amongst older SMEs.
48. The Charterhouse BBS showed that SMEs were less likely to consider switching when they held additional products with their bank.

Figure 18: Switching consideration by number of products held by SMEs with their main bank in GB

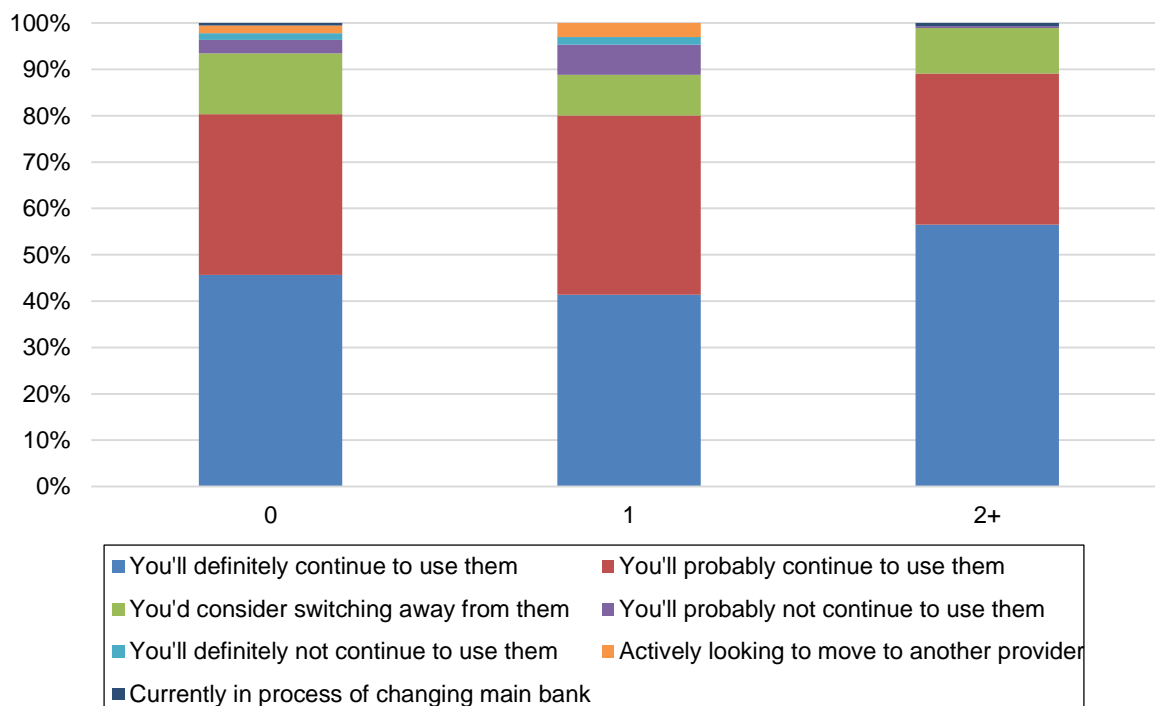


Source: Charterhouse BBS.

Base: All SMEs asked about products held 2014: 0 (907), 1 (1,137), 2 (1,055), 3-4 (1,175), 5+ (718).

Note: The number of other products are those the SME has held in the last 12 months at its main bank in addition to a BCA and overdraft.

Figure 19: Switching consideration by number of products held by SMEs with their bank in NI



Source: Charterhouse NI BBS.

Base: All SMEs; 0 other products (538), 1 other product (134), 2+ other products (136).

Note: The number of other products are those the SME has held in the last 12 months at its main bank in addition to a BCA and overdraft (if it had one).

Levels of switching

49. Annual switching rates in GB were estimated at around 4% in 2014. This followed a decline in switching after the recession, where switching rates fell from 6% in 2010 to 4% in 2012.²⁵ This compares with earlier estimates of switching, including the ICB report, which found that annual switching rates among SMEs were between 3 and 6% over the period 2005 to 2009.²⁶
50. Estimates of switching through CASS were much lower than survey estimates.²⁷ In total only around 0.4% of the total number of active BCAs switched their BCA through CASS in 2014.²⁸
51. CASS figures are likely to underestimate the total number of business switching because of two main reasons.
- (a) CASS does not cover all SMEs. When CASS was initially implemented in September 2013 it only covered businesses with an annual turnover and/or balance sheet total that did not exceed €2 million (or sterling equivalent) and fewer than ten employees, approximately 95% of the SME population. From March 2015, this changed so that SMEs with turnover up to £6.5 million are able to use CASS. This covers 99% of the overall SME population.
 - (b) Some SMEs may not be using CASS to switch their bank account because they are unaware of the service.
52. In addition, the Payments Council conducted research on SME switching to monitor the effects of CASS.²⁹ While this research only covered businesses with a turnover less than £1.8 million and fewer than nine employees, it found that 2.3% of businesses had switched in 2014 and a further 12% had considered switching but had not done so.

²⁵ Charterhouse asked respondents: 'Have you changed your main bank over the past 12 months?' Whilst the main bank does not necessarily mean the BCA provider, 96% of businesses named their main bank as their BCA provider.

²⁶ ICB report, p180. ICB based its estimates of switching on TNS RI Small Business Banking Survey Great Britain. It only covered businesses with turnover up to £1 million.

²⁷ In September 2013, the CASS was launched which enabled consumers and the majority of SMEs to switch current accounts in seven days, guaranteeing the switch against any financial losses and redirected old payments to the new account.

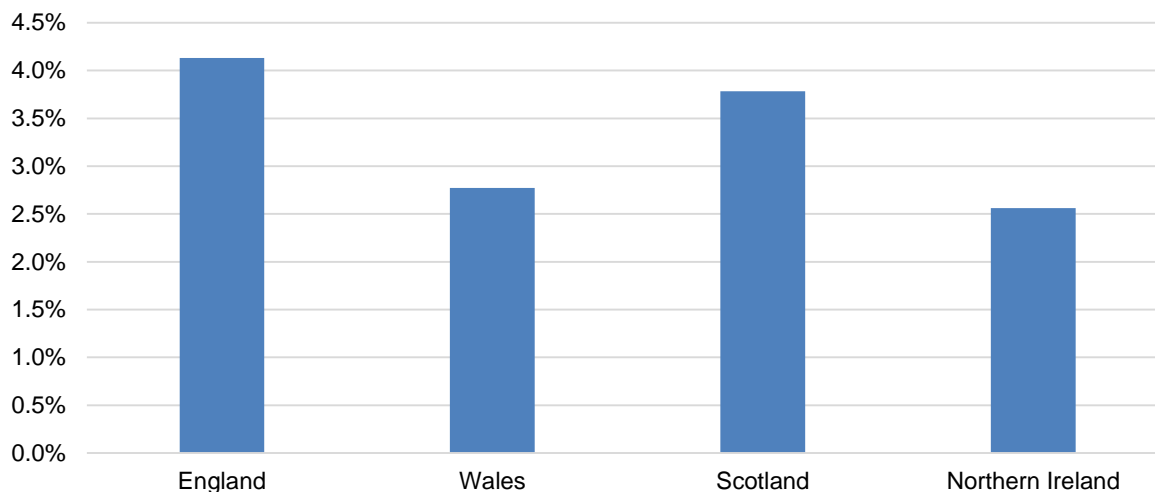
²⁸ This equates to 22,452 SMEs.

²⁹ See Payments Council research. Because of the focus on CASS, businesses with turnover higher than £1.8 million or more than nine employees were excluded from the research. Therefore, the switching estimates reflect the rate of switching among microbusinesses only.

SME switching by region

53. There is some variation in switching by nation, with switching rates in NI appearing to be lower than in England (see Figure 20).

Figure 20: Switching rates by nation (2014)



Source: Charterhouse BBS 2014, Charterhouse NI BBS 2015.

Base: England (11,075), Wales (527), Scotland (2,637), NI (808).

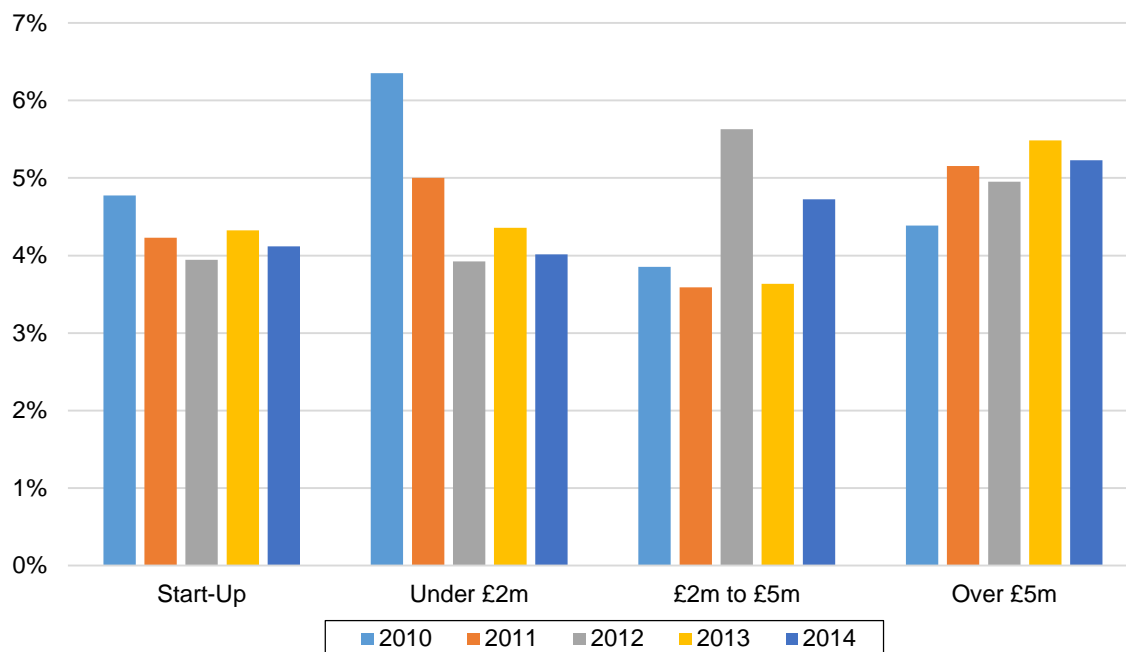
Note: The switching rates in Wales and Scotland are not statistically significantly different from England at the 0.05 significance level.

SME switching by type of SME

54. There is evidence that switching rates vary between different types of SMEs. Figure 21 shows switching rates by turnover across years for GB, and Figure 22 shows switching rates by turnover for NI in 2015. The difference between those with annual turnover over £5 million and those with annual turnover under £2 million in GB is not statistically significant, despite the slightly higher switching rates in the survey.³⁰ In 2010 switching rates were highest among businesses with a turnover under £2 million. Switching rates for this group have since declined. Much of the decline in the overall headline rate of switching seems to have been driven by a decline in switching rate of SMEs with turnover under £2 million.

³⁰ The same applies to NI, where the difference between the rates for SMEs over and under £500,000 turnover is not statistically significant.

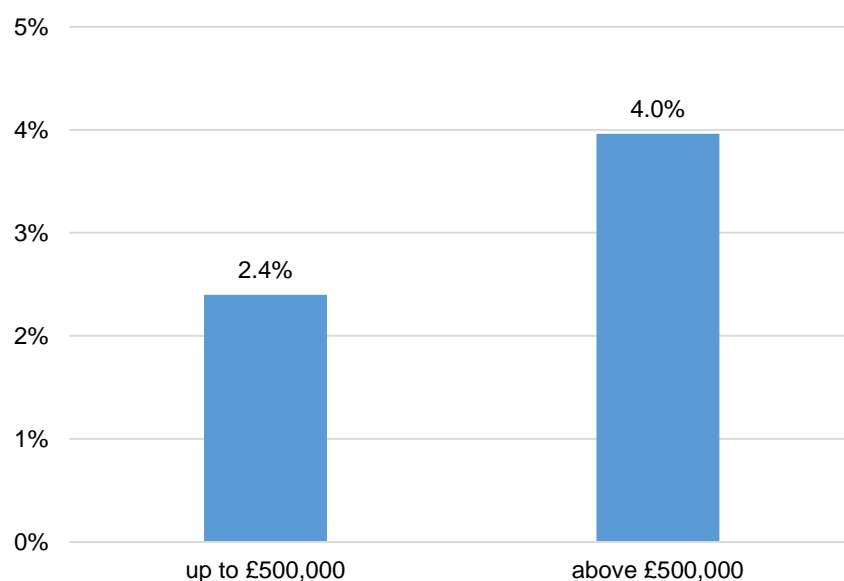
Figure 21: Switching rate by turnover (2010–2014), GB



Source: Charterhouse BBS 2010–2014.

Base: All start-ups: 2010 (4,408), 2011 (4,731), 2012 (4,337), 2013 (4,379), 2014 (2,920); all SMEs under £2 million: 2010 (9,128), 2011 (9,093), 2012 (9,100), 2013 (9,073), 2014 (8,938); all SMEs £2 to £5 million: 2010 (922), 2011 (971), 2012 (920), 2013 (938), 2014 (967); all SMEs over £5 million: 2010 (1,425), 2011 (1,393), 2012 (1,389), 2013 (1,448), 2014 (1,414).

Figure 22: Switching rate by turnover NI (2015)



Source: Charterhouse NI BBS, 2015.

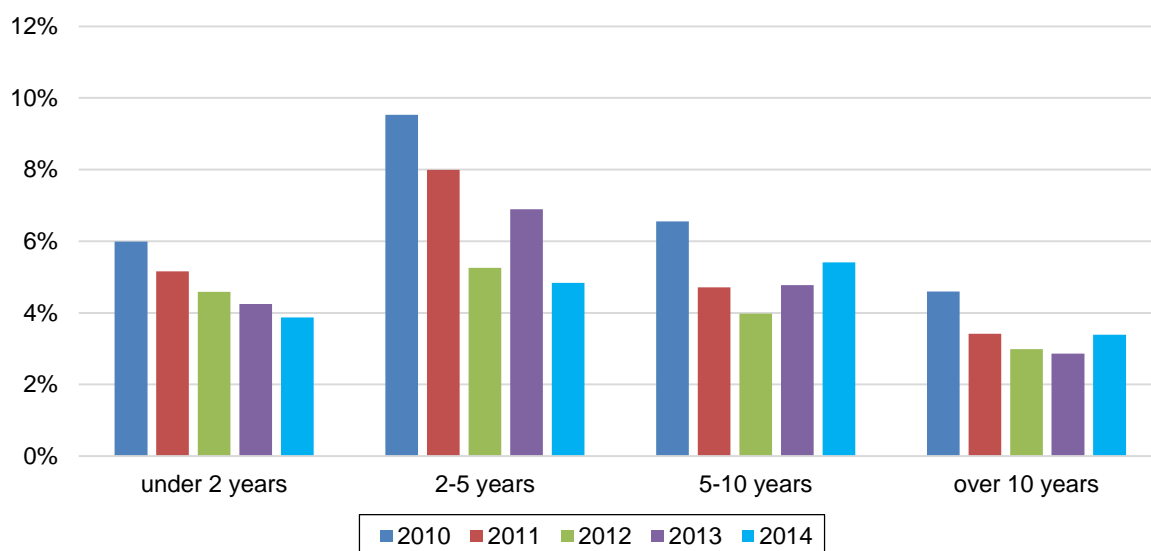
Base: All SMEs up to £500,000 (658), above £500,000 (150)

Note: Due to the smaller sample size in NI it was only possible to make comparisons by size for SMEs over and under £500,000 turnover.

55. Figure 23 shows that generally switching rates also appear to be higher for businesses aged between two and five years old. Switching rates among older businesses over ten years old appear to be relatively low both in GB and NI.

56. One potential explanation for why switching rates might be higher for businesses aged between two and five years is the end of free banking. Typically start-ups will receive a period of free banking lasting between 18 months and two years, after which they are charged for the use of their BCA. This can sometimes act as a prompt to switch bank to reduce or avoid charges. This is explored in more detail below under motivations for switching in paragraphs 86 to 124.

Figure 23: Switching rates by age of business, GB (2010–2014)

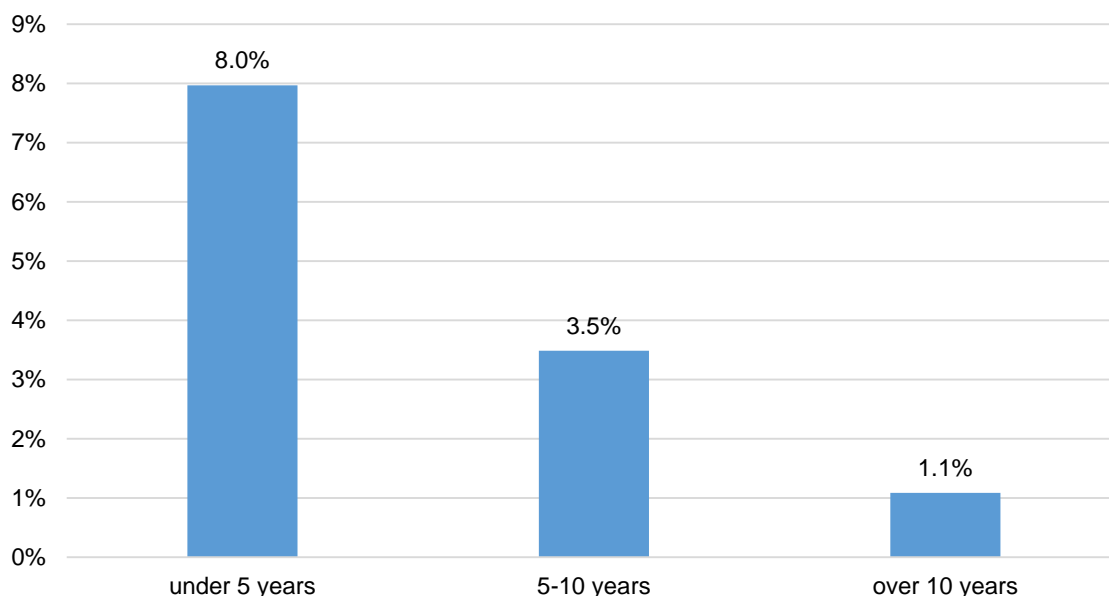


Source: Charterhouse BBS 2010–2014.

Base: All SMEs under 2 years 2010 (5,143), 2011 (5,333), 2012 (4,886), 2013 (4,866), 2014 (3,239); all SMEs 2–5 years: 2010 (1,825), 2011 (1,979), 2012 (2,263), 2013 (2,264), 2014 (2,159); all SMEs 5–10 years: 2010 (1,051), 2011 (1,404), 2012 (1,472), 2013 (1,566), 2014 (1,593); all SMEs over 10 years: 2010 (7,760), 2011 (7,364), 2012 (7,057), 2013 (7,025), 2014 (7,061).

Notes: Charterhouse BBS records the year the SME started trading. However where this date is before 2005 this is just recorded in 5-year bands. This means, depending on the year of interview, it is not always possible to accurately identify whether an SME is 5–10 years old or over 10 years old when it began trading between 2000 and 2005. In these cases a proportion of cases have been randomly assigned to the 5–10 years or over 10 years band depending on the likelihood of being in that band. For example, for the 2013 dataset 1/5 of those who started trading between 2000 and 2004 are assigned to 5–10 years (as only those who started in 2004 would enter that band).

Figure 24: Switching rates by age of business, NI (2015)



Source: Charterhouse NI BBS 2015.

Base: Under 5 years (109), 5–10 years (103), over 10 years (588)

Note: Due to the sample size of the Charterhouse NI BBS, there are few SMEs that have been in business for less than two years. Therefore all SMEs under five years old are grouped together.

Which banks do SMEs switch to?

57. In this section, we provide more detail on switching, summarising:

- (a) the proportion of overall switchers that each bank gained;
- (b) the proportion of switchers relative to banks' own customer base;
- (c) the proportion of net switchers that each bank gained; and
- (d) the proportion of net switchers relative to banks' own customer base.

58. All the charts in this section are for GB.³¹

Proportion of overall switchers each bank has gained

59. Figure 25 shows that the largest five banks are all gaining a proportion of switchers. [✂] and [✂] are gaining some switchers, although less than the five largest banks.

Figure 25: Proportion of switchers gained by bank in GB (2011–2014)

[✂]

Source: Charterhouse BBS.

[✂]

³¹ The sample size of switchers in NI is too small to analyse.

Switchers as a proportion of banks' own customer base

60. Figure 26 shows that, for [X] and [X], switchers are higher proportions of their customer base, suggesting that switching is an important factor for their BCA businesses. The four largest UK wide banks are gaining less than [X]% of their customer base through switchers.

Figure 26: Switchers gained as a proportion of customer base in GB (2011–2014)

[X]

Source: Charterhouse BBS.
[X]

Proportion of net switchers each bank has gained

61. Figure 27 shows that once switching losses are accounted for, [X] is making small switching gains whilst [X] and [X] are losing customers through switching. [X] made gains in 2012, but lost customers in 2014. [X] was the largest proportionate gainer in 2014, followed by [X] and [X].

Figure 27: Net (gained minus lost) proportion of switchers in GB (2011–2014)

[X]

Source: Charterhouse BBS.
[X]

Net switchers as a proportion of banks' own customer base

62. Figure 28 shows net switchers as a proportion of the bank's customer base. Consistent with the results above, [X] and [X] have the highest proportions.

Figure 28: Net switchers as a proportion of the bank's current base in GB (2011–2014)

[X]

Source: Charterhouse BBS.
[X]

Comparison of switching with other industries

63. At present there are no sources that compare SME switching behaviour across different industries using a consistent sample of SMEs. However, there are individual and separate studies that examine switching rates by SMEs in

specific industries, most notably energy and communications. For example, in energy, a survey by BMG Research Ltd for Ofgem found the following.³²

- (a) Approximately, three-fifths of SMEs had switched gas/electricity suppliers in the last five years. 26% had switched once, 21% had switched twice and 13% had switched three or more times over this period.
 - (b) Of those that had switched energy and gas suppliers in the last five years, 39% had switched in the last year. This equated to an annual switching rate of 23% across all SMEs.
 - (c) Switching rates were highest for those that spent between £5,000 and £10,000 on their energy bill.
64. In the communications sector, a research report by Jigsaw for Ofcom found that approximately one-fifth (20%) of SMEs had switched their internet supplier in the last two years, 21% had switched their mobile phone and 19% had switched their land line. 47% had never switched.³³
65. Compared with these industries, it appears that BCA switching levels are lower, but these differ from BCAs in two key respects.
66. First, gas, electricity and communications represent a larger proportion of SMEs' overall business costs compared to BCAs:
- (a) BMG Research Ltd's research for Ofgem found that on average, businesses spent approximately £5,000 a year (including VAT) on electricity and it accounted for, on average, 16% of all operating costs. The average spend on gas was lower at around £4,000 (including VAT) and 13% of overall costs on average.
 - (b) Similarly, research conducted on behalf of Ofcom found that average expenditure on communications was just over £1,000 for the smallest SMEs, almost £4,000 for SMEs with ten to 49 employees and over £11,000 for the largest SMEs.
 - (c) The average cost of a BCA, by contrast was £380 in 2014.³⁴

³² *Micro and Small Business Engagement in Energy Markets*, a research report by BMG Research Ltd prepared for Ofgem, March 2015.

³³ *SMEs experience of communication services*, a research report by Jigsaw Research prepared for Ofcom, October 2014.

³⁴ See Appendix 7.2, Table 1. This is the average revenue for a bank account excluding the net value of funds. This is equivalent to the average cost. Note that the costs may vary depending on the number of transactions and use of overdraft facilities.

67. Second, utilities typically have fixed-term contracts. The end of a contract was often a trigger for SMEs to search for alternative offers and switch suppliers. For example, the second most popular factor prompting SMEs to switch their energy supplier, after pursuing cost savings, was receiving a renewal notice from an existing supplier or seeing the contract end date on the bill.³⁵
68. In banking there are no fixed-term contracts for BCAs. The evergreen nature of the product means that SMEs are often not prompted into considering and reviewing their banking arrangements. The end of free banking can sometimes act as a prompt to review banking, but as discussed in Section 8 the effects of this are limited to a subgroup of SMEs.

Multi-banking

69. Switching is one measure of customer engagement, but there are other indicators of customer engagement, including multi-banking. There are two different definitions of multi-banking.
- (a) Narrow multi-banking, where an SME holds a BCA at more than one bank.
 - (b) Broad multi-banking, where an SME holds different financial products at different banks.
70. Figure 29 shows that whilst a substantial minority of SMEs hold products at more than one bank, the proportion that hold more than one BCA with different banks is much lower at only 3.6% in 2014. Figure 30 shows that in NI, fewer SMEs hold multiple products at different banks (12%) but there is slightly more narrow multi-banking (6%).
71. Our qualitative research also found that multiple product holdings with different providers was in some cases driven by a belief that it would be an advantage in applying for other products in the future.³⁶ We also noted that the larger SMEs (in GB) are more likely to be multi-banking under both definitions.³⁷ We consider the narrow multi-banking measure to be a more important indicator of potential customer engagement with respect to BCAs,

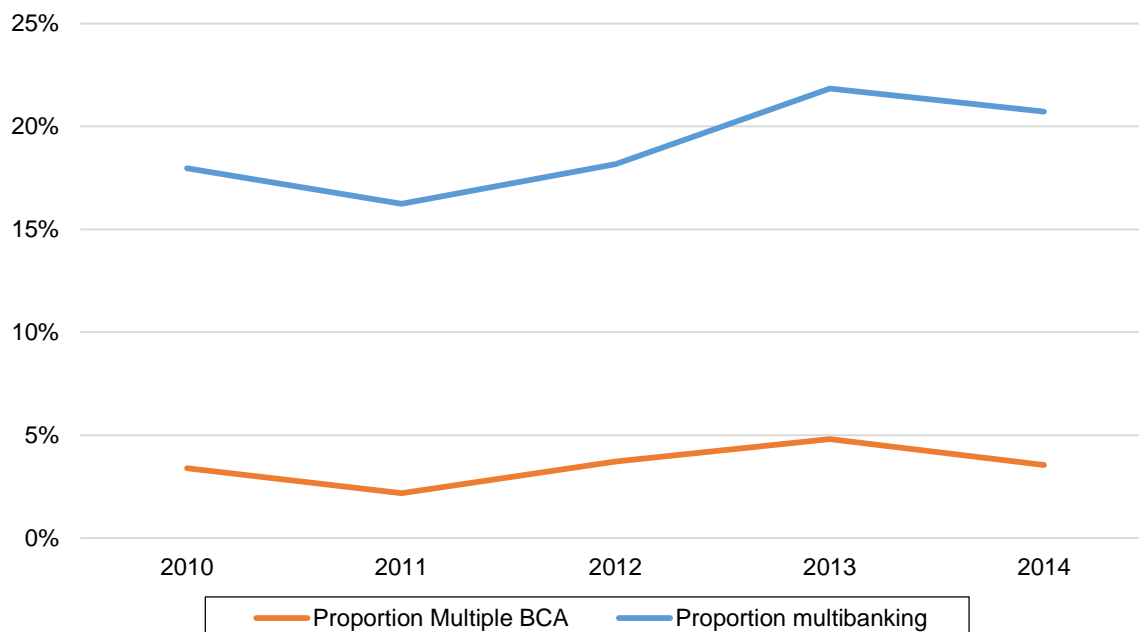
³⁵ [Micro and Small Business Engagement in Energy Markets](#), a research report by BMG Research Ltd prepared for Ofgem, March 2015.

³⁶ This is much lower than for PCAs, where 31% of customers hold a PCA at more than one bank. See Appendix 6.4.

³⁷ See Figures 31 and 34.

whereas the broad measure is more suitable when considering the behaviour of SMEs in relation to other products.³⁸

Figure 29: Proportion of SMEs multi-banking with different providers in GB (2010–2014)



Source: Charterhouse BBS, 2010–2014.

Multiple bank base: 2010 (4,435), 2011 (4,450), 2012 (4,245), 2013 (5,015), 2014 (4,435).

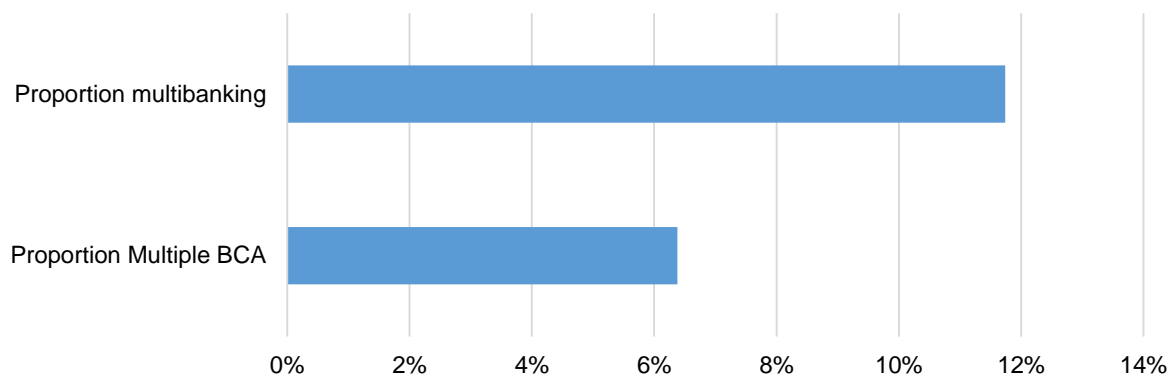
Multiple BCA base: 2010 (4,210), 2011 (4,311), 2012 (4,109), 2013 (4,813), 2014 (4,847).

Note: Multi-banking products are taken to include BCAs, Overdrafts, Credit cards (and charge cards), factoring/invoice discounting, business loans, commercial mortgages, asset finance, instant access deposit account, and term deposits.

72. The level of narrow multi-banking does not suggest high levels of SME engagement in BCAs. This means that banks are unlikely to be considering this as a substantial threat from their existing customer base.
73. In NI the level of multiple BCA holding is higher than in GB, although the proportion holding another banking product with another bank is lower than in GB.

³⁸ We note that 82% of SMEs are using more than one banking product, although 77% hold more than one product with their own bank. The products SMEs are most likely to get from another bank is credit cards and asset finance (see Appendix 8.2, Figure 9).

Figure 30: Proportion of SMEs multi-banking with different providers in NI (2015)



Source: Charterhouse NI BBS.

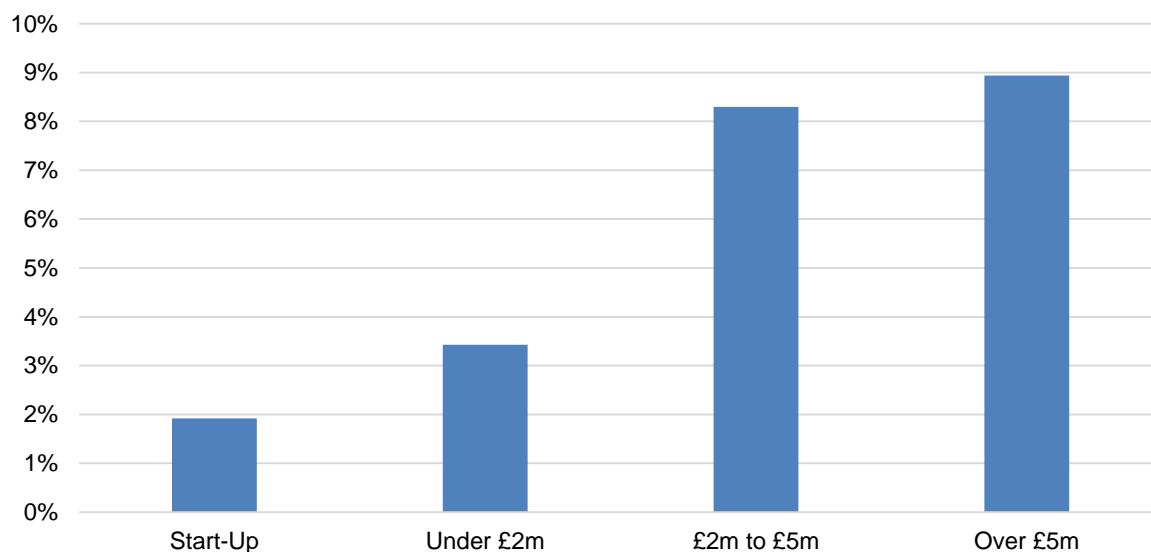
Multiple bank base: All SMEs with sterling BCAs who were asked about products they held in the last 12 months (340).

Multiple BCA base: All SMEs with sterling BCAs (716).

Note: Multi-banking products are taken to include BCAs, overdrafts, factoring/invoice discounting, business loans, commercial mortgages, asset finance, instant access deposit account, and term deposits. Therefore 'multiple products with multiple banks' is taken to mean having any of the products listed at a bank other than their main bank.

74. The level of multiple BCA holding can vary depending on the size and age of the SME. Figure 31 shows that SMEs in GB with a larger turnover are the most likely to have more than one BCA.^{39,40}

Figure 31: Proportion of SMEs holding more than one BCA by turnover, GB (2014)



Source: Charterhouse BBS 2014.

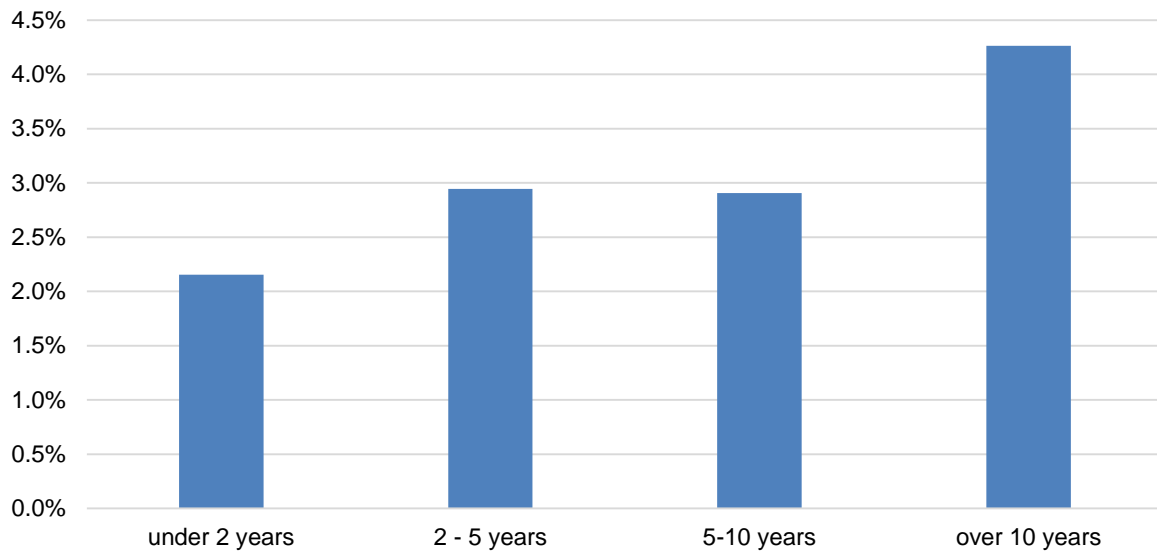
Base: start-ups (2,920); SMEs under £2 million (8,938); SMEs £2 to £5 million (498); SMEs over £5 million (728).

75. Older businesses also had a higher level of narrow multi-banking (see Figure 32).

³⁹ Potentially, some of these BCAs are dormant rather than active.

⁴⁰ The HSBCG survey 2015 found 9% of SMEs surveyed have more than one BCA. It also found that the highest proportion of multi-bankers was amongst SMEs with turnover of between £500k-£2 million, although SMEs with turnover above £2 million were more likely to multi-bank than SMEs with turnover below £500k.

Figure 32: Proportion of SMEs holding more than one BCA by age of business, GB (2014)



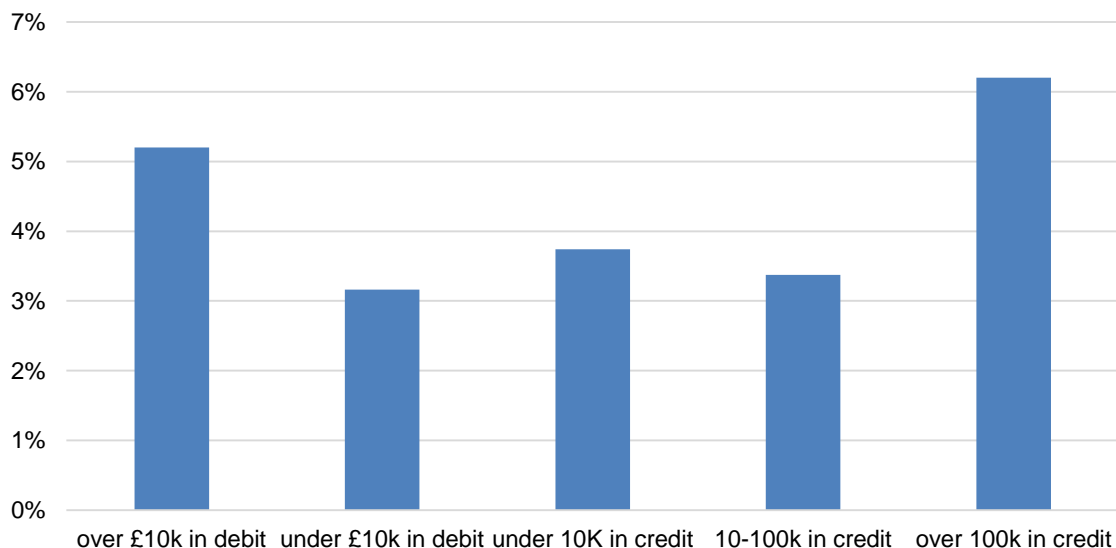
Source: Charterhouse BBS 2014.

Base: SMEs under 2 years (3,239); SMEs 2–5 years (2,159); SMEs 5–10 years (1,593); SMEs over 10 years (7,061).

Notes: Charterhouse BBS records the year the SME started trading. However where this date is before 2005 this is just recorded in 5-year bands. This means, depending on the year of interview, it is not always possible to accurately identify whether an SME is 5–10 years old or over 10 years old when it began trading between 2000 and 2005. In these cases a proportion of cases have been randomly assigned to the 5–10 years or over 10 years band depending on the likelihood of being in that band. For example, for the 2013 dataset 1/5 of those who started trading between 2000 and 2004 are assigned to 5–10 years (as only those who started in 2004 would enter that band).

76. Figure 33 shows that SMEs with high-credit balances are most likely to have more than one BCA.⁴¹

Figure 33: Proportion of SMEs holding more than one BCA by size of balance GB, (2014)



Source: Charterhouse BBS 2014.

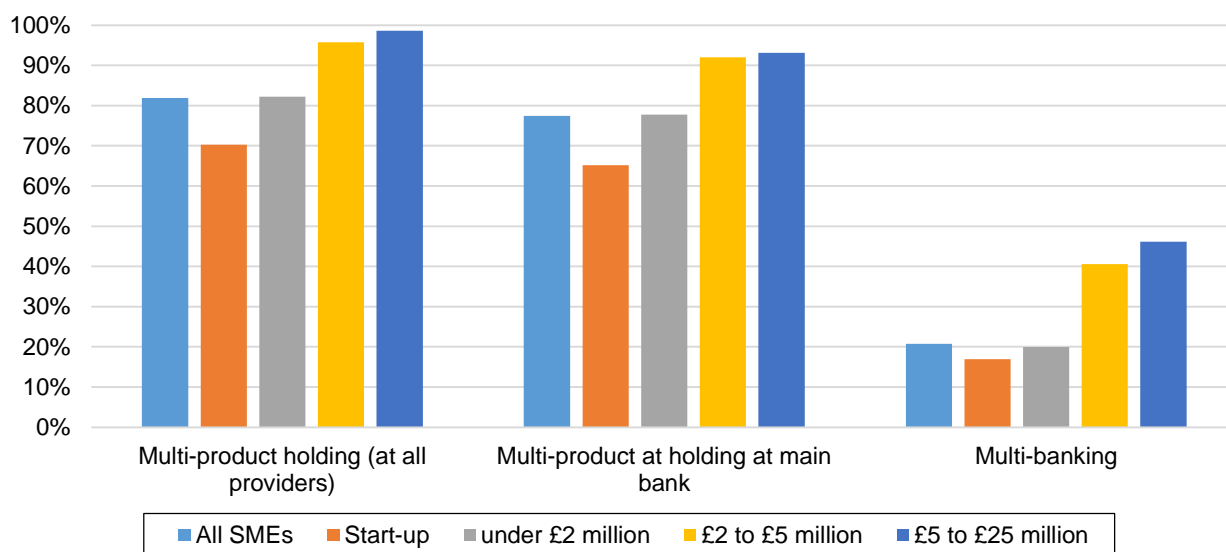
Base: All SMEs asked about account balances (2,014): over £10k in debit (337), under £10k in debit (330), under £10k in credit (1,836), £10–100k in credit (1,168), over £100k in credit (662).

Note: Balances are for BCAs only (including overdrafts) but do not include loans.

⁴¹ The difference between those who are over £10,000 in debit (ie with a large overdraft) and those under £10,000 in debit or credit is not statistically significant.

77. The level of broad multi-banking can depend on the size of SMEs, with larger SMEs more likely to multi-bank.

Figure 34: Proportion of SMEs holding multiple products at any bank, own bank and other banks, GB (2014)



Source: Charterhouse BBS 2014.

Base: All SMEs asked about other banking products (4,993), start-ups (608), <£2 million (3,151), <£2 to £5 million (502), over £5 million (732).

Other indicators of customer engagement

78. We found that BCA switching rates appeared low. However, this is not the only indication of customer engagement and not the only way in which customer behaviour could exert a competitive constraint on banks. Barclays told us that it ‘considered that it was incorrect to assess switching in isolation from multi-banking and competition for customer churn’⁴² whilst HSBCG told us ‘the CMA has not demonstrated that the current rates of switching equate to weak competition...The CMA will also need to address the question of whether the consistently high churn rate (linked to SME business failures) is sufficient to drive competition.’

79. In this section we assess:

- (a) the extent to which customers negotiate with banks, which can be a way for customers to exert a constraint on banks without switching; and
- (b) the length of time with banks.

⁴² Further Barclays noted that multi-sourcing, where the customer had a relationship with a UK financial provider other than a bank was also relevant.

Negotiation

80. If an SME is able to negotiate successfully with its bank to attain better terms either on a BCA or other products, this may reduce the need for an SME to consider switching, whilst still meaning a bank is having to compete to retain existing customers.⁴³ This may provide a reason why switching statistics understate SME engagement.
81. Responses from the largest banks indicated that negotiation for BCAs primarily take place with the largest or more complex SMEs, with only limited negotiation on periods of free banking for smaller SMEs. The exact threshold above which banks negotiate terms varies from bank to bank but in general encompasses only commercial banking customers (see Table 2 above). These businesses account for a small proportion of the SME customer base.⁴⁴
82. Similarly, the Research Works qualitative research indicated that smaller SMEs were rarely successful in negotiations with their bank and the attitude to negotiation among this group depended very much on the personalities involved in the business.
83. Therefore, the vast majority of SMEs have limited scope to negotiate with their bank on terms for BCAs. This suggests switching statistics are not substantially underestimating engagement levels because they do not take account of negotiations between SMEs and banks over BCA pricing.⁴⁵

Length of time with bank

84. Another indicator of engagement is the length of time an SME has spent with its bank. If an SME has been with its bank for a long time, this may be an indicator that it is not engaged. Figure 35 shows that 34% of SMEs in GB had been with their main bank for over ten years. This compares to 46% of SMEs having been in business for at least ten years. In fact 70% of SMEs that have been in business for over ten years have been with their main bank for at least ten years, and 79% of SMEs that have been in business for at least five years have been with their main bank for at least five years.⁴⁶

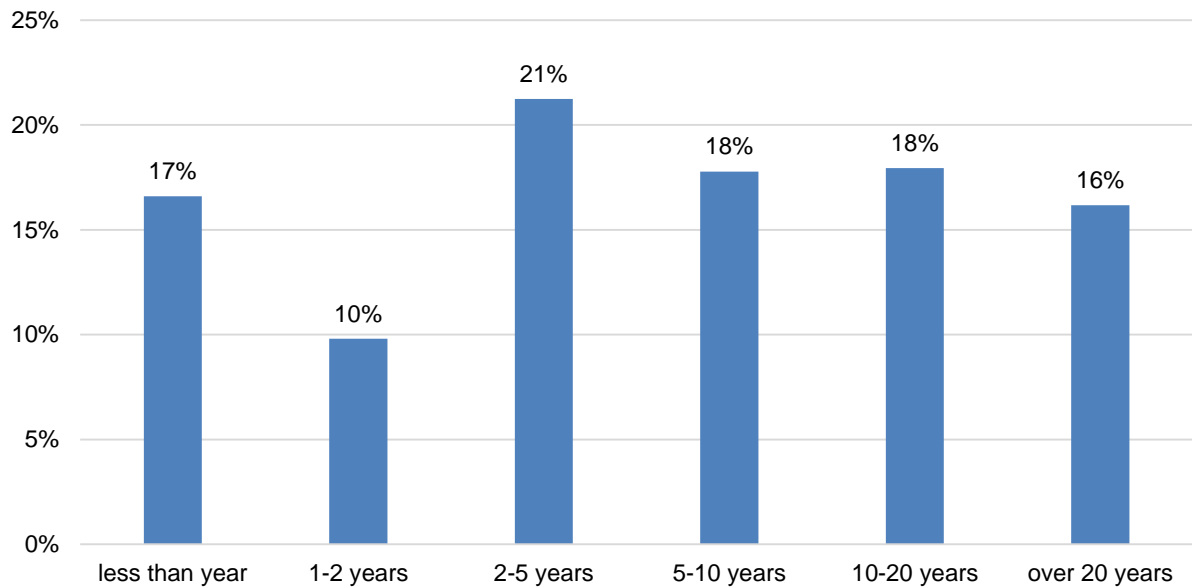
⁴³ This will only be true if the SME has a credible threat to switch.

⁴⁴ Businesses with turnover between £6.5 million and £25 million account for less than 1% of all SMEs. See business population estimates.

⁴⁵ Negotiation appears to be a more important consideration for loans.

⁴⁶ Charterhouse BBS 2014.

Figure 35: Amount of time spent with main bank, GB

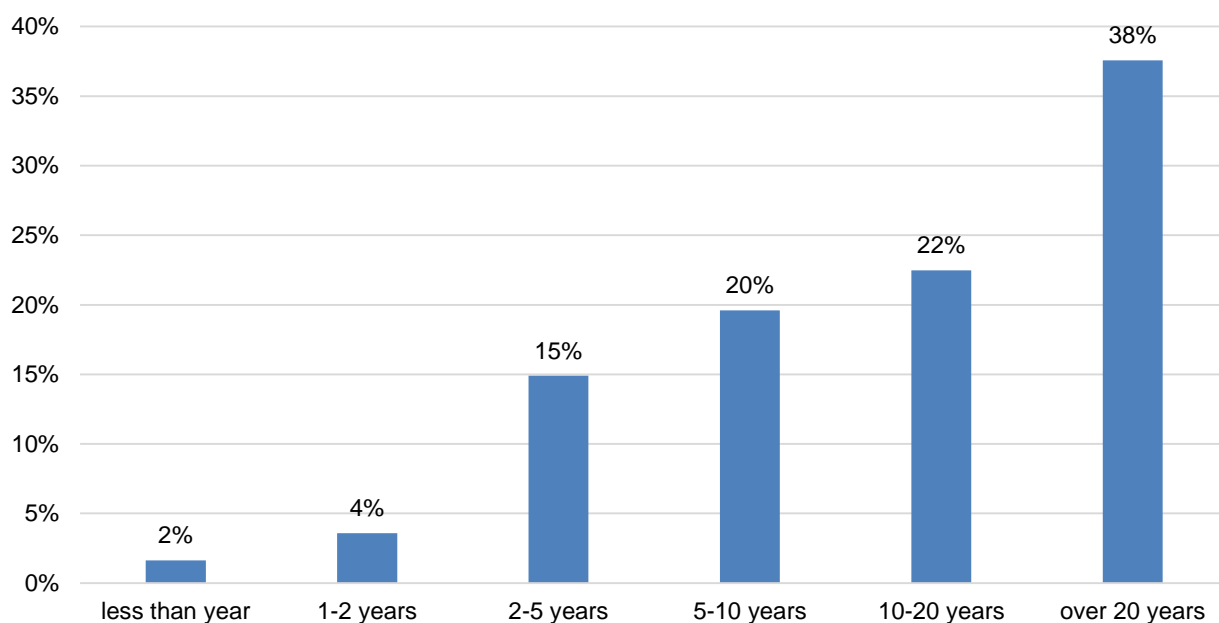


Source: Charterhouse BBS 2014.
Base: All SMEs (14,239).

85. In NI, 21% of SMEs have been with their bank for less than five years, while 60% have been with their main bank for over ten years. As noted in paragraph 18 70% of SMEs in NI have been in business for more than ten years. In NI 77% of SMEs that have been in business for over ten years have been with their main bank for at least ten years, and 88% of SMEs that have been in business for at least five years have been with their main bank for at least five years.⁴⁷

⁴⁷ Charterhouse NI BBS.

Figure 36: Amount of time spent with main bank NI



Source: Charterhouse NI BBS.
Base: All SMEs (808).

Motivations for switching

86. In this section we explore the motivations for switching. In particular we look at the potential prompts to switching, including:

- (a) SMEs' level of satisfaction with their banks;
- (b) switching triggers including push and pull factors;
- (c) behaviour at the end of free banking periods; and
- (d) SMEs' attitude to banking.

Customer satisfaction

87. When SMEs are dissatisfied with the service they are receiving, one could expect a greater propensity to change provider. Data from the Charterhouse BBS suggested that satisfaction levels were around 51% for the largest four UK wide banks.⁴⁸ This was slightly lower than for other banks (60%) (see Figure 38).

⁴⁸ This is for satisfaction levels "Excellent" and "Very good".

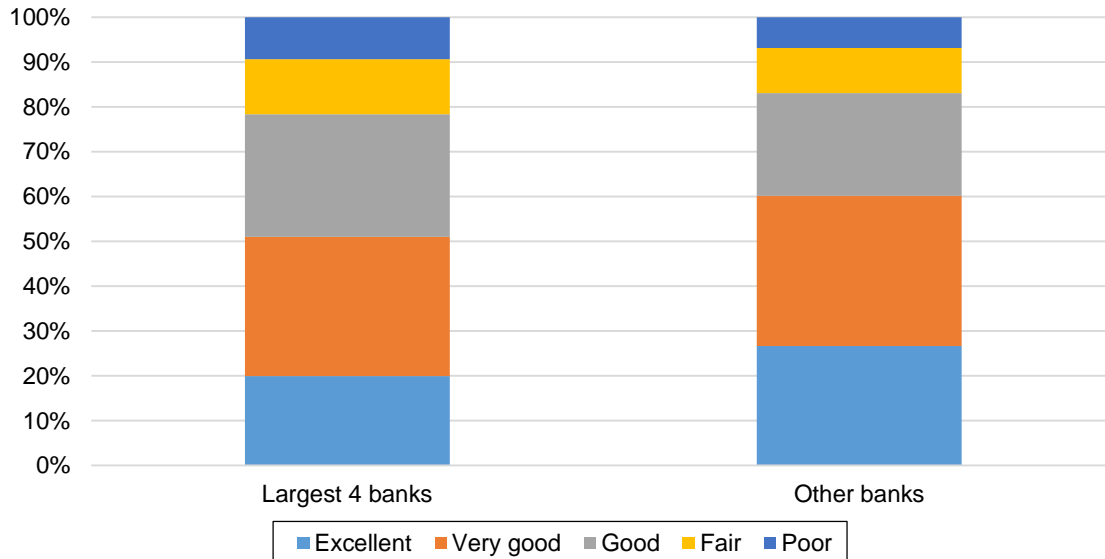
Figure 37: Satisfaction with main bank in GB (2014)



Source: Charterhouse BBS 2014.



Figure 38: Satisfaction with main bank, GB (2014)



Source: Charterhouse BBS 2014.

Base: SMEs with largest four banks (11,759), SMEs with other banks (2,480).

88. Satisfaction scores in NI are similar to those in GB, with [✂] and [✂] having the highest satisfaction scores.

Figure 39: Satisfaction with main bank, NI



Source: Charterhouse NI BBS.



89. An alternative measure of satisfaction is the NPS. Under this measure, the four largest UK wide banks and other established banks typically have negative scores, whilst some [✂] have positive scores. See Figure 40 for GB results and Figure 41 for NI results.

Figure 40: NPS by bank, GB (2014)



Source: Charterhouse BBS 2014.



Figure 41: NPS by bank, NI

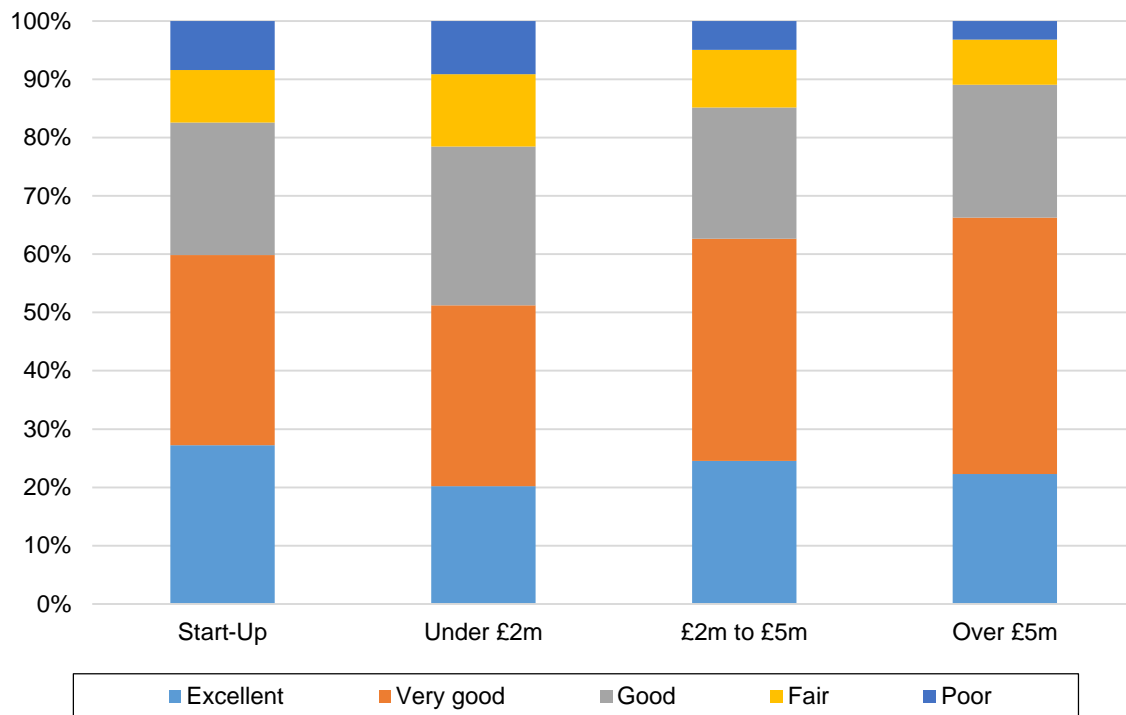


Source: Charterhouse NI BBS.



90. Satisfaction is lowest among SMEs with turnover under £2 million in GB (Figure 42).

Figure 42: Satisfaction by turnover, GB (2014)

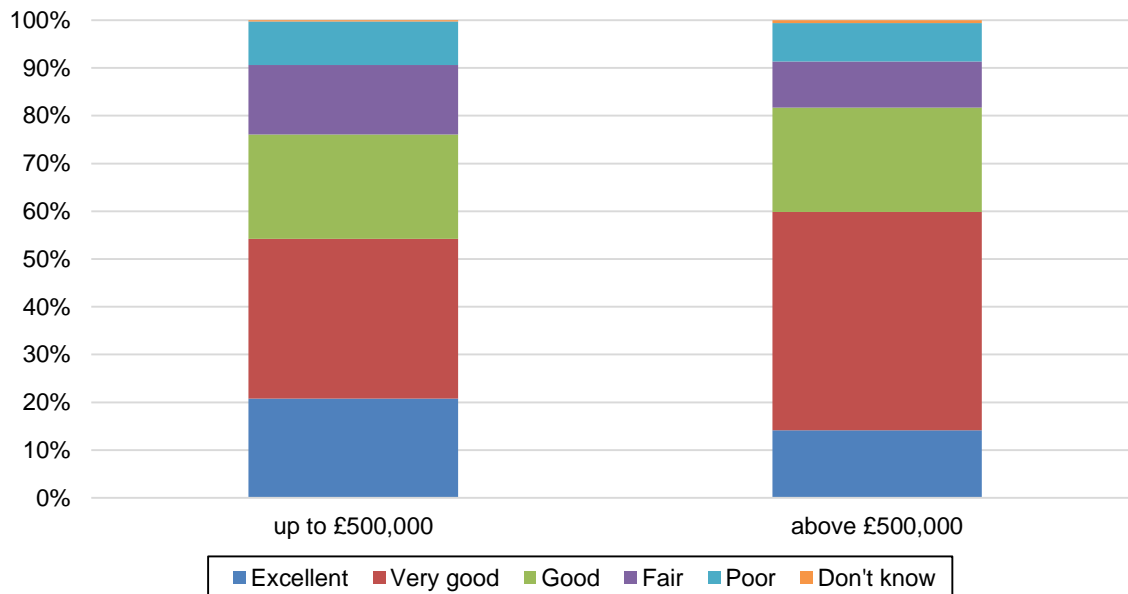


Source: Charterhouse BBS 2014.

Base: All SMEs 2014: start-ups (2,920), under £2 million (8,938), £2 to £5 million (967), over £5 million (1,414).

91. Satisfaction levels between the smaller and larger SMEs in NI are similar (see Figure 43), although larger SMEs are less likely to rate their satisfaction with their main bank as “excellent.”

Figure 43: Satisfaction by turnover, NI



Source: Charterhouse NI BBS.

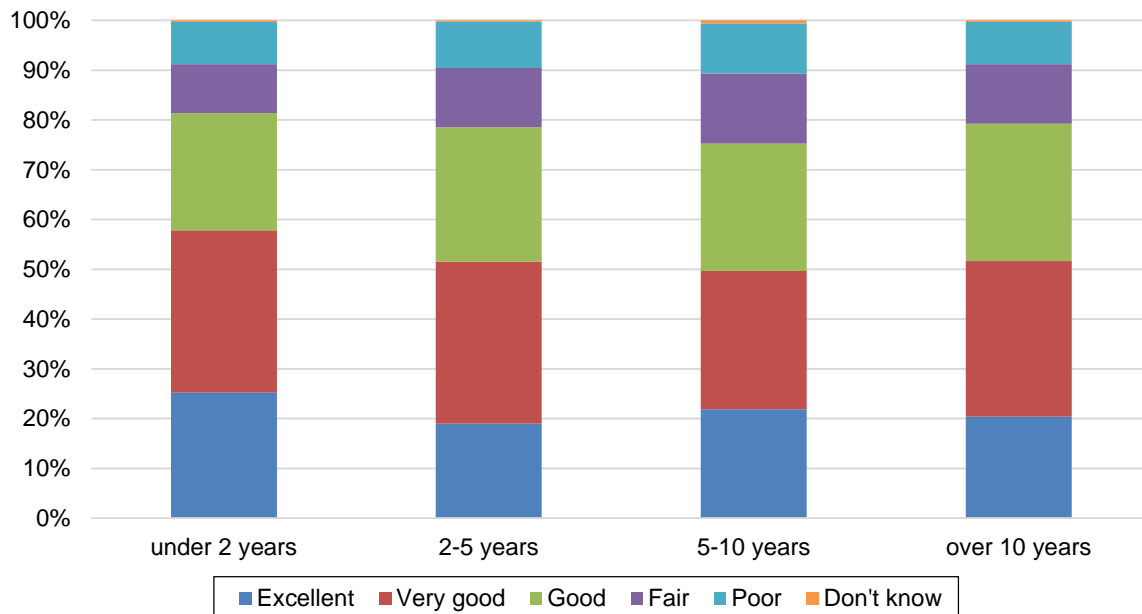
Base: All SMEs, up to £500,000 (658), above £500,000 (150).

Note: Due to the smaller sample size in NI it was only possible to make comparisons by size for SMEs over and under £500,000 turnover.

92. Figure 44 for GB shows satisfaction among SMEs over two years old is relatively similar, those under two years have slightly higher satisfaction scores.⁴⁹

⁴⁹ The HSBCG survey 2015 found that 9% of SMEs were dissatisfied with their bank, with a third of those not considering switching. These results are consistent with the Charterhouse BBS findings. HSBC also found larger and older SMEs were more likely to be very satisfied with their bank. The turnover findings are consistent with Charterhouse, although Charterhouse finds businesses under two years are the most satisfied.

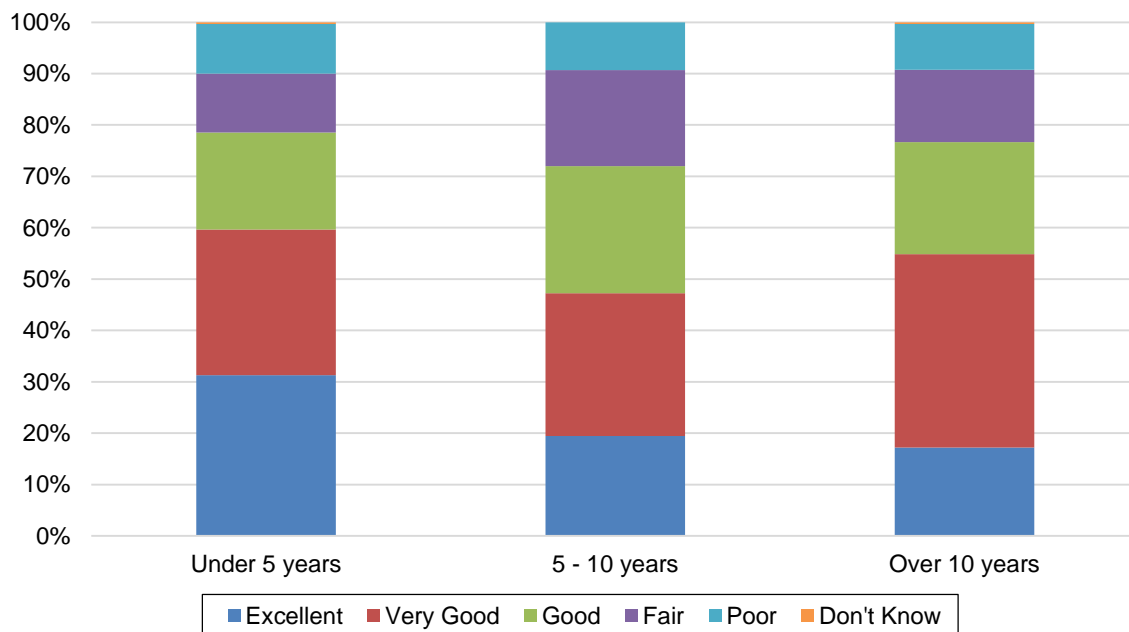
Figure 44: Satisfaction by age of business, GB (2014)



Source: Charterhouse BBS.

Base: All SMEs 2014: SMEs under 2 years (3,239), 2–5 years (2,159), 5–10 years (1,593), over 10 years (7,061).

Figure 45: Satisfaction by age of business, NI



Source: Charterhouse NI BBS.

Base: under 5 years (109), 5–10 years (103), over 10 years (588)

Note: Due to the sample size of the Charterhouse NI BBS, there are few SMEs that have been in business for less than two years. Therefore all SMEs under five years old are grouped together.

93. The FCA CASS qualitative research⁵⁰ found that SMEs that were not considering switching were 'Happy with existing provider.' However, it noted that:

[i]n the majority of cases this perceived 'happiness', could perhaps be more accurately be described as a passive level of satisfaction. When prompted, *non-considerers* typically specified two key factors, which correlated with the reasons for inertia...:

- (a) They saw their provider as reliable as they had never had any problems with them, so their account was low maintenance. In addition they tended to be have grown used to their provider's services (whether branch or online), as they often had a long-term 'relationship' with them.
- (b) ...relatively few 'moments of truth' where a provider can drive a more active level of satisfaction. These tended to differ by audience, but involved instances of a provider 'being there when needed', such as ... offering lending to support *business* cash flow.⁵¹

94. Elsewhere in the report, it noted the views of both microbusinesses and SMEs that were non-considerers. It found the following:

- (a) Micro business non-considerers tended to be much more negative about their banking relationship than their consumer counterparts. This appears to be driven by a sense that banks aren't particularly interested in meeting the needs of smaller businesses. Reasons for this included a perceived lack of flexibility in supporting businesses with cash flow and lending solutions, as well as a sense that the relationship management which was formerly offered, was being gradually eroded.⁵²
- (b) SME non-considerers tended not to reference as many of the problems [with their banking relationship as were] identified by smaller businesses. Whilst distance of their relationship with their bank was [mentioned] this was not always seen in negative terms. In part this was because generally SMEs

⁵⁰ Optimisa Research, [Engagement with current accounts and the switching process](#). This research covered consumers, micro-businesses, SMEs and charities.

⁵¹ Optimisa Research, [Engagement with current accounts and the switching process](#), p31.

⁵² *ibid*, p20.

tended to feel a little more in control [...] and were more likely to feel they were receiving the necessary financial support.⁵³

95. This research therefore provides a mixed picture of SME satisfaction levels, with some SMEs not necessarily satisfied with their banking relationship and feeling that their bank did not care about them. This aligns with the FSB survey, which found that 56% considered that banks didn't care about small businesses.⁵⁴
96. Research conducted on behalf of the Payments Council found that businesses that had neither switched nor considered switching were most satisfied with their banking services. Those that had considered switching but had not switched were least satisfied with their BCA.⁵⁵ 76% of non-considerers had not switched because they were satisfied with their current provider, whereas only 7% of considerers gave the same reason for not switching.⁵⁶
97. The HSBCG survey 2014 also noted that 44% of non-considerers did not switch because they were satisfied with their existing service while 21% said they valued their existing relationship and were concerned that [a] new [relationship] would not be as good.⁵⁷ HSBCG found that 'the existence of a significant group of SME customers whose propensity to switch is low because they are satisfied with the service they receive and value their relationship with their existing provider.'
98. Similar to GB, SMEs that were least satisfied with their bank were most inclined to consider switching in NI.⁵⁸

⁵³ *ibid*, p21.

⁵⁴ [FSB survey](#), slide 17.

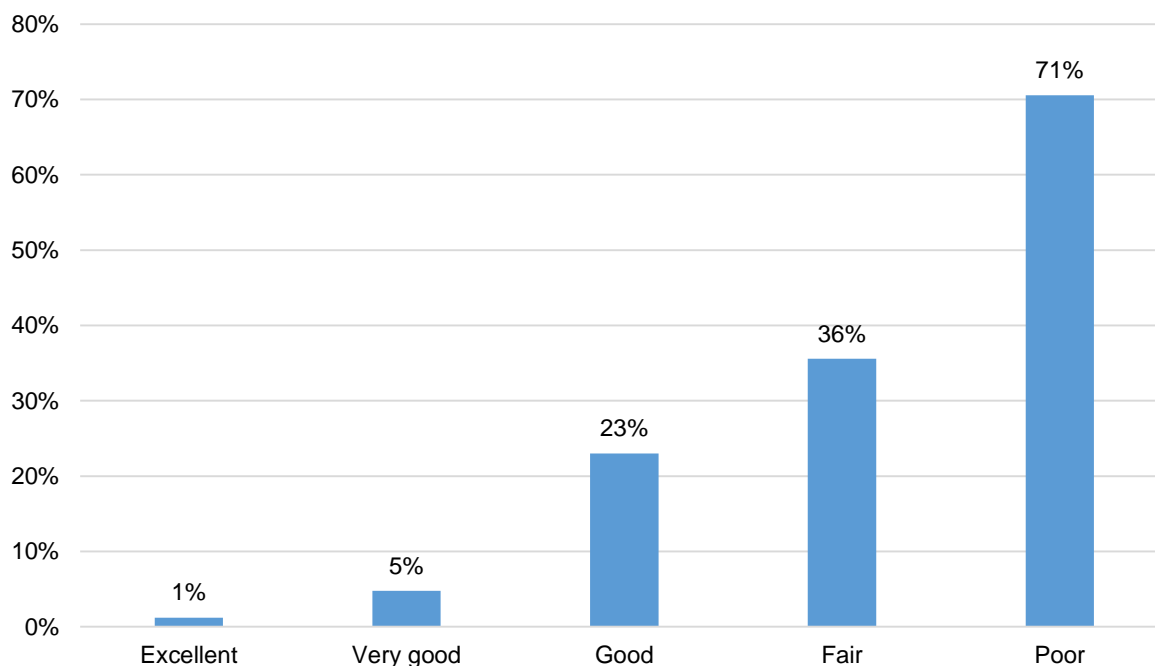
⁵⁵ Payments Council research, p20. Note that this research excludes businesses with turnover greater than £1.8 million or more than nine employees (ie it is focused on microbusinesses that are eligible for CASS).

⁵⁶ Payments Council research, p27.

⁵⁷ HSBCG survey 2014.

⁵⁸ This analysis for GB can be found in Section 8.

Figure 46: Rates of switching consideration by satisfaction level, NI



Source: Charterhouse NI BBS.

Base: All SMEs; Excellent (145), Very Good (288), Good (189), Fair (109), Poor (75).

Switching triggers including push and pull factors

99. When SMEs need to make regular active decisions over which provider to use, there can be many natural points (or triggers) for customers to consider which provider is most suitable. For example, in the context of insurance products, annual contracts with renewal letters can act as a trigger for customers to consider whether they want to continue using their current provider or to switch to another provider.
100. However, for SMEs using BCAs, the evergreen nature of the product means there are few natural trigger points. The Research Works study found that switching is often prompted by dissatisfaction with some aspect of the current provider's offering although it identified four potential trigger points. These are:
 - (a) when moving from PCA to BCA;
 - (b) at the end of the free banking period;
 - (c) when the business reaches a particular stage of growth or requires different banking support (such as a need to borrow); and
 - (d) if the relationship with the bank is perceived to have broken down.
101. The latter trigger points are less regular and may not occur for all SMEs. We note that dissatisfaction appears low although the rate of SMEs considering

switching increases as satisfaction decreases.⁵⁹ When SMEs are motivated to switch, this can be either because they became frustrated with their previous provider ('push' factors) or because they were enticed by the offering of a new provider ('pull' factors).

102. In this section we summarise the evidence on which push and pull factors are important in leading to SMEs to switch and whether it is push, pull or a combination that leads SMEs to change provider.

Which push and pull factors are important?

103. In the Charterhouse BBS, switchers were asked 'What was it about your former bank that encouraged you to move away from them as your main bank?' and '... what was it about your main bank that made you choose them as your new main bank?'. The results are set out in the charts below.

Figure 47: Top 10 push factors, GB (2010–2014)

[✂]

Source: Charterhouse BBS.

[✂]

Figure 48: Top 10 pull factors, GB (2010–2014)

[✂]

Source: Charterhouse BBS.

[✂]

104. From Figure 47 we see that [✂] are the most important push factors. The importance of [✂] has been decreasing over time. The importance of [✂], whilst small, appears to be increasing over time as a push factor. The [✂] factor has been declining over time, but it is unclear what may be driving this.
105. From Figure 48 we see that [✂] are the two most important pull factors. In addition, [✂] appears to be an important pull factor. [✂] is less important as a pull factor. However the reason for this may be the high degree of SMEs already using their PCA provider for their BCA so they are then not able to switch to their PCA provider for their BCA.
106. We also assessed whether the push and pull factors differed by SME turnover and age.

⁵⁹ However, a third of dissatisfied SMEs do not consider switching. In addition, not all SMEs that consider switching go on to switch providers.

Figure 49: Top 10 push factors for SMEs by turnover, GB – All years combined (2010–2014)

[✂]

Source: Charterhouse BBS 2010–2014.

[✂]

Figure 50: Top 10 pull factors for SMEs by turnover, GB – All years combined (2010–2014)

[✂]

Source: Charterhouse BBS.

[✂]

107. Figure 49 sets out the push factors for businesses of different sizes. Among push factors, [✂] appeared to be the most important across all sizes of business. However, we note [✂] did not appear to be an important push factor for larger businesses. [✂] were more important for this group. [✂] appeared to be less important as turnover increases.
108. Figure 50 shows that for businesses with a turnover of less than £2 million, [✂] appears to be an important pull factor, notably more than for the other sizes of business. [✂] are not important pull factors for businesses with a turnover over £5 million.
109. We also assessed whether push and pull factors varied depending on the age of the business. Figure 51 shows that businesses between two and five years old are most likely to cite [✂] as a push factor, whereas [✂] was more important for businesses over ten years old, compared to other businesses.

Figure 51: Top 10 push factors for SME by age of business, GB (2014)

[✂]

Source: Charterhouse BBS.

[✂]

Figure 52: Top 10 pull factors for SME by age of business, GB (2014)

[✂]

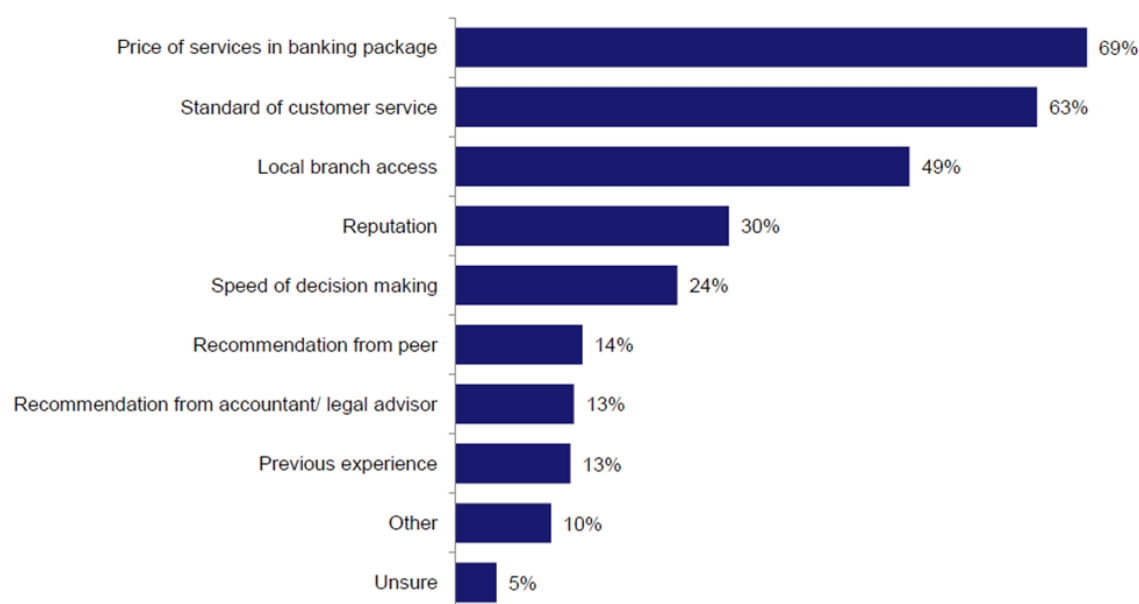
Source: Charterhouse BBS.

[✂]

110. With respect to push factors, Figure 52 shows that the [✂] was more important for businesses between two and five years old. [✂] appeared to be a more important pull factor for newer businesses than older businesses.

111. Among FSB members, pricing was the most important consideration when switching accounts.⁶⁰ This was followed by customer service and local brand access (see Figure 53).

Figure 53: Considerations when switching accounts



Source: FSB.

112. HSBCG told us that ‘market research studies suggest that [...] SME customers of different sizes attach different levels of importance to certain ‘push factors’ and ‘pull factors’ (for example, free banking is typically a more important ‘push factor’ and ‘pull factor’ for smaller SME customers, while customer service is typically a more important ‘push factor’ and ‘pull factor’ for larger SME customers).’

113. The HSBCG survey 2014 found that for those customers who moved their account, free banking was by far the most important rationale/incentive. Cheaper charges are also important, ranked third. Convenient branch ranks highly (second). However, this is entirely driven by single-employee SMEs, and as such is more likely to be reflective of local branch demand rather than regional or national branch demand.⁶¹

114. The HSBCG survey 2015 found that the key aspects of service an SME wanted to know more about from a new bank was price (69% of three most important mentions), digital offering (50%) and branch location (43%).⁶²

⁶⁰ FSB survey, slide 6.

⁶¹ HSBCG survey 2014.

⁶² HSBCG survey 2015.

115. For both non-switchers and considerers, 67% and 62% respectively considered that having a good relationship with their bank was more important than cheaper fees. Amongst switchers, however, only 46% agreed, suggesting that there may be differences to what drives switchers and non-switchers.⁶³

Push, pull or both?

116. The research above outlines the importance of particular push factors or particular pull factors. Below we set out evidence about whether push factors, pull factors, or a combination of those are responsible for switching behaviour.

117. A number of different sources of evidence suggested that push factors were predominant in switching decisions.

(a) The FCA's qualitative consumer research found that the reasons to switch cited by switchers and considerers tended to be dominated by 'push' factors.⁶⁴ Pull factors tended to play more of a secondary role and customers often suggested that there was little differentiation across providers and/or relatively limited incentives on offer.⁶⁵ The initial triggers were often further underpinned by underlying motivations such as dissatisfaction with the product and service levels.⁶⁶

(b) [X] conducted exit interviews to understand the reasons why its business customers (turnover up to £5 million) switched. In July 2012 it found that for 41% of customers it was due to the push factors including charges being too high and a poor relationship with the business manager. For 18% of customers it was due to pull factors, including free banking. For 32% of customers it was due to a combination of the push and pull factors. It also noted that 'In many switching decisions, "push" factors arise first. This leads to consideration of other providers and an awareness of the "pull" factors such as free banking.'

(c) For larger SMEs,⁶⁷ [X] noted that 'As customers move up the SME turnover range, they become even more likely to be multi-banked. Correspondingly, it is less common for a bank to lose its entire relationship with an existing customer. Customers may move their main banking relationship but often retain products with their existing bank.' It

⁶³ *ibid.*

⁶⁴ Push factors include (1) banking errors, (2) branch closures, (3) end of free banking, and (4) unwillingness to support/lend to the business. Optimisa Research, *Engagement with current accounts and the switching process*.

⁶⁵ Pull factors include (1) incentives (like free banking), (2) better interest/lending rates, (3) better international banking rates, and (4) ethical lending policy (more important for charities).

⁶⁶ Optimisa Research, *Engagement with current accounts and the switching process*, pp24 & 25.

⁶⁷ Those with turnover between £5 million and £25 million.

considered that 'It is more common that 'push' rather than 'pull' factors cause a SME with turnover of £5-25 million to move. It is often an accumulation of poor service rather than one specific issue that results in a customer moving. Relevant 'push' factors could include a change in their relationship director, or a poor relationship in overall terms.'

- (d) LBG told us that 'key switching triggers are generally linked to push factors (perceived failures on the part of LBG) rather than pull factors (incentives provided by competitors). The research concluded that smaller businesses (with annual turnover under £500,000), typically cited high bank charges and/or convenience factors, eg closure of local branches as reasons to switch. These factors were compounded by the lack of perceived service received in return for their payments. Larger business (with annual turnover over £500,000) were more likely to have more complex issues and cited the lack of service, flexibility and understanding as reasons for switching. Concerns were most typically associated with managing growth, short-term cashflow issues and/or longer term financial difficulties.'⁶⁸
- (e) LBG's research also noted that 'Often underlying reasons for dissatisfaction with LBG, which on their own don't trigger to switch, but as they build up serve to reinforce motivations to move.' In addition it noted 'Failure to meet basic banking needs were a major trigger to move – bank charges were key for smaller businesses, whereas larger SMEs focused more on the service provided.'
- (f) The HSBCG survey 2015 found the most common reasons cited for SMEs to consider making a change to their business bank in the last five years was dissatisfaction/bank error (33%) and the SME coming to the end of free banking (20%).⁶⁹
- (g) Qualitative research conducted by Charterhouse and submitted by LBG, mentions '[t]he decision to switch was a push from their existing bank rather than a proactive decision based on pull factors from the new banks.'⁷⁰

⁶⁸ LBG noted that this was qualitative research conducted in 2013 involving interviews with 27 customers who had switched away from LBG. LBG also told us that in general, when a customer decided to switch provider, both push and pull factors were likely to be relevant to some extent and the relevant importance of different drivers of switching behaviour would differ, and that it was unaware of any analysis that attempted to quantify the relative importance of these different drivers in a robust manner.

⁶⁹ HSBCG survey 2015.

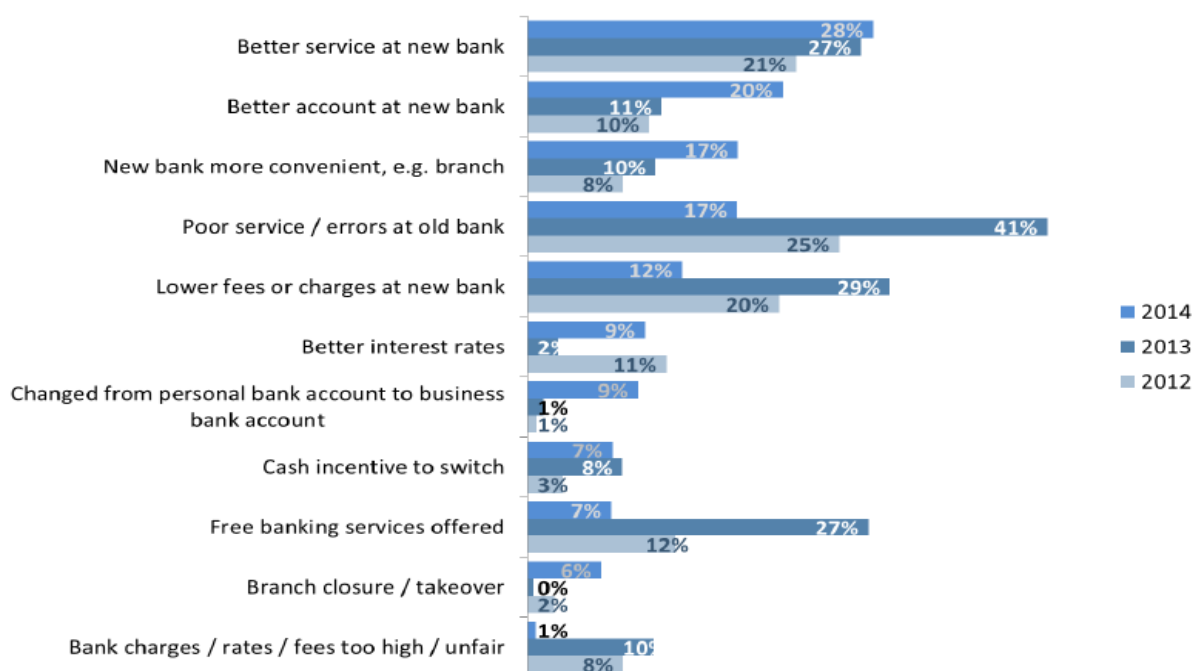
⁷⁰ This research analysed the rationale for switching for SMEs with turnover of up to £1 million.

- (h) Metro and Handelsbanken both mentioned poor service as reasons that customers left their old banks.
- (i) TSB's initial research suggested that being forced to move (relevant for Lloyds/TSB split) was the main push factor. Access to branches and having a PCA with the provider were cited as the main reasons for their choice of (new) BCA provider.

118. However, other research noted a more mixed picture of drivers for switching, with push factors only being a little more prevalent than pull factors. For instance:

- (a) A Payments Council survey suggested that for most years, pull factors were predominant over push factors (see Figure 54). However, in 2013, 41% of respondents claimed that poor service or errors at their old bank led them to switch accounts.⁷¹

Figure 54: Reasons for switching accounts



Source: Payments Council.

Base: All businesses that have switched accounts in the past 12 months.

- (b) Research conducted on behalf of Santander noted that 'service and relationship tends to push businesses, whilst firmer attributes such as rates and international capabilities pull businesses; switching tends to be a combination of push and pull factors.' They also noted that 'When asked about reasons to switch business bank, those who have not switched in

⁷¹ Note that sample size is likely to be small as switching rates were around 2% and for a sample of 1,000, that would equate to around 20 respondents. This would help to explain the high variability in the results.

the past tend to overstate the role of most push factors, and emphasise different ones. Those who have switched before tend to have a more focused view of factors that played a role in their decision.’

Behaviour at the end of free banking

119. The research outlined above shows that the end of free banking can act as a trigger for businesses to switch banks in search of a better deal or extended free banking period. This is consistent with the information received from parties, which showed higher account closures in the period running up to the end of free banking and in the subsequent periods just after the free banking period.⁷² For example:

(a) HSBCG stated that “for both start-up and switcher businesses which received a period of free banking, there were clear points through the customer lifecycle at which we can observe peaks in customer attrition, above and beyond the typical portfolio attrition rates:

(i) For start-ups, [REDACTED]. (See Figure 55).

Figure 55: HSBCG analysis of attrition rates for start-ups over time

[REDACTED]

Source: HSBCG.

(ii) For switchers, [REDACTED].

(b) LBG, similarly, found evidence of higher account closures around the end of free banking periods.

(c) [REDACTED] told us that account closures increased notably in the month before free banking ended. In addition, dormancy rates among continuing accounts increased from around [REDACTED]% to more than [REDACTED]% six months after the end of free banking which could indicate they were switching to a competitor. It also noted that this increase may also reflect normal business closure, however it was unable to identify from the data those accounts that were switching and those that resulted from normal business closure.

(d) However, another piece of [REDACTED] research tracked exits and switcher rates of start-ups and SMEs that had switched to [REDACTED]. It found that for both these groups switching rose around the end of the free banking period.

⁷² We note that account closures can be due to businesses exiting/closing down, rather than just switching.

SMEs' attitude to banking

120. SMEs' attitude to banking could affect their willingness to engage with the product. FCA CASS qualitative research explored what inhibited SMEs from switching BCAs and the extent to which this related to the switching process. The research included SMEs, microbusinesses, charities and consumers.
121. Four common themes emerged from the research which helped to explain a relative lack of SME engagement in the provision of BCAs.⁷³
- (a) Low maintenance – A reliable current account service was often taken for granted, as generally there were relatively few examples of SMEs having problems with their accounts, even if there was a high volume of both incoming and outgoing payments.
 - (b) Low costs – It was recognised that BCAs were an essential product, but they were generally not perceived to be a big cost burden on customers. In contrast to other products or services which were switched more regularly (eg insurance or energy), the lack of a clear price anchor meant that switching BCAs did not offer an obvious way to make cost savings.
 - (c) Long term – The majority of non-considerers had been with their existing bank for a number of years, with some having only ever had one banking provider. This could lead to entrenched behaviour as SMEs stuck to what they knew. In addition some SMEs felt they may receive beneficial treatment for being a long-term customer, as their existing bank/building society would know their history, eg their ability to keep up with payments. This sentiment was particularly pronounced among businesses with long-standing relationships with relationship managers.
 - (d) Convenience – Linked to the often long-standing relationships which customers had with their existing providers was the sense that they were comfortable with their existing banking services. Longevity meant that SMEs grew used to the way they managed their accounts through their existing banks' services, whether their preferred channel was online, telephone or the branch. Local branches could be particularly important for businesses or charity organisations that regularly needed to pay cash or cheques into their accounts.
122. The Research Works SME qualitative research found that some SMEs would not consider switching BCA if they felt existing arrangements were working well. Their attitude tended to be one of 'if it's not broken, don't fix it.' This

⁷³ Optimisa Research, [Engagement with current accounts and the switching process](#), pp17 & 18.

attitude was particularly prevalent among respondents representing younger businesses, largely because they did not demand much from their banking providers. Among this group, transaction rates were typically low due to smaller client bases, as were charges, and the types of transaction were relatively straightforward. As a result, this group typically had a limited interaction with their banking provider, particularly if all their transactions were carried out online. This research also found that some respondents considered that banks would be more inclined to give the SME a better deal if they did not switch, because the bank would know the business better.⁷⁴

123. LBG research also noted that perceived barriers to switching were relatively high so it was a big decision to move bank. It also mentioned inertia, hassle and risk as barriers to SME switching.⁷⁵ Switching appeared to happen around certain 'moments of truth' where businesses had more advanced needs such as lending. LBG's research on customer retention noted that it was push factors that triggered switching. This was either when businesses' circumstances change or there was a failure to meet either a basic or advanced business need.
124. The FCA CASS qualitative research noted that SMEs did not think other providers would be any different.⁷⁶ This barrier was often identified as part of a wider distrust in the banking industry and was more evident among smaller businesses that felt they were 'just a number' to the big banks.⁷⁷
125. The Research Works SME qualitative research found similar results. In particular, it found that the perception of a lack of differentiation was based on assumptions rather than a factual appraisal or understanding of the range of BCA banking offers. Nonetheless, when prompted during the research interview, no bank was perceived to have a clearly differentiated business offer, ie a business offer distinct from any other provider; and, when prompted during the research interview, there was perceived to be a general lack of specific BCA advertising (particularly in comparison with PCA advertising).
126. The HSBCG survey 2014 asked customers how much they expected to save if they switched. Among considerers, 22% did not know how much they could save, 15% did not expect that they could save anything while a further 36% expected to save less than £10 per month.⁷⁸ Among non-considerers, 38% did not know how much they could save, 35% did not think they could save

⁷⁴ Research Works [SME qualitative research](#).

⁷⁵ The research did also note however that changing circumstances reduced the barriers to switching as [they] often forced the customer to rethink their finances or open new accounts anyway.

⁷⁶ Optimisa Research, [Engagement with current accounts and the switching process](#).

⁷⁷ Optimisa Research, [Engagement with current accounts and the switching process](#), p32.

⁷⁸ The remaining proportion were distributed as follows: £11–£25 (12%), £26–£50 (9%), £51–£100 (6%), >£500 (1%). Please note that weighted base for this question was 135.

anything while a further 24% expected to save less than £10. 88% did not think they could save enough to make switching worthwhile.

Barriers to switching

127. The HSBCG survey 2015 found that the most common reason for SMEs who were considering switching, deciding not to switch was SMEs not wanting to lose the benefits of their current relationship (80%). Problems with the switching process (51%) and problems finding out information about other banks (48%) also featured.⁷⁹
128. For those who did not consider switching, 89% did not want to lose existing benefits, 77% considered there to be a lack of incentives, whilst fewer considered the switching process (39%) or lack of information (36%) to be barriers to switching.⁸⁰
129. In this section we consider:
- (a) the practical steps an SME needs to undertake to switch banks;
 - (b) CASS awareness;
 - (c) SMEs' confidence in the switching process; and
 - (d) the ease of the switching process.

Practical steps of the switching process and the length of time to switch

130. SMEs seeking to switch BCA need to go through a number of processes before they are able to switch banks. First they must choose a new bank to switch to and then open a new account with that bank. This includes filling in all the necessary paperwork and providing the relevant documentation. They must also organise for their balances and payments details to be transferred to their new bank. SMEs can either do this manually or use CASS.
131. FCA CASS qualitative research showed that SMEs often confused the account opening process with the switching process. For SMEs the account opening process can be onerous. This is in part due to AML regulations (described in more detail in Section 3 and Appendix 3.1). The information required will vary according to the potential AML risk the customer poses and will be higher for SMEs trading internationally.

⁷⁹ HSBCG survey 2015.

⁸⁰ HSBCG survey 2015.

132. For example, LBG told us that the complexity of the application process and the length of time taken to open a bank account was in large part determined by the need to comply with increasingly onerous mandatory regulatory requirements such as AML regulations and the time taken by applicants (and where relevant their professional advisers) to provide the required information. Data collected from banks shows that while smaller SMEs were often able to open their accounts within 48 hours, ten days or more was not uncommon and this could extend to months in complicated cases. In particular two banks noted it took around 48 hours for smaller businesses (which are more likely to involve simpler AML checks).⁸¹ For larger SMEs the time to open an account was at least two weeks.
133. The Research Works SME qualitative research found that some SMEs considered that the account application and administrative process dissuaded them from switching banks.⁸² It also found that for some customers there were perceived barriers in both the application and switching process. It was noted that 'those who saw the application process as a barrier to switching also tended to see themselves as time poor. Typically, this group had little appetite for the assumed complexity of the application process which, for some, was a barrier to switching in its own right'.

CASS awareness

134. Evidence suggested there was low awareness of CASS.

(a) The FCA's CASS qualitative research:

highlight[ed] the lack of awareness of CASS, particularly amongst businesses and charities. The research suggested that CASS had been more visible to consumers than businesses and charities; there was recall of advertising for CASS that appeared to predominantly target consumers, and recollection of the CASS logo appearing in advertising for high street banks. In addition to this, some financial news sources were seen to have helped to create noise about CASS in the consumer world.⁸³

- (b) Payments Council research in 2014 suggested slightly higher awareness. It found that 49% of those businesses that had not switched accounts recently were aware that there was assistance available to them from the banks to help them switch accounts, although 61% of those businesses

⁸¹ And in some circumstances this could be completed more quickly. [X]

⁸² Research Works [SME qualitative research](#), pp17 & 18.

⁸³ Optimisa Research, [Engagement with current accounts and the switching process](#), pp44 & 45.

said that they knew little or nothing about what assistance was provided. The research results indicated that between 62% and 88% of SMEs were aware of the various aspects of CASS.⁸⁴

- (c) The HSBCG survey 2014 found that a large number of SMEs still did not know about CASS, with 57% of switchers, 71% of 'considerers', 71% of 'non-considerers' not aware of CASS, or thought it applied only to PCAs. CASS made it more likely for 57% of considerers, 42% of switchers and 21% of non-considerers to consider switching providers.

Confidence in switching process

135. Payments Council research, shown in Table 5, found that among non-switchers, 57% thought the process would be easy and 52% considered it would be quick. However, they were less confident that the process would be error free.⁸⁵

Table 5: Non-switchers: attitudes towards switching

	%		
	2012	2013	2014
I think it would be easy to switch banks	54	56	57
I think it would be quick to switch banks	46	48	52
I think there would be very little work or effort involved on my part	46	47	50
I think our organisation would be in control of the process	54	61	57
I think the process would be error free	33	38	41

Source: Payments Council.

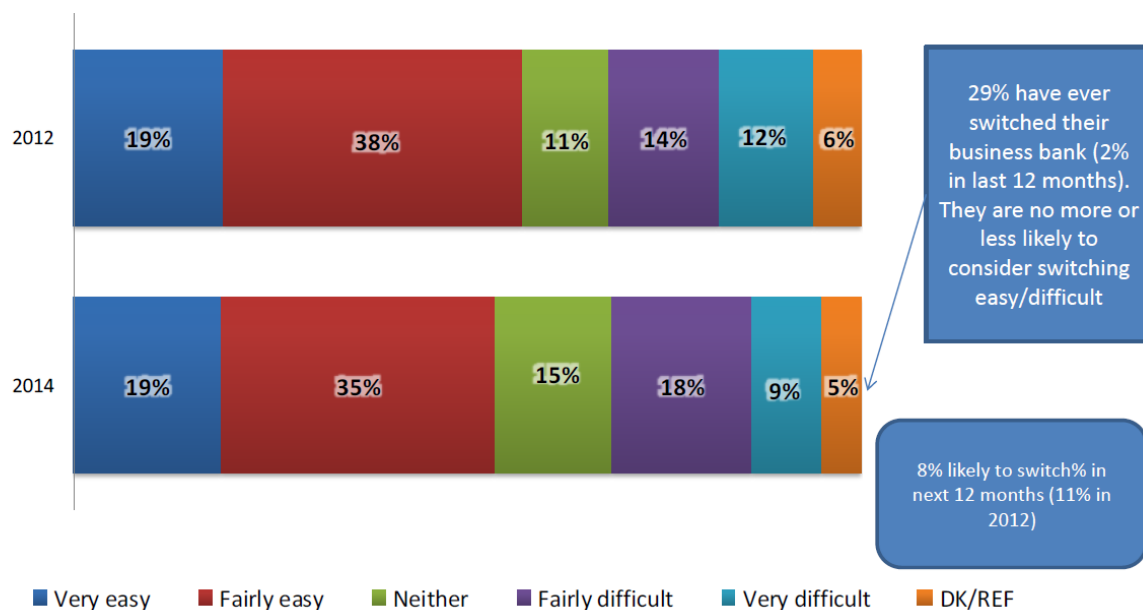
Base: All businesses that had not switched accounts in the past 12 months.

136. Research from the BBB showed that 54% of customers perceived that it would be easy to move banks, with 27% considering it would be difficult.

⁸⁴ Payments Council survey, pp30 & 31.

⁸⁵ Payments Council survey, p31.

Figure 56: Perceptions of how easy/difficult it is to move to a different bank (2012, 2014)



Source: BBB/BMG (2014), 'SME Journey Towards Raising Finance' survey, p45.
 Note: DK means 'don't know', and REF, 'refused'.

137. Whilst some SMEs considered the switching process to be easy, there was a group of SMEs which perceived that the switching process could be a difficult process and would take time. There were particular worries about incoming payments going missing, which would have an impact on the running of the business. As noted below, CASS awareness was low. The HSBCG survey 2014 considered there was some evidence that those who did not know about CASS, or thought it applied to PCAs only, would be more likely to consider switching if they knew CASS applied.⁸⁶

Ease of switching process

138. There were three pieces of research that discussed the ease of switching.
- (a) The HSBCG survey 2014 found that a significant number of switchers thought switching was a 'high effort' process with 33% of switchers regarding the process as 'high effort', even though 87% of them stated the process went 'well' for them.⁸⁷
 - (b) In the FSB survey, 73% found the switching process easy.⁸⁸ For those who did have issues with the switching process, many of the responses were focused upon the pace of the process, the inability to speak to the

⁸⁶ HSBCG survey 2014.

⁸⁷ HSBCG survey 2014.

⁸⁸ FSB survey, slide 7.

right staff, the lack of clarity of what was required, and the onerous paperwork.⁸⁹

- (c) Payments Council research found that 17% of recent switchers had experienced problems during the switching process, which was an increase on 2013 (10%) but higher than 2012, when a third of businesses experienced problems during their switch. The most common problem experienced was errors with direct debits and standing orders, which was higher (11%) compared to the 4% of switchers in 2013, but still down from 19% in 2012.⁹⁰

139. FCA CASS qualitative research indicated a number of areas where there were potential concerns.

- (a) Payments (incoming and outgoing) going missing – This concern was particularly acute for larger SMEs and charities and incoming payments. These problems could affect short-term cash flow and/or result in failures to deliver products or services to customers, which could affect future sales.
- (b) Informing customers – If businesses (and charities) needed to inform their customers and donors of the changes, this was felt to add a lot of inconvenience to the process.
- (c) Charges being incurred – Whilst they considered that any charges wrongly incurred would be reimbursed, this added to the hassle factor of switching.
- (d) Changing standing orders and direct debits – There was often an expectation that this might be something that the banks could switch automatically but lack of knowledge about the process meant it remained a concern for some.
- (e) Length of time the process takes – The time the switch would take emerged as a secondary concern for the majority, the more important thing being to get it right.

140. 21% of SMEs between two and five years old considered it would be too much hassle to switch banks after the end of free banking and 7% said it would take too long.⁹¹

⁸⁹ FSB survey, slide 8.

⁹⁰ Payments Council research, p23.

⁹¹ SME follow-up surveys, p29.

141. The HSBCG survey 2014 found that 53% of considerers and 28% of non-considerers identified the switching process as a reason for not switching accounts. This included the process being too much hassle and the process taking too much time.^{92,93}
142. Payments Council research found that among non-switchers, 57% thought the process would be easy and 52% considered it would be quick. However, they were less confident that the process would be error free.⁹⁴ Research from the BBB showed that 54% of customers perceived that it would be easy to move banks with 27% considering it would be difficult.
143. The HSBCG survey 2014 considered there was some evidence that those who did not know about CASS, or thought it applied to PCAs only, would be more likely to consider switching if they knew CASS applied.⁹⁵
144. Research Works SME qualitative research found that:
- Those who saw the switching process itself as a barrier typically valued their familiarity with existing arrangements, and were apprehensive about having to learn a new set of procedures and passwords. More importantly, they also anticipated difficulties with customers and disruption to processing payments. A fear of jeopardising current payment systems was a key barrier to switching.⁹⁶

Developments in pricing and quality of BCAs

145. In this section we consider developments in relation to:
- (a) free banking for start-ups and switchers;
 - (b) BCA tariffs after free banking periods; and
 - (c) relationship management and service quality.

⁹² HSBCG survey 2014.

⁹³ This finding is in contrast to the FCA CASS qualitative research findings. The HSBCG survey 2014 is focused on non-considerers and is quantitative. The qualitative study may have explored these views in more depth and found the length of time to be less of an issue once fully considered.

⁹⁴ Payments Council survey, p31.

⁹⁵ HSBCG survey 2014.

⁹⁶ Research Works [SME qualitative research](#), p17.

Free banking for start-ups and switchers

History and rationale of free banking for start-ups and switchers

146. Introductory offers in the form of free banking for start-ups and switchers have been a common feature of the SME banking market since at least the 1990s. Variations in the length and conditions of free banking have been driven in response to rivals' offers. HSBC was the first bank to introduce free banking for start-ups and for switchers in 1986 and 1998 respectively. Other banks soon followed and introduced free banking for start-ups in the early 1990s to attract new customers.
147. Prior to this, most banks charged their SME customers for their banking services. Santander, which inherited its SME banking business when it acquired Abbey National and Alliance & Leicester in 2010, told us that both Abbey National and Alliance & Leicester had offered free banking (for day-to-day transactions) to most of their SME customers prior to the acquisition. This had been part of their strategy to establish both brands in the market through a 'very obvious' differentiator to the big four banks at the time, particularly as neither brand was known for serving businesses. [X]. Following the acquisition, Santander in November 2011, started to offer a fixed fee (tariff) banking proposition and only offered a 'fee free' period for start-ups (for day-to-day transactions).⁹⁷
148. Banks told us that the main reasons they offered free banking to start-ups and switchers were the following:
- (a) To minimise the cost of banking during the start-up phase:
- (i) Barclays told us that as part of its citizenship agenda it considered it should offer assistance to start-ups. Approximately half of start-ups would typically close in the first three years primarily due to cash flow pressures. If Barclays could assist during the start-up phase it was not only good for SMEs, but may also benefit Barclays in the longer term.
 - (ii) Santander told us that its free banking policy for start-ups was designed specifically to cushion the cost of banking, whilst the business was starting-up.
 - (iii) RBSG told us that it offered free banking to start-ups to ensure SMEs had the best possible chance to test their idea at as low a cost as

⁹⁷ Which we view as more in line with its larger competitors.

possible. It hoped that once the two years were over, the 'goodwill' generated by the two-year free banking period would increase the chance of its customers maintaining and even expanding their banking relationship with RBSG.

- (b) To compensate SMEs for the cost of switching banks:
- (i) LBG told us that established businesses might experience costs in switching, mainly attributed to the transfer of lending facilities (eg security and valuation fees, and arrangement fees). Switcher offers might therefore be offered to encourage a business to switch all of its financial services needs as well as to migrate any associated cost in establishing its new facility.
- (c) The policy was commercially viable for banks, ie the income generated from these customers over time more than compensated for the incremental cost of acquisition:
- (i) HSBCG told us that many of the free banking customers would generate future revenues from fees paid after the period of free banking expired and from other products and services they purchased from the bank. They would also generate incremental income from the deposits they maintained.
 - (ii) Barclays told us that free banking was commercially viable to it because some start-ups went on to become very successful middle-sized businesses and indeed progressed to become larger corporates.
 - (iii) LBG told us that it continued to earn income from other income streams related to start-ups and switchers including net interest income from the balances of these customers. Further, the income these customer groups generated was positive during the free transactional banking period, and the cumulative income of these customers exceeded the cumulative incremental costs during the [X] year of their tenure with LBG.
- (d) In response to competitive pressures:
- (i) RBSG told us that its initial policy was to charge for all accounts, with free banking subsequently being introduced as an incentive to improve customer acquisition in a very competitive market.
 - (ii) RBSG also told us in respect to Ulster that the decision for Ulster not to charge transaction fees to start-ups was made around eight years

ago to follow competitors such as Santander, Bol and AIB, which had taken similar steps.

- (iii) LBG told us that at various points in time, providers had offered discounted transactional fees for periods between 12 and 24 months with additional benefits such as discounts on accounting packages and business support services. The duration of the discounted offers were influenced by customers' needs and competitors' offers. Historically, Lloyds TSB had varied its start-up discount offers over time as a direct response to competitor offers. For example, in 2003, following the price controls introduced by the 2002 SME banking investigation by the CC, Lloyds TSB offered a three-year discount, providing 100% discount for one year, a 50% discount in year two, and a 25% discount in year three. At the time competitors were also offering a range of start-up discounts, (such as Barclays 12 months free transactional banking), which in some cases were linked to existing PCA relationships, eg HSBC offered an additional 12 months on top of the 12 months of free banking if customers held a PCA with HSBC and NatWest offered an additional six months for customers that held a PCA with it.

Recent developments in free banking offers

149. We asked banks whether there had been changes to their free banking offers to start-ups:

- (a) Barclays' free banking policy has not materially changed since 2002, although it informed us that during this time there had been introductions and withdrawals of 'free banking' extensions linked to other products (ie alongside a customer's 12 months' free banking they would be entitled to an additional six months if they signed up to certain services). For example, in November 2013 it withdrew its offer to extend the period of free banking for start-ups if they signed up to specified business packaged accounts or a business protection plan for late payments or bad debt on opening their initial BCA with Barclays.⁹⁸
- (b) RBSG told us that its offer of free banking for start-ups remained unchanged at 24 months since 2007 for its NatWest brand and since 2010 for its RBS brand, the longest free period of any of the banks.

⁹⁸ Until November 2013, Barclays extended the period of free banking to 18 months if the start-up SME signed up to its monthly packaged account (which included business software applications and support services alongside the BCA); or it took out a business protection plan for late payments or bad debt.

- (c) Santander told us it had not changed its free banking policy for start-ups since 2011, when it removed its monthly fee free banking product from sale and replaced it with the Fixed Fee Business Bank Account.⁹⁹
 - (d) Similarly, LBG has not changed its free banking policy for start-ups since at least 2011.
 - (e) HSBCG has not changed its free banking offer to start-ups since 2012.¹⁰⁰
 - (f) Handelsbanken does not have a standard policy of offering free banking for start-ups or switchers.¹⁰¹ It told us that it did not provide free banking for start-ups because it had a conservative risk appetite and therefore few of its customers were start-ups, and furthermore that it did not segment customers.
150. There has, however, been some variation in free banking periods for switchers:
- (a) RBSG told us that it withdrew its offer of free banking for switchers in 2014 as part of RBS and NatWest's strategy to end teaser rates across all brands for personal and business customers. It replaced the offer with a flat rate cash contribution of between £150 and £250 to cover SME switching costs.
 - (b) Santander told us that it did not currently offer a period of free banking for switchers, as its rationale for the free banking period to assisting start-ups was not relevant to switchers.
 - (c) LBG told us that it had reintroduced six months free transactional banking for SME switchers in December 2014 following its withdrawal in 2013.
 - (d) HSBCG told us that in February 2015 it revised its policy for switchers, increasing the length of free banking from six months to 12 months (see further detail in paragraph 152). This followed no change in the free banking period for switchers since 2012.
 - (e) Handelsbanken told us that 'whether customers are charged for their current account, and if so the amount that is levied, is a decision taken

⁹⁹ This account offers start-ups a 12-month fee waiver period for all standard transactions (or 18 months for existing Santander customers with a 123 Current Account or 123 credit card).

¹⁰⁰ [REDACTED]

¹⁰¹ Handelsbanken noted that decisions on whether a charge was levied, for any type of customer, was determined locally ([REDACTED]).

locally in-branch, according to the specific discussions that have taken place between the customer and the account manager.’

151. There does not appear to be any correlation between shorter periods of free banking and declining market share. For example, Santander and Barclays saw increases in their share of new BCAs between 2012 and 2014.¹⁰² HSBC, on the other hand, saw a decline in its market share, despite having a longer free banking period. The main reasons provided by most banks for their reduced focus on free banking in recent years for start-ups and switchers was to focus on offering higher levels of quality of service and improving their banking tariffs for all customers rather than only start-ups and/or switchers.
152. Both HSBCG and LBG submitted further information on the impact of free banking offers to switchers on their customer acquisition rates.
 - (a) HSBCG told us that following a promotion in January 2011, which extended the free banking period for switchers from 18 months to 24 months, [✂]. In February 2012, it reduced the free banking period from 18 months to six months. [✂] from switchers. This is shown in Figure 57 below.¹⁰³

Figure 57: HSBC switcher account opening volume

[✂]

Source: HSBCG.

- (b) In mid-2013 LBG stopped offering six months’ free transactional banking for switchers, replacing it with individually negotiated arrangements. The number of switchers LBG acquired reduced significantly. This prompted LBG to review its policy and at the end of 2014 it reintroduced a six month free banking offer for switchers.

BCA tariffs after free banking periods

153. Most banks have at least two tariffs for smaller SME customers: one tariff for customers who use branches and a lower tariff for customers who use online channels.
154. In the last few years there have been a number of adjustments made to these tariffs; for example:

¹⁰² See Section 7.

¹⁰³ We note that HSBCG provided other example of changes in free banking period, but these were some of the most substantial changes made by HSBCG.

- (a) Barclays: Barclays restructured its pricing in 2013, and has subsequently been migrating all customers to this updated pricing structure. This revised pricing structure led to an increase, albeit a small one, of average current account charges, in relation to its SME customers with turnover of up to £5 million.
- (b) HSBCG: As part of [redacted] in 2012/13, HSBCG introduced the Business Direct Tariff (now called the Electronic Banking Tariff) for SME customers with an annual turnover below £500,000. It was developed to provide smaller SME customers that predominately use remote channels (such as online or telephone banking) with a lower cost proposition. It was triggered by HSBCG's monitoring of competitor and new entrant offerings ([redacted]).
- (c) LBG: In June 2011, LBG introduced the monthly price plan which, for a fixed fee, included a certain number of transactions per month, with extra charges for off-plan transactions. In addition in February 2015, LBG simplified the tariff structure for its Business Banking Electronic Tariff on its Business Banking Extra accounts. LBG stated that it considered that the changes would make it easier for SMEs to better understand the charges they were incurring.
- (d) Santander: Santander introduced a fixed fee BCA allowing unlimited transactions included within a monthly account maintenance fee.
- (e) Danske: [redacted].
- (f) Metro: [redacted].

Relationship management and service quality

Customer satisfaction and service quality

155. Banks provided some examples of improvements they have made to services to SMEs based on results from various quality and service measures:
- (a) Barclays told us that customer satisfaction scores improved, fewer customers left the bank and more new customers were gained due to an initiative based on feedback on satisfaction from the Charterhouse BBS.
 - (b) Barclays also noted that it monitored the level of customer relationship losses as an indicative measure of the quality of service provided.

- (c) Based on complaints data (among other information),¹⁰⁴ HSBCG improved the visibility of charges on tariffs, speeded up customer service queries, and the way it handled complaints.
- (d) In 2015, Lloyds' retail business banking set average monthly complaints targets of [redacted] complaints, which equates to a 10% year-on-year reduction to the 2014 monthly average of [redacted] complaints.

156. Generally, attempted improvements in customer service seem aimed at not losing customers, although we do note some instances of trying to win new customers.

Relationship management

157. In recent years there have been changes implemented by banks to their provision of relationship managers. For example:

- (a) Barclays: In May 2014, Barclays announced an internal reorganisation involving the creation of PCB.¹⁰⁵ [redacted]. As part of the re-organisation, Barclays had been reviewing its relationship model, providing better access to products and services through all channels.
- (b) HSBCG: As part of [redacted], HSBCG had introduced differentiated relationship management propositions based primarily around the size of the SME. In a hearing with the CMA, HSBCG told us [redacted]. HSBCG told us it had since made efforts to improve its relationship management offering to ensure a greater number of meetings between relationship managers and relationship management-managed SMEs.
- (c) LBG: In 2013/14, Lloyds split its SME banking division in two, as described in Appendix 2.1, with one division focused on smaller SMEs (up to £1 million turnover and lending exposure of less than £50,000) and one servicing larger SMEs (turnover between £1 million and £25 million, or lending exposure greater than £50,000 or customers with more complex banking needs). LBG stated that this model aimed to deliver improved relationship management for larger SMEs with smaller portfolios and more customer contact, with a multi-channel approach for smaller SMEs.

¹⁰⁴ Other information included: data from market research; internal dashboards; competitor benchmarking; post sales feedback; reviews of out-switchers; monitoring of service level agreement of back office operations and social media.

¹⁰⁵ For further details please see Section 2 and Appendix 2.1.

- (d) Santander: Santander has moved to needs based segmentation where SMEs are grouped by the services and support they require regardless of the size of their turnover. It has also expanded its workforce of local relationship managers (from [redacted] in 2014 to target of [redacted] in 2015).¹⁰⁶

Customer acquisition strategies and cross-selling

Advertising/promotion

158. There is evidence of more targeted advertising by banks to either retain or acquire SMEs in relation to either BCAs or lending products, often using digital advertising, or targeted direct mail, such as the following:

(a) [redacted]

(b) [redacted]

(c) LBG told us that in the last three years, above the line (ATL) mass media communications have formed a core part of LBG's marketing strategy to SMEs. LBG uses a mix of TV, radio, press, 'out-of-home' (OOH) and digital display advertising. These advertising methods are, according to LBG, particularly effective in raising brand awareness and consideration of a bank by SMEs.

(d) RBSG has run a number of campaign initiatives across BCAs and core lending products.

(e) [redacted]¹⁰⁷

159. Evidence from Mintel (Table 6) shows that advertising expenditure by the largest five banking groups on SMEs was £24.7 million in 2013. Advertising expenditure has risen every year since 2009.

Table 6: Advertising expenditure on Business Banking services, by the top seven providers of small business bank accounts (2009–2013)

12 months to 30 September	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2012/13 % change	2013 % share
Barclays*	2.87	1.91	6.38	6.41	6.81	+6	16
HSBC	5.25	3.97	1.79	6.11	5.98	-2	14
Lloyds Bank	0.56	2.51	2.31	3.16	5.81	+84	13
NatWest	0.58	2.75	2.16	1.48	3.08	+108	7
Santander	0.22	0.40	0.57	2.74	2.03	-26	5
Royal Bank of Scotland	0.63	0.39	0.65	0.38	0.71	+86	2
Bank of Scotland	0.20	0.18	0.02	0.02	0.32	++	1

¹⁰⁶ This relates to local business managers for Business Banking only. Commercial Banking has [redacted] relationship directors.

¹⁰⁷ [redacted]

Sub-total of listed banks	10.30	12.11	13.87	20.28	24.74	+22	57
Others	12.19	17.56	17.89	17.78	18.80	+6	43
Total	22.49	29.67	31.76	38.06	43.54	+14	100

Source: NMR/Mintel.

*Includes Barclaycard.

++Denotes significant increase.

Role of intermediaries

160. We have found little evidence of banks using intermediaries to acquire new customers. While there was some referral behaviour, this tended to be more informal than formal, and more based on personal contacts than financial relationships.¹⁰⁸

Cross-selling other SME products

161. While banks may try to attract new customers for their products, they may so seek to encourage existing customers to take out new products or renew existing facilities. For example:

(a) [REDACTED]

(b) [REDACTED]

(c) HSBCG focuses on relationship banking and building long-term relationships with customers to provide them with appropriate solutions to meet their banking needs. Rather than engaging in non-targeted product marketing campaigns, it primarily markets its products through its frontline staff as they build and maintain customer relationships.

162. Much of the cross-selling takes place in the context of relationship managers, with both HSBC and LBG telling us that they use their relationship managers to offer products to customers. Given a bank has more detailed transactional information for its existing customers when considering lending decisions, it is not surprising to find much marketing activity aimed at existing customers rather than new customers.

¹⁰⁸ Barclays submitted evidence that it used brokers and intermediaries to supplement sales made through other channels.

Appendix 8.2: SME lending – further evidence

Introduction

1. This appendix provides supporting evidence for Section 8 in relation to lending. It covers the following topics:
 - (a) Sources of evidence.
 - (b) Why SMEs may need finance.
 - (c) Profile of SMEs who use credit facilities.
 - (d) Trends in SME lending.
 - (e) Types of finance available and use.
 - (f) Competitive developments in SME lending.
 - (g) Responses to competitors.

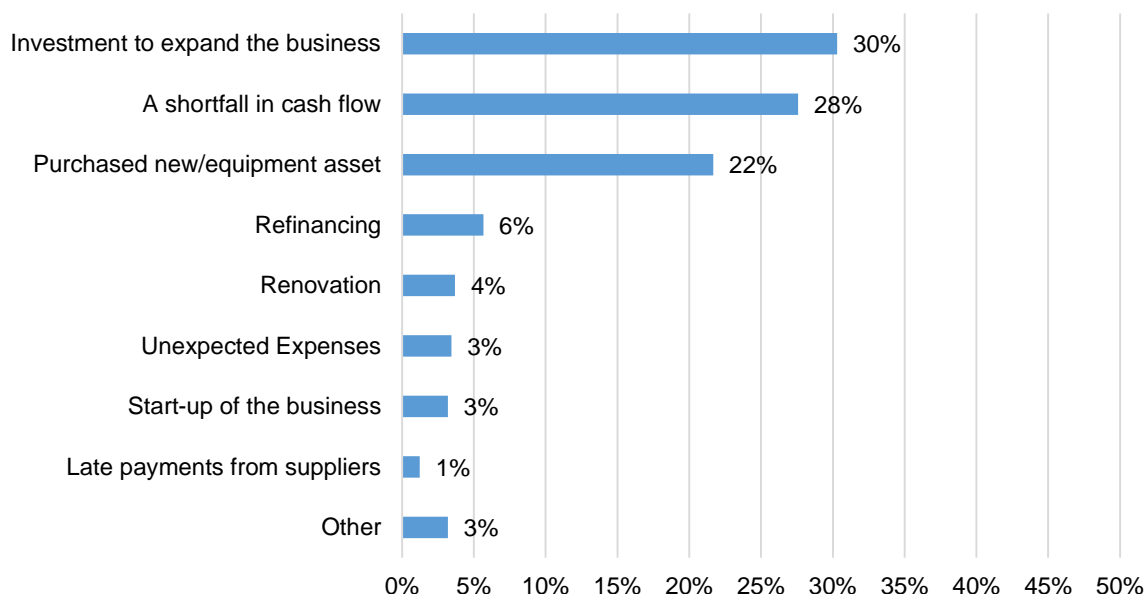
Sources of evidence

2. We use the Charterhouse BBS to produce statistics on the use of finance products by SMEs. We have also analysed the SME Finance Monitor to obtain estimates on the proportion of SMEs that use finance. We note that the SME Finance Monitor includes SMEs that use PCAs for their business, but is weighted to be representative of the population of all SMEs by size, where size is defined by the number of employees.
3. The Charterhouse BBS is representative of the population of SMEs with BCAs by size, where size is measured as annual turnover. While both number of employees and annual turnover are measures of SME size, they lead to quite different SME profiles. The SME Finance Monitor therefore has a much larger proportion of very small businesses (particularly sole traders), with some not using SME banking products. This means that the Charterhouse BBS reports higher proportions of SMEs holding finance than the SME Finance Monitor. Further, the SME Finance Monitor measures the flow of financial products by asking SMEs what they currently use whilst the Charterhouse BBS asks about any product held in the last year (whether or not SMEs are currently using it).
4. In general, where both the Charterhouse BBS and SME Finance Monitor could be used for a statistic, we report results from the Charterhouse BBS (covering GB). Where possible we also report figures from the Charterhouse NI BBS. Results reported from the SME Finance Monitor and the Charterhouse follow-up surveys include NI.

Why SMEs may need finance

5. There are a number of reasons why SMEs may need finance. This includes lending for immediate expansion of the business, an investment in future expansion, a shortfall in cash flow, late payments from customers, or an unexpected cost. Figure 1 shows that the most common reasons for seeking finance were for investment to expand the business, purchasing new equipment or shortfalls in cash flow.

Figure 1: What prompted business to seek finance (UK)

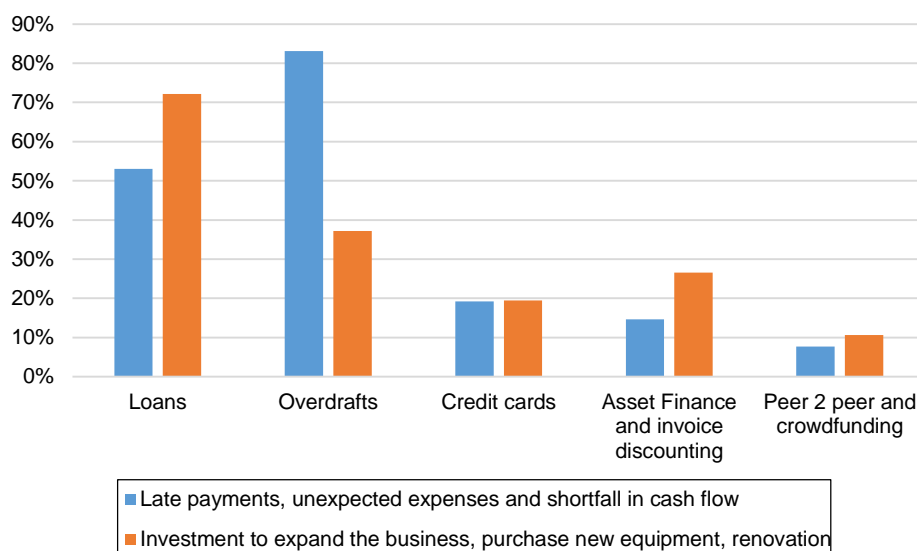


Source: Charterhouse follow-up survey 1 (applying for finance), Question B1.
Base: All (406).

6. As noted in Section 4 some finance products will be suitable for a range of purposes and equally some needs may be appropriately met by a number of specific products. However, there are some differences between lending products that may mean only certain products are suitable for a particular need. For example:
- The choice of finance may depend on whether the need is short term to manage working capital and day-to-day cash flows, or longer term for investing in business development, acquisition of property or other business assets.
 - The availability of external finance and the urgency with which it is required will also influence the decision to obtain a specific type of loan as certain types of finance take longer to put in place.

7. When applying for a general purpose business loan, security may be required. Security is not only applicable to some loans, but may also be required on overdrafts.¹
8. Security may affect the price of the loan; where more security is held against the loan, the interest rate will typically be lower. While security may affect the decision to lend to SMEs, the lender will still need to assess the risk of the SME's ability to make repayments.
9. Figure 2 shows that SMEs consider different forms of finance, depending on their needs. In particular, overdrafts may be more suitable for cash flow issues while loans and asset finance may be more suitable for investment and business expansion.

Figure 2: Type of finance considered by need (UK)



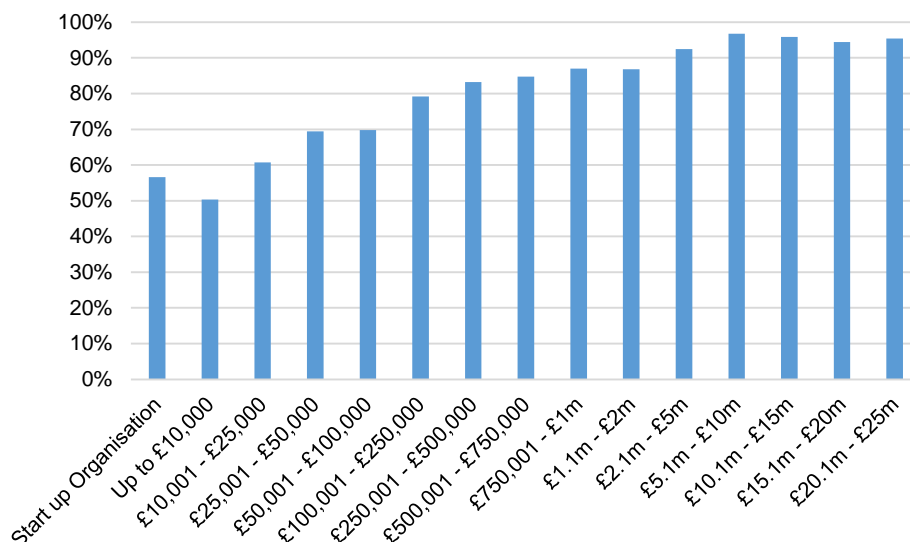
Source: Charterhouse follow-up survey 1 (applying for finance).
Base: All (406).

Profile of SMEs that use credit facilities

10. Lending facilities are not used by all SMEs. Some SMEs do not require finance, others are cautious of debt, and others are more suitable for (or would prefer to) finance via other means (such as personal equity). This is covered in more detail in paragraphs 15 and 16.
11. The Charterhouse BBS reveals that larger SMEs are more likely to take out lending (see Figure 3 below).

¹ The [SME Finance Monitor](#) (Q2 2015) suggests 35% of all overdrafts granted to SMEs required security, p186.

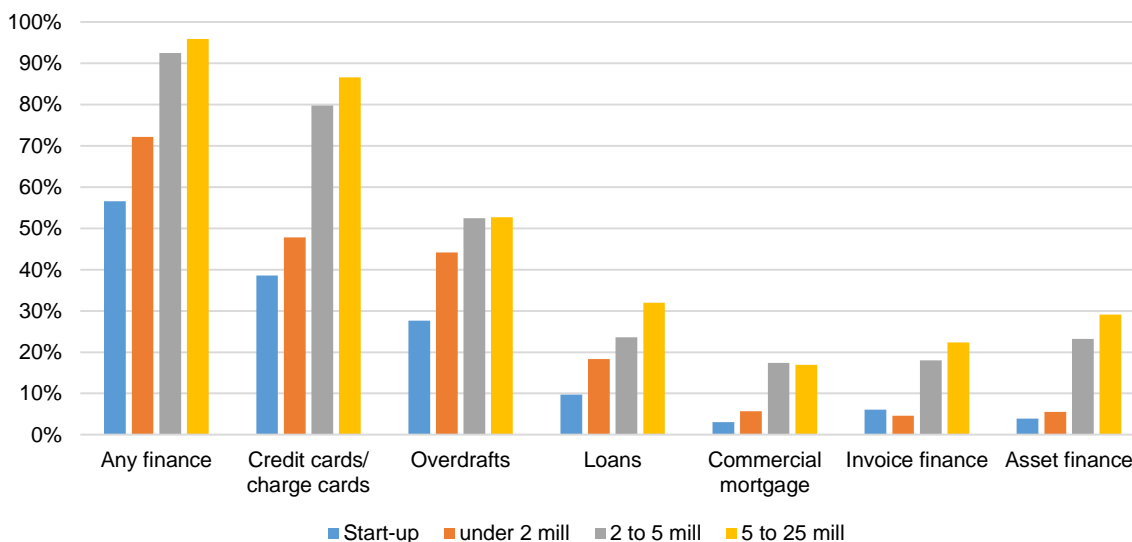
Figure 3: Proportion of SMEs that held finance in last 12 months by SME turnover (GB)



Source: Charterhouse BBS 2014.
 Base: All SMEs asked about banking products other than their BCA.

12. Credit cards and overdrafts account for the greatest proportion of lending (48% of SMEs had credit cards² and 43% held overdrafts), while only 18% of SMEs held a loan in the last 12 months. Few SMEs use invoice finance or asset finance, and those that do are predominately larger SMEs. Figure 4 shows the proportion of SMEs in GB that take out finance products broken down by the size of SME.

Figure 4: Proportion of SMEs taking out finance (GB)

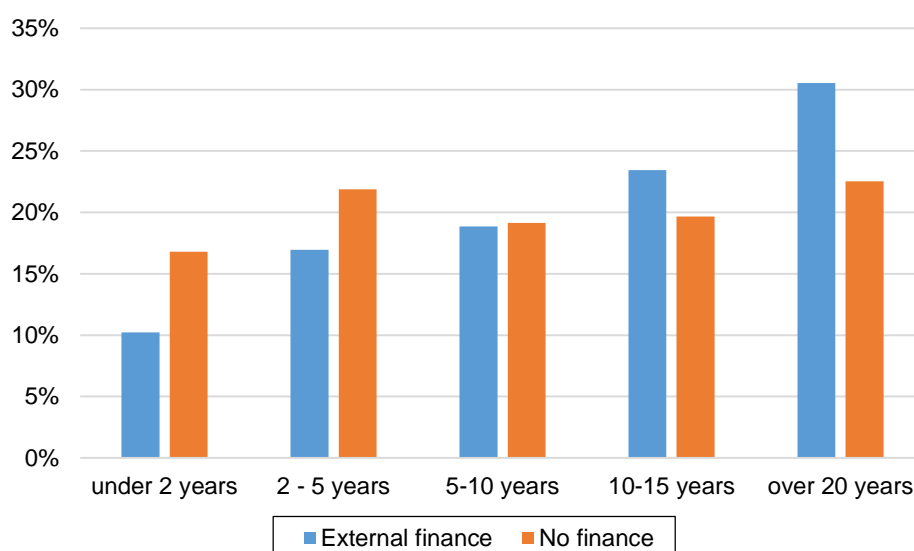


Source: Charterhouse BBS 2014.
 Base: All SMEs asked about banking products other than their BCA: start-ups (608), under £2 million (3,151), £2 million to £5 million (502), over £5 million (732).

² Including charge cards.

13. Over 90% of SMEs with an annual turnover greater than £2 million take out some lending facility, compared with just over half of start-ups. However for start-ups, the majority of lending products taken are credit cards (and charge cards) and overdrafts, with very few taking out other types of finance.
14. Figure 5 shows that the age profile of SMEs that take out finance is skewed towards longer established businesses.

Figure 5: Age profile of SMEs that take out finance (GB)



Source: Charterhouse BBS 2014.

Base: All SMEs asked about banking products other than their BCA: under 2 years (717), 2 to 5 years (576), 5 to 10 years (785), 10 to 15 years (1,089), over 20 years (1,758).

Trends in SME lending

Use of non-bank finance

15. While banks offer different types of debt finance, some SMEs may have a wider selection of ways to fund their business. Some SMEs may not generate any revenue in the near term, with a strategy of becoming profitable at some point in the future. These SMEs may not be suitable for debt finance as this relies on being able to make repayments with the income the business generates over a period of time. Where an SME expects future, rather than current profitability, it may instead consider equity finance, selling off a stake in the business for immediate credit. As noted in Section 4, it is unlikely that equity finance would be a substitute for debt finance for many SMEs.
16. There are also other options for some SMEs needing finance. For example, they may consider using personal funds to grow the business and/or take out a personal loan to invest in the business. However, such arrangements are

more like equity finance and some banks may also have formal restrictions on the use of a personal loan for business purposes.³

17. The SME Finance Monitor reports that in Q2 2015 approximately 36% of all SMEs that were using a lending facility (in the form of a loan, an overdraft or a credit card) had it in their personal name rather than the business. However, the use of personal loans was considerably more prevalent among sole traders, those that were using a PCA for business use and those SMEs that had worse risk ratings.⁴
18. The SME Finance Monitor also reports that 26% of SMEs had used some personal injection of finance in the last 12 months to Q2 2015 (having fallen from 40% in 2013),⁵ while just 2% used equity from third parties.⁶

Use of bank finance

19. The financial crisis affected the amount of lending that banks issued to SMEs. Since the financial crisis, the volume of lending has been low and remained so.⁷ This fall has been due to a combination of supply- and demand-side factors, including banks deleveraging (after the financial crisis), low appetite by SMEs to borrow due to the economic climate and low confidence in obtaining external finance from banks.⁸
20. As noted in paragraph 2, both the SME Finance Monitor and the Charterhouse BBS record the usage of SME lending products. Both surveys suggest that the use of external finance has remained constant over the last few years,⁹ however we report Charterhouse BBS results in Figure 6 for the reasons discussed in paragraphs 2 to 4.

³ [✂]

⁴ BDRC (2015), [SME Finance Monitor, Q4 2014](#), pp53 & 54. BDRC (2015), [SME Finance Monitor Q2 2015](#), pp58 & 59.

⁵ BDRC (2015), [SME Finance Monitor, Q2 2015](#), p66.

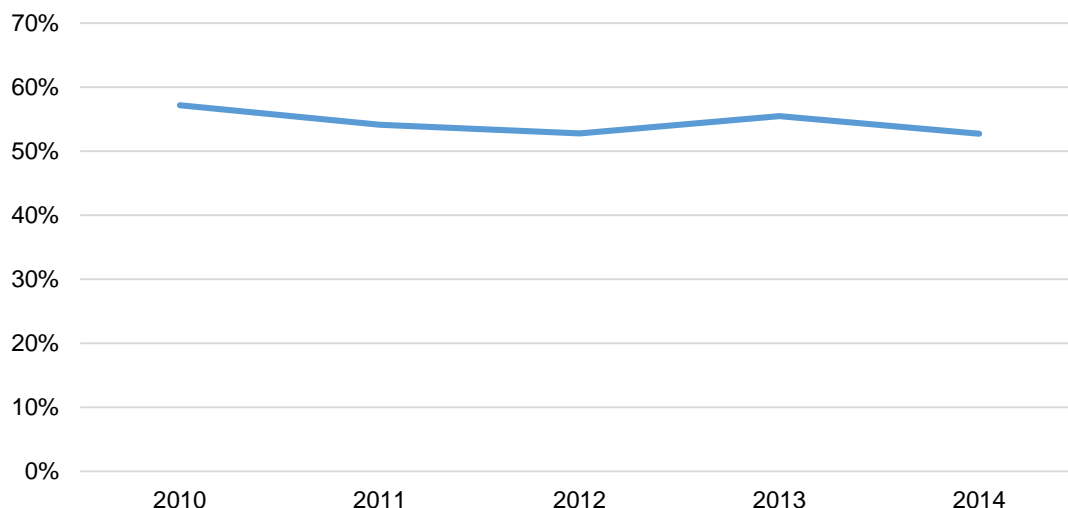
⁶ BDRC (2015), [SME Finance Monitor, Q2 2015](#), p62.

⁷ LBG submitted that while there had been a year-on-year net industry decline of 3%, LBG had increased its lending by 5%.

⁸ BDRC SME Finance Monitor – see paragraph 22.

⁹ Both surveys were established a few years since the start of the financial crisis so do not capture an earlier fall in lending to a more stable level.

Figure 6: Proportion of SMEs holding any external finance in last 12-month period, excluding credit cards (GB)



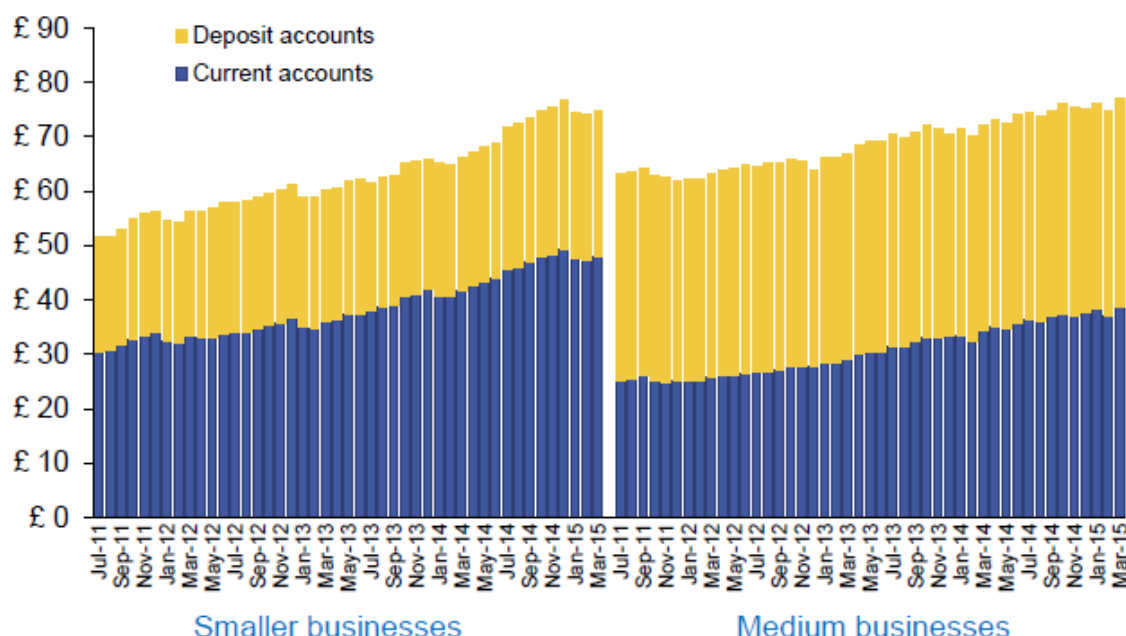
Source: Charterhouse BBS 2010 to 2014.

Base: All SMEs asked about other products: 2010 (4,412), 2011 (4,450), 2012 (4,239), 2013 (5,015), 2014 (4,993).

Note: Credit cards are excluded from this chart.

21. Figure 7, from the BBA’s statistics on bank support for SMEs, shows that many SMEs have been building their cash balances during this time, despite the low BoE base rate. At the end of Q1 2015, cash held by SMEs in current and deposit accounts totalled £151.6 billion, a 10% increase in balances from March 2014.¹⁰

Figure 7: Deposits held (balances outstanding £bn)



Source: BBA statistics, [Statistics, Bank support for SMEs – 1st Quarter 2015](#), Fig 5.

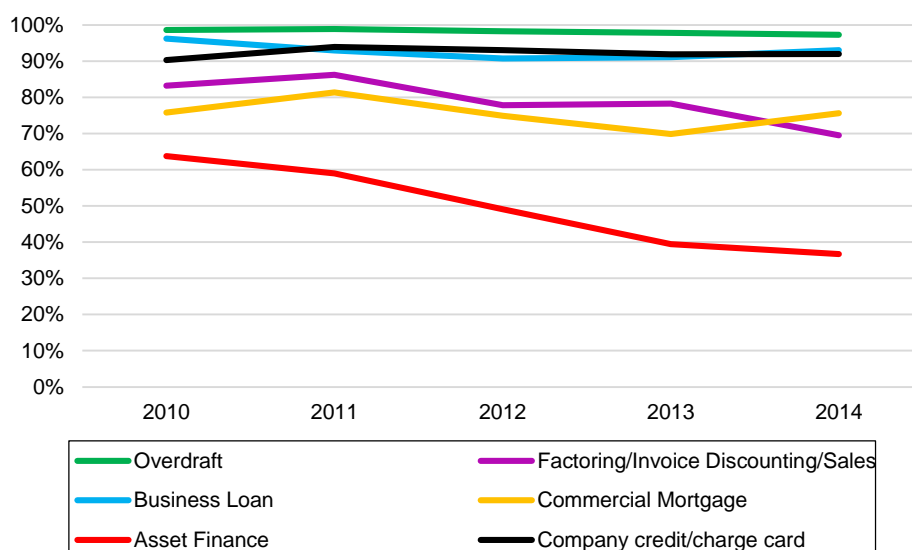
¹⁰ BBA (2015), [Statistics, Bank support for SMEs – 1st Quarter 2015](#), p2.

22. However, there is disparity between SMEs' confidence in banks' willingness to lend, and actual lending approval rates. According to the SME Finance Monitor in Q2 of 2015 69% of loans and 84% of overdrafts were approved (both the highest approval rates since 2012) while SMEs' confidence that they would be approved was much lower at 49%.¹¹ The SME Finance Monitor also found that this reluctance to borrow was in part down to discouragement and the hassle of the borrowing process or cost.¹²

Use and reasons for going to main bank for finance

23. Figure 8 shows, across time, the proportion of SMEs that use their own bank for a particular product rather than a different lender.¹³

Figure 8: Proportion of respondents saying they used their main bank for each product (GB)



Source: Charterhouse BBS 2010–2014.

Base: All SMEs asked about banking products other than their BCA: overdraft: 2014 (2,219), 2013 (2,207), 2012 (1,950), 2011 (1,899), 2010 (1,888); factoring/Invoice discounting: 2014 (469), 2013 (447), 2012 (398), 2011 (384), 2010 (355); business loan: 2014 (1,062), 2013 (1,034), 2012 (990), 2011 (845), 2010 (799); commercial mortgage: 2014 (461), 2013 (432), 2012 (409), 2011 (355), 2010 (364); asset finance: 2014 (633), 2013 (689), 2012 (539), 2011 (553), 2010 (490); company credit/charge card: 2014 (2,802), 2013 (2,820), 2012 (2,178), 2011 (2,218), 2010 (3,962).

24. When comparing individual banks there is little variation.

Figure 9: Proportion of SMEs that took out lending product with their main bank (of all that hold lending product) (GB)



Source: Charterhouse BBS 2014.



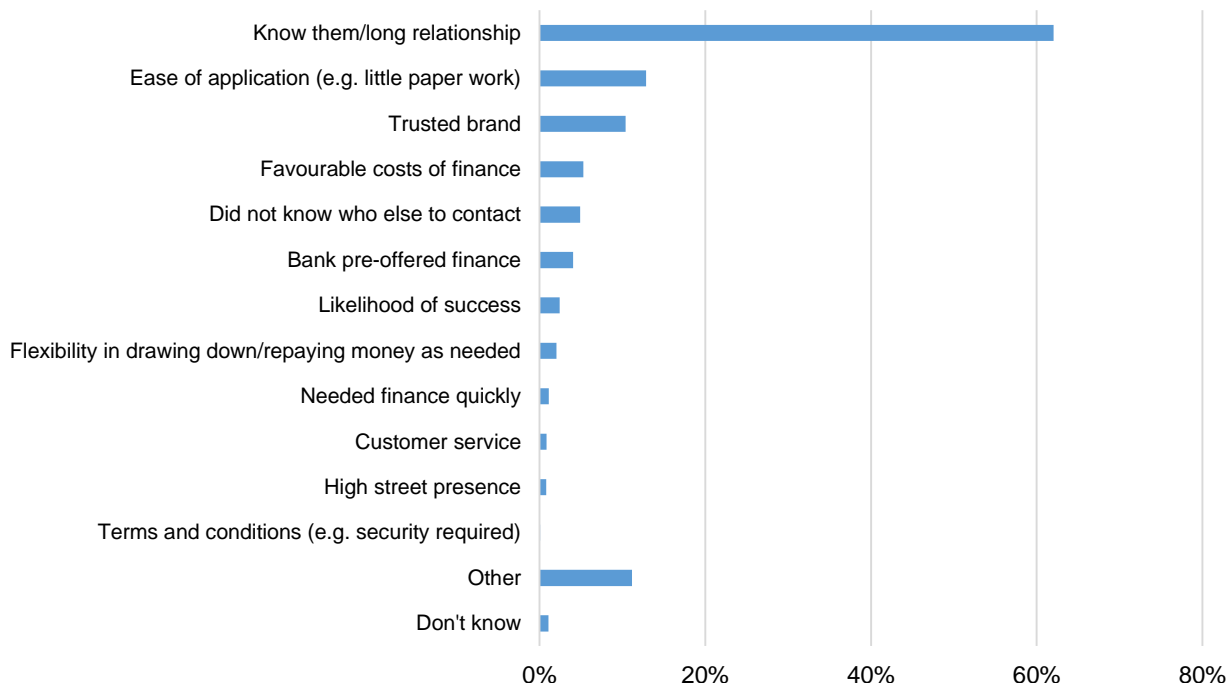
¹¹ BDRC (2015), [SME Finance Monitor, Q2 2015](#), pp146, 163 & 264.

¹² BDRC (2015), [SME Finance Monitor, Q2 2015](#), p221.

¹³ These results for NI in 2015 are shown in Section 8.

25. The BBB/BMG Journey Toward Raising Finance survey asked SMEs why they went straight to their bank without considering other banks. As shown in Figure 10, relationship with their bank and ease of application were the most common reasons given.

Figure 10: Reasons why SMEs went straight to their main bank (GB)



Source: BBB/ BMG Journey Toward Raising Finance 2014, A16a.
Base: All that went directly to main bank (164).

Use of alternative finance

26. Evidence from the challenger banks roundtable and a report by Nesta and the University of Cambridge on understanding alternative finance, suggests that smaller alternative lenders filled gaps in lending when the banks reduced their lending. This may have led to a rise in invoice finance, asset finance, peer-to-peer and trade finance. For instance, 33% of those who used peer-to-peer lending and invoice trading said it was unlikely that they would have obtained bank finance. While 79% of peer-to-peer borrowers said they had attempted to obtain a bank loan, with 22% having been successful.¹⁴ Several banks have arrangements with alternative finance lenders. For instance Santander operates a customer signposting arrangement with Funding Circle and RBS/NatWest have reported forming arrangements with alternative lenders where they refer certain customers which do not meet their lending criteria.

¹⁴ Nesta and the University of Cambridge (2014), *Understanding alternative finance: The UK Alternative Finance Industry Report 2014*, p31.

Types of finance available to SMEs and use

27. SMEs have access to a range of different types of debt finance.¹⁵ As noted in paragraph 6, typically, different types of finance are designed to serve specific business needs and may differ in various aspects, such as the loan term, type of security required, interest rates and repayment methods. Below we discuss some of the different types of finance available to SMEs in more detail.

General purpose business loans (including commercial mortgages)

28. General purpose business loans are lending products whereby a bank lends a specific amount of money to an SME, with the requirement that it is repaid over a fixed time period. The repayment amounts will vary with the size and period of the loan and the applicable interest rate. The main purpose of a business loan is to help SMEs to invest and grow their businesses and is, therefore, more suited to meet medium- or long-term financial needs. General purpose business loans can either be secured or unsecured and are a major source of lending for many SMEs.
29. A commercial mortgage is a form of a business loan secured on commercial property. It is usually directed at those SMEs that are seeking to acquire or refinance their commercial property. Most commercial mortgages have a variable interest rate and their length usually ranges from three to 25 years, thus making them more suitable to finance long-term financial goals.
30. The Charterhouse BBS suggests that in 2014 business loans and commercial mortgages were used by 18% and 6% of SMEs respectively.¹⁶

Asset finance

31. Asset finance consists of various finance packages which can be used by a customer to purchase or lease assets. The most common forms of asset finance include leasing (finance and operating leases) and hire purchases. Under leasing and hire purchase the lender owns the assets and rents them out to the business. Under hire purchase, at the end of the lease period the business is also given the option to purchase the assets.
32. Asset finance is commonly used in the purchase of capital equipment, which could vary from large value items such as plant and machinery and vehicles, to 'soft assets' such as ICT software and fixtures and furnishings. Around 80%

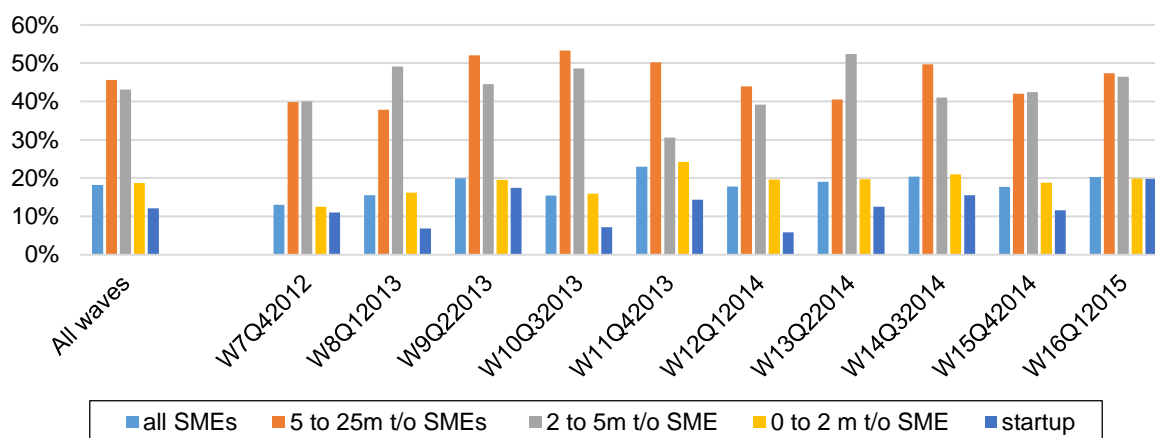
¹⁵ As noted in paragraph 15, our view is that equity finance is different from other financing options and, for the purposes of our investigation, we focus on debt-based finance only.

¹⁶ Charterhouse BBS 2014.

of asset finance is used to finance the acquisition of vehicles or industrial equipment,¹⁷ suggesting that it is mostly suitable for medium- or longer-term funding. Asset finance is also provided by other companies, such as GE, Siemens and Hitachi, originally to assist the purchase of their own products and is therefore highly specialised.

33. Some parties have also suggested that the rise of asset finance is a strong competitive constraint to lending more generally.¹⁸ While we see that asset finance is an alternative to some types of finance we note that it is primarily used by larger SMEs (see paragraph 12), and that it has not materially increased as a proportion of all external finance in the last few years (see Figure 11).

Figure 11: Asset finance as a proportion of all external finance over quarters (2012 Q4 to 2015 Q1) (UK)



Source: SME Finance Monitor, Q4 2012 to Q1 2015.

Base: All SMEs taking out finance: All waves: all SMEs (27,315), start-ups (1,962), £0–£2 million (20,211), £2–£5 million (2,406), £5–£25 million (2,736); individual wave ranges: all SMEs (2,399–2,962), start-ups (149–233), £0–£2 million (1,842–2,105), £2–£5 million (158–305), £5–£25 million (151–397).

34. In 2014 asset finance was used by 6% of SMEs.¹⁹ However, due to its characteristics, asset finance is more suitable for certain types of SMEs and is more prevalent among the larger SMEs.

Invoice finance

35. Invoice finance (factoring and invoice discounting) is a form of finance where an SME can transfer claims on outstanding invoices to a finance provider

¹⁷ BBB, *Small Business Finance Markets 2014*, p38.

¹⁸ In particular HSBCG noted that 'Specialist invoice finance, asset finance and peer-to-peer lending providers provide a competitive constraint on the provision of both these specific forms of financing and on more conventional financing methods, such as general purpose business loans and overdrafts'. RBSG noted 'Increasing activity within SMEs to make investment has been evidenced in reported figures from the Office of National Statistics and corresponding growth in the use of Asset Finance has been seen'.

¹⁹ Charterhouse BBS 2014.

who, in exchange for a fee, transfers a certain percentage of the outstanding invoice value upfront in advance of payment of the invoice. Banks typically finance up to 85% and 90% of the value of outstanding invoices.²⁰ The difference between invoice discounting and factoring is that under the former the SME owns its sales ledger and is responsible for the collection of payments, whereas under factoring the SME hands this to the bank to manage and collect the debt. Therefore factoring usually also incurs higher charges. The nature of this product makes it similar to an overdraft and a useful tool to manage SMEs' cash flows.

36. Banks have told us that invoice finance has been used as an alternative to overdrafts and loans, and could be an important source of working capital. However invoice discounting takes some time to set up. Some banks have told us that it can take a number of months from application to receiving finance. This suggests it would not be so useful when finance is required at short notice. We also note that while invoice finance is used to solve cash flow issues (as overdrafts and credit cards may be), as it takes quite some time for a bank to set up, it is less desirable for unexpected cash flow issues.
37. 5% of SMEs were reported to have used invoice finance in 2014.²¹ However, it is only suitable for certain types of SMEs in relation to certain forms of borrowing and is most commonly used by larger SMEs.²²

Alternative finance

38. Alternative finance includes internet based peer-to-peer lending, crowdfunding and invoice trading platforms which directly match potential lenders to potential buyers without involving a bank (see Appendix 2.1 for more information on different types of alternative finance and the biggest lenders):
 - (a) Crowdfunding is a form of lending that allows many people to contribute small amounts of funding with the view of obtaining a combined total that meets the business' lending target. Crowdfunding is typically delivered through a platform, which can be focused on either debt or equity and can take various forms, depending on the expected reward.
 - (b) Peer-to-peer lending is a form of crowdfunding of loans. It is done through a platform that matches borrowers to lenders which then agree on a secured or unsecured loan.

²⁰ In particular [38] have indicated financing up to 85%, [38] – up to 90%.

²¹ Charterhouse BBS 2014.

²² BDRC, [SME finance monitor, Q4 2014](#), p56.

- (c) Invoice trading is a form of lending where businesses sell their invoices or receivables to a pool of individual or institutional investors.
39. Alternative finance has been growing very rapidly. It has been estimated that the alternative finance markets grew by around 160% in 2014.²³ Despite the rapid growth, alternative finance currently accounts for a very small share of SME lending (in 2014 alternative finance accounted for less than 2% of SME lending).²⁴ In addition, awareness of alternative finance is low, with only 24% of SMEs being aware of peer-to-peer lending and 21% of invoice trading. Awareness of other types of alternative finance was even lower and only 8% reported having tried some type of alternative finance.²⁵ Similarly, the SME Finance Monitor reports that in 2014, while 27% of SMEs were aware of crowdfunding only 1% of SMEs were using it. Only 30% of those aware of crowdfunding said that they would consider applying for it in future whereas 63% said they would not.²⁶ On the other hand, peer-to-peer borrowers reported being happy with the service, 86% of them indicating that they were likely to approach a peer-to-peer platform even if a bank offered similar terms.²⁷
40. Our view is that the sector's future growth possibilities depend largely on individual investors' willingness to lend and therefore are very difficult to estimate. However, current developments suggest that the importance of alternative finance providers will continue to increase in the future.²⁸
41. As noted in paragraph 6 some types of finance are more suitable for certain SMEs or for particular timing and lending needs. If an SME requires finance at short notice it will need to find a lender who will be able to make a decision quickly.
42. Around one-quarter of SMEs thought that alternative finance platforms were faster and more flexible than traditional banks, making alternative finance platforms an attractive option when SMEs need quick and easy access to

²³ Nesta and the University of Cambridge (2014), *Understanding alternative finance: The UK Alternative Finance Industry Report 2014*, p12.

²⁴ BBB, *Small Business Finance Markets 2014*, p53.

²⁵ Nesta and the University of Cambridge (2014), *Understanding alternative finance: The UK Alternative Finance Industry Report 2014*, pp25 & 26.

²⁶ BDRC (2015), *SME Finance Monitor, Q4 2014*, p275.

²⁷ Nesta and the University of Cambridge (2014), *Understanding alternative finance: The UK Alternative Finance Industry Report 2014*, p31.

²⁸ In April 2014 the FCA began regulating investment-based crowdfunding and peer-to-peer lending. The government backed business finance partnership scheme also includes peer-to-peer platforms and several banks have reported forming relationships with peer-to-peer service providers to cross-refer their customers and increase SME access to finance. In its [2014 Autumn Statement](#), HMT also expressed its intentions to review financial regulation, which it noted currently stands in the way of institutional lending through peer-to-peer platforms.

funds.²⁹ For instance, a loan from Funding Circle, the biggest provider of peer-to-peer business loans in the UK, can typically be obtained within a week.³⁰ SMEs can also sell their invoices via online invoice trading platforms and receive the funds in 24 hours.³¹

Competitive developments in SME lending

43. A number of recent competitive developments in the lending market have come from banks looking to improve the availability of finance or speed of decisions. For example:
- (a) Barclays told us in July 2014 it launched a facility to provide SMEs with pre-assessed lending decisions online for unsecured borrowing up to £25,000. Barclays told us that whilst this new service was principally driven through customer feedback, it was also the result of competitive pressure both from new lending platforms and from competitor banks.
 - (b) LBG told us that it had streamlined its lending applications and affordability assessment for new lending applications up to £[redacted] to provide a quicker assessment.
 - (c) HSBCG told us that it was seeking to grow its lending book. It currently had [redacted]% of the BCA market, but only [redacted]% of gross SME loans. To do this it was (among other things) taking the following actions:
 - (i) [redacted]
 - (ii) [redacted]
 - (iii) [redacted]
 - (iv) [redacted]
44. Other recent developments, namely the offer of discounts and incentives, appear to have principally come about because of government initiatives. The FLS brought about different responses from different banks. For example Barclays had provided 2% cashback on loans to boost the amount of resources available (although it no longer provides this cashback facility). Barclays told us that:

²⁹ Nesta and the University of Cambridge (2014), *Understanding alternative finance: The UK Alternative Finance Industry Report 2014*, p27.

³⁰ See the [Funding Circle website](#). It takes two working days for the business to have its application assessed and a risk rating assigned and up to an additional seven days to have the loan funded by investors. We note however that banks have told us that they can issue loans within this timescale also.

³¹ [MarketInvoice](#), the biggest invoice trading specialist in the UK, can provide finance within 24 hours.

This differs from other banks who offered the benefit to customers through a reduction in the margin or a fee waiver. Barclays' unique cashback proposition was designed to give us a competitive advantage, as it enabled the customer to receive all the benefit upfront and when they need it most (ie when they have a cash requirement), rather than incrementally over the life of the loan through a margin reduction. Barclays saw customers invest the cashback in a range of ways – for example, by investing more in the underlying project than originally planned. This would not have been possible with Barclays' competitors' FLS schemes.

45. LBG implemented FLS differently; it initially reduced the interest rates on all eligible new term lending to SMEs written from March 2012 by 1% for a pre-agreed period of time. LBG designed its FLS offer to be simple, straightforward and open to all existing and prospective SME customers, in contrast to competitors' more complex propositions.
46. LBG commented that:

The response of competitors to FLS varied: certain institutions (for example, HSBC) chose not to participate, while others offered a range of discounts (for example, RBSG reduced the interest rates on certain loans by 1.7% – excluding lending to the property sector - while Barclays introduced a 2% cash-back offer on certain business loans with a term of three years or more). Responding to this, and in order to reach its ambitious lending targets in respect of SMEs, LBG has introduced additional discounts on a series of loans on a targeted basis. The discount for these loans was increased by a further 1% (ie 2% in total) below the pricing guidance matrix. There have been tranches of double-discount loans, occurring in the fourth quarter of 2012, the first quarter of 2013 and the third and fourth quarters of 2013.

Responses to competitors

47. While banks do not compete publicly on prices, some SMEs, in particular larger SMEs, can negotiate with banks, including stating what they consider they could achieve with other banks, such as the following:
- (a) LBG told us that loan pricing was inherently bespoke in nature. When setting prices for term loans and overdrafts it based these on a wide range of factors including whether the customer had been offered terms by a rival bank or was threatening to move some or all of its products to a

rival provider, the bespoke terms represented a competitive offer to keep that customer. For example, some large SMEs conducted a tender-like process to procure the best banking in terms of service and price.

(b) Similarly, Barclays told us [REDACTED].³²

48. Meanwhile, despite not participating in FLS, [REDACTED].

³² [REDACTED]

Appendix 9.1: Case studies on barriers to entry and expansion

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Introduction

1. This appendix sets out the findings¹ of the case studies that we undertook in order to identify what, if any, barriers to entry or expansion exist in the supply of PCA and SME banking services.²
2. In previous market investigations we have found that case studies of market entry and expansion can provide powerful insights into the practical difficulties that firms may face trying to break into particular markets. Such studies have contributed both to the identification of possible AECs and to the design of remedies to dismantle or lower barriers to entry.
3. The value of case studies lies in their ability to provide a very detailed understanding of the practical difficulties that firms encounter in entering particular markets, the strategies available to them in order to overcome those difficulties and the extent to which they have been successful in doing so.
4. The drawback of case studies is that, because they are quite resource intensive, the number which can be undertaken as part of an MIR is relatively limited. In addition, since the 'sample' is small we can be less confident that the lessons we learn from them are of general application rather than relevant to the particular circumstances of the case.

¹ These are based on the CMA retail banking market investigation's working papers on individual case studies that were completed and/or published during May-June 2015.

² Our guidance states that the prospect of entry and expansion within a short time can sometimes countervail against a prospective AEC decision and notes that the possibility of entry by outside firms or the expansion of incumbent firms have featured in most findings on whether or not there is an AEC in a market. CC3 (revised), paragraph 205.

5. Choice of case study, therefore, is crucial, though since market entry in retail banking has been quite rare, selecting appropriate cases for study was less of a problem than in some other markets investigated previously by the CMA.
6. We selected examples of entry and expansion in both the provision of SME banking services and of PCAs and included cases where firms had contemplated entry or expansion but had decided against doing so as well as cases where they had gone ahead. The cases we selected were:
 - (a) Aldermore Bank;
 - (b) the entry of Metro Bank;
 - (c) Nationwide Building Society's BCA;
 - (d) Tesco Bank's PCA;
 - (e) the entry of TSB; and
 - (f) Virgin Money's PCA; and
 - (g) potential new entrants.
7. In addition, in order to understand whether recent changes to the authorisation process and developments in financial IT had affected barriers to entry or expansion, we gathered information from five prospective new entrants to retail banking which were currently seeking authorisation.³

³ Atom, CivilisedBank, Fidor, OakNorth and Starling.

Aldermore Bank

8. *[The Aldermore case study has been redacted in its entirety for confidentiality reasons.]*

Metro Bank's experience of entry

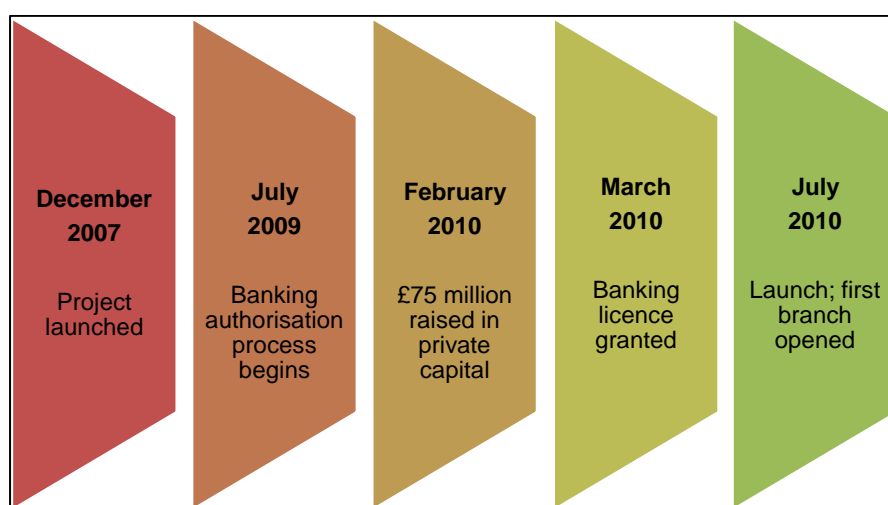
9. This case study examines Metro Bank's (Metro's) experience of entry and expansion as a relatively new high street bank in the UK and what, if any, obstacles that it faced in doing so.
10. Metro launched in July 2010. It offers a range of retail banking services to personal and business customers (including SMEs), and at the end of 2014 had 31 branches in and around Greater London. Metro has grown its total number of customer accounts from 8,912 in 2010 to 447,000 in 2014, and aims to have 200 branches by 2020.
11. Although Metro has grown rapidly since launch, it told us that it faced some obstacles to further expansion. These included: the availability of suitable high street corner sites for new branches; capital holding requirements; access to payment systems both in respect of quality of service and costs; and the larger banks' ability to subsidise new customers. However, it told us that it had sought to overcome these obstacles through a strategy of providing high-quality customer service coupled with a branch-based business model, to differentiate itself from its competitors.

Introduction and background

12. Here we examine Metro's experience of entry and expansion as a relatively new high street bank in the UK. We begin with a background to Metro's launch in the UK which is followed by a description of its business model and strategy. Next, we discuss how successful Metro has been in growing its business since launch, and finally consider the extent to which Metro's experience suggests the presence of barriers to entry or expansion in UK retail banking.
13. Metro was launched in July 2010 and was the first de novo high street bank to be granted a licence in the UK in more than 100 years. It is a deposit-taking and lending institution which services retail (personal) and business customers in London and its wider commuter belt area. Metro's decision to enter the market was based on a belief that a significant opportunity existed for a new bank in the UK that provided customers with high levels of customer service and convenience, whilst providing good returns for its shareholders.

14. Metro's launch in the UK was based on a successful antecedent – Commerce Bank – that was established by Vernon Hill in the USA in 1973.⁴ At the centre of Commerce Bank's strategy was the branch, in contrast with other banks which were generally steering customers away from their branches to cheaper-to-serve channels. Commerce Bank started with a single branch in 1973 to become one of the largest banking groups in the USA before it was sold to Toronto-Dominion Bank for \$8.5 billion in 2007.⁵
15. Following his discussions with the FSA, Mr Hill launched the Metro project in December 2007, and raised £75 million in initial capital in February 2010 from a pool of investors, including Fidelity and Wellington Capital.^{6,7} Figure 1 shows key milestones leading up to Metro's launch in the UK.

Figure 1: Key milestones leading up to Metro's launch



Source: Metro.

16. Metro told us that its decision to launch in the UK was a direct response to what it called lack of choice for consumers and businesses. Its aims are to differentiate itself from other banks by presenting to its customers a service-based rather than a product sales model. Metro has decided to initially set up its branches (referred to as 'stores' by Metro) in and around London – learning from the Commerce Bank's success in New York where it had 250 branches in Manhattan alone. Metro's first branch at Holborn, London, opened in July 2010 (Figure 2).

⁴ Vernon Hill, the founder and chairman of Metro Bank is an American businessman. He is also the former Chairman and President of Commerce Bank which he founded in 1973 in the USA.

⁵ [Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise](#) (2010), pp9–10. Temenos is a software company which was founded in 1993 in Geneva, Switzerland. Its stated mission is 'to rid the banking industry of its legacy software.'

⁶ *ibid*, p12.

⁷ The FCA replaced the FSA from 1 April 2013.

Figure 2: Metro's branch in Holborn, London



Metro's business model

Strategy

17. Metro's strategy is based on building a strong brand, creating loyal customers and offering its customers best experience from their banking.⁸ Metro aims to implement this strategy through a customer-focused culture, retailer-type operations, and reliance on its customers telling their friends about their experiences, in order to attract more people to visit its branches.⁹
18. A key element of Metro's business model is its focus on service and not price. As Craig Donaldson, Metro's CEO told the PCBS, 'If you [customers] want the very best pricing on deposits, you can go to other people ... I do not expect to win everybody, just those who value real service and convenience, because that is what we offer'.¹⁰
19. Metro's PCA offers free-if-in-credit banking and currently pays 0% interest, and it has no imminent plans to introduce credit interest in the event of a base rate movement. Metro does not offer any incentives for new customers, and told us that 'Our products are designed to appeal to as wide a range of customers as possible. Our model, focussed on high-quality service, is designed to attract all types of customers.'
20. In August 2013, Metro acquired SME Invoice Finance Limited, a company which specialised in invoice discounting, factoring and cash-flow funding for

⁸ In Mr Hill's words 'Our model in Britain, as it was in America, is this idea of building customers as fans. Great companies build fans who stay with the company and recommend them to a friend.' [House of Commons Treasury Select Committee](#), 14 December 2010. Vernon Hill's oral evidence. Answer to Question 442.

⁹ Hill, Vernon (2012), *Fans Not Customers*, Profile Books.

¹⁰ [Craig Donaldson's oral evidence to PCBS, 13 November 2012](#). Answer to Q52.

businesses.¹¹ Metro told us that it wanted to provide full-service range to SMEs, and in order to do so, wanted to include invoice and asset finance as part of its product portfolio.¹² Metro stated that since these markets were specialised in nature it thought it best to find an existing provider that had the technology, processes, expertise and resources in these businesses.

Importance of branches

21. Metro's branches are modelled like retail outlets, are located on high street corners, and represent its main sales channel, although telephone, mobile (for PCA customers) and internet banking are also available to its customers. It believes that customers are willing to pay more for superior service, because they enjoy the experience, likening this effect to the customers of Starbucks.¹³
22. Metro believes that having physical branches is important because it enables it to provide traditional banking services, and build relationship with customers. To build a relationship with customers, Metro wants its first interaction with a customer to be face to face, through a branch.
23. Metro's strategy is to build a branch network organically rather than buying branches of existing banks, and is focusing on building these in London, the South East and commuter belt locations near to where people live and work.
24. Metro's service offering to its customers in its branches includes the following:
 - (a) Open seven days a week for extended hours.¹⁴
 - (b) Instant account opening (cards + cheque book printed in store).
 - (c) Free coin counting.
 - (d) Internal ATMs.
 - (e) Safety deposit vault.
 - (f) Toilet and baby changing facilities.
 - (g) Dog friendly with dog bowls of fresh water in the lobby.

¹¹ [Metro-Bank 'The-Entrepreneur's Bank' acquires SME Invoice Finance](#), August 2013.

¹² The deal involved Metro purchasing an end-to-end Invoice Finance and Asset Finance capability – ie systems, processes and people.

¹³ [Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise](#) (2010), p13.

¹⁴ Opening hours for all Metro's branches are Monday–Friday: 8am–8pm Saturday: 8am–6pm Sunday: 11am–5pm Bank holiday: 11am–5pm.

Product strategy

25. Metro offers a range of products but claims not to cross-sell, and its staff are not incentivised to do so, but are rewarded based on customer satisfaction. (see Annex B for details of Metro's products).¹⁵
26. Metro's retail proposition for personal customers rests on offering superior levels of service and convenience. It aims to focus on simplicity and transparency by offering one type of PCA for all its customers, and having a simple overdraft pricing model. Metro said that the simplicity of its product offering ensures that it does not cross-subsidise between customer segments, and provides its best rates and offers to all its customers.¹⁶ The key elements of Metro's retail proposition include:
 - (a) developing and communicating a series of commitments to its customers including giving them the best saving and mortgage rates it has, and simpler overdraft rates; and
 - (b) keeping the product range simple while addressing some gaps in the range and also improving the availability of a number of existing propositions and channels.
27. Metro's strategy for its SME customers is based on a need to offer something on the high street to serve the SME market.¹⁷ It categorises SME customers based on turnover, and its local business managers based in its branches focus on serving the needs of smaller businesses with under £2 million turnover; larger businesses are serviced by its Relationship Managers who also focus on specific sectors, including property, healthcare, not for profit, franchising and leisure. Metro told us that its SME business was key to its wider banking strategy, and SMEs represented 47% of deposits and 45% of its lending at the end of 2014.
28. Describing its product strategy, Metro had told the House of Commons TSC: 'We believe [that] people will buy other products from you if you have fair products—not if you are aggressively out to sell them, but because they have faith in your brand.'¹⁸

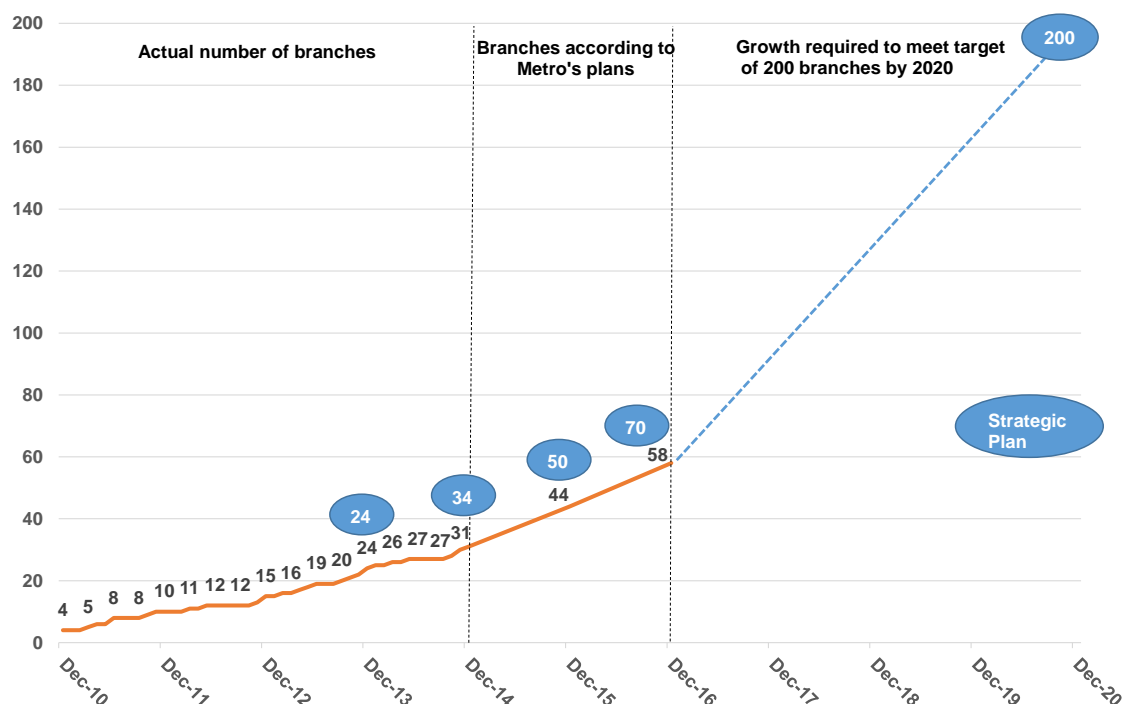
¹⁵ ['No Stupid Bank Rules. Metro Bank case study', *Customer Insight* \(November 2011\)](#), p15.

¹⁶ Metro indicated to the CMA that this was in contrast with the practices followed by many other banks, which offer attractive offers for their new customers but not to their existing customers.

¹⁷ As Craig Donaldson told the PCBS 'what they [SMEs] tell us they want is the high street presence, continuity of relationship and somebody who will get to know their business' [Craig Donaldson's oral evidence to PCBS, 13 November 2012](#). Answer to Q49.

¹⁸ [House of Commons TSC](#), Vernon Hill's oral evidence, 14 December 2010. Answer to Question 470. The Treasury Select Committee is one of the select committees related to government departments, established by the House of Commons. When the committee has chosen the subject of an inquiry it normally issues a press

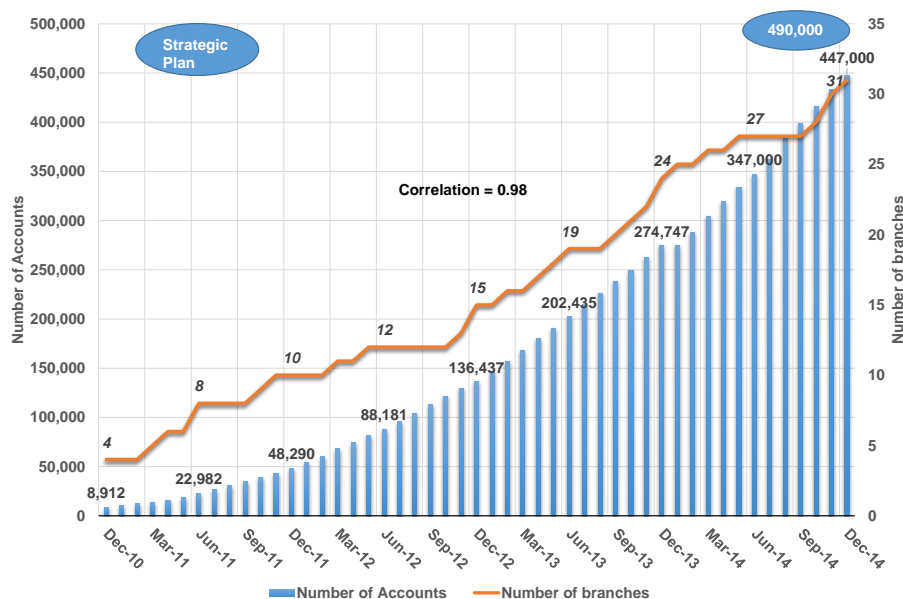
Figure 4: Number of Metro’s branches – actual, planned and target



Source: Collated from Metro’s website and documents.

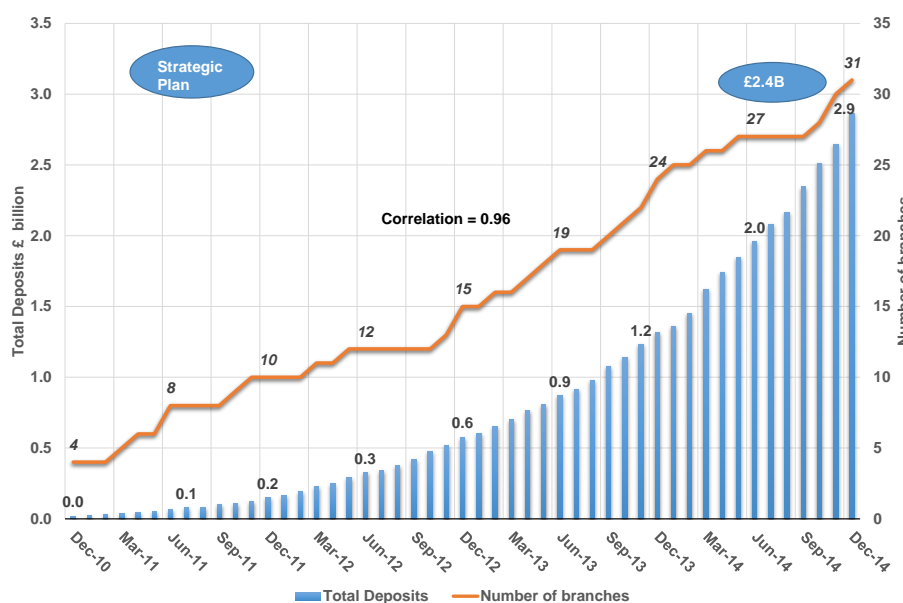
32. Figure 5 shows that Metro has been able to rapidly grow its number of accounts since it launched in 2010. The total number of accounts increased from 8,912 in 2010 to 447,000 in 2014 – a CAGR of 166%. The figure also illustrates that the increase in the number of accounts has been in line with the growth in Metro’s branches during this period (correlation of 0.98) reinforcing the importance of branches to its business model. The number of accounts at the end of 2014 was slightly behind its Strategic Plan of 490,000.
33. A similar trend is seen in Figure 6 which shows that Metro’s deposits have grown at a fast pace – CAGR of 256% between 2010 and 2014. Total deposits stood at £2.9 billion at the end of 2014, higher than the Strategic Plan of £2.4 billion. The growth in Metro’s deposits also closely follows the growth in its number of branches (correlation of 0.96).

Figure 5: Evolution of number of accounts and branches



Source: Collated from Metro's documents.

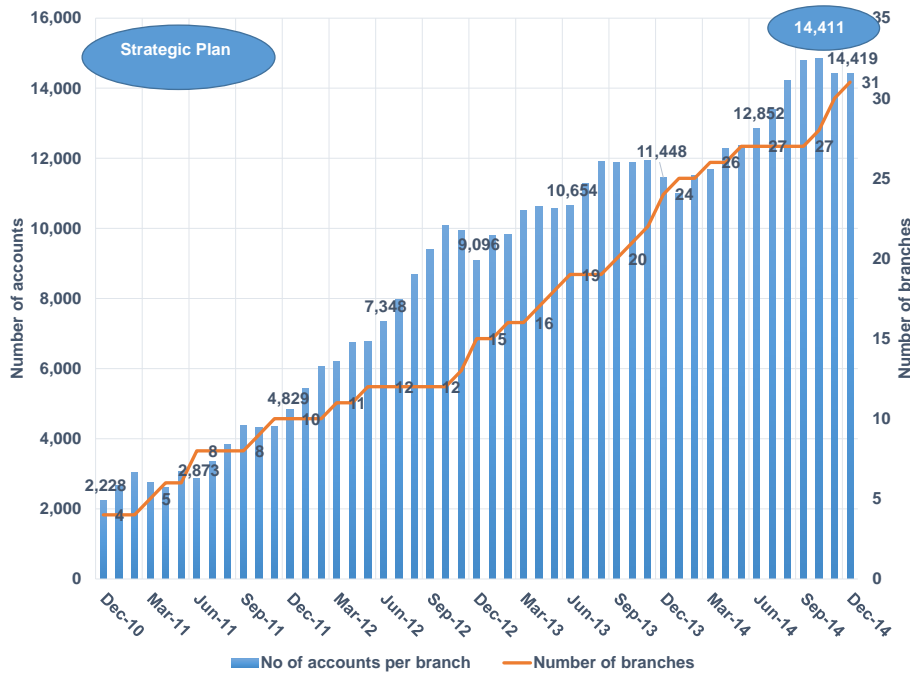
Figure 6: Evolution of deposits and number of branches



Source: Collated from Metro's documents.

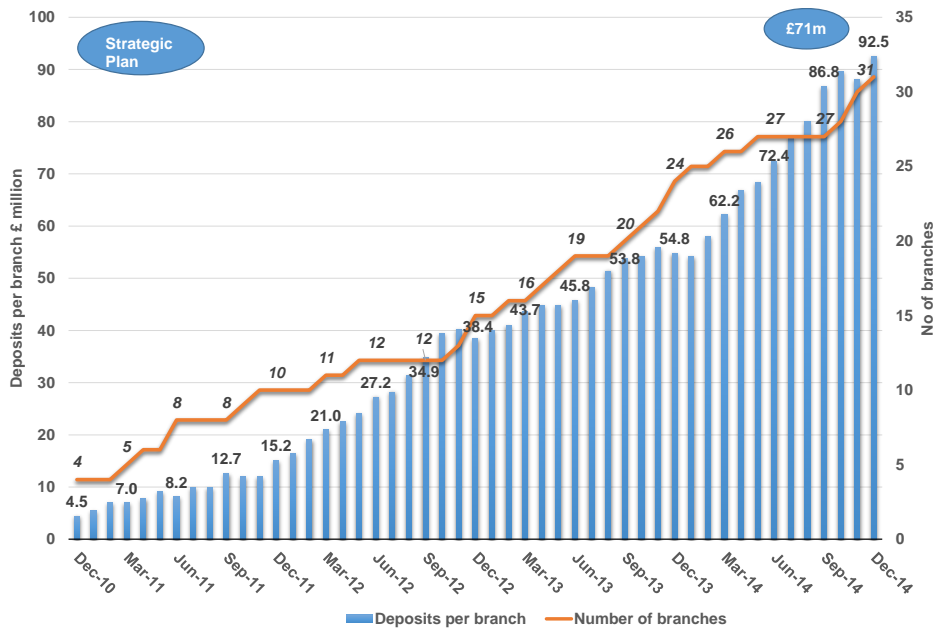
34. Figures 7 and 8 show the growth in Metro's number of accounts and deposits per branch. The number of accounts per branch has grown rapidly to 14,419 at the end of 2014 (CAGR of 59% since 2010) – close to what was assumed in the Strategic Plan. Similarly, average deposit per branch has also grown consistently over the last four years (CAGR of 113%) and was £92.5 million at the end of 2014, higher than what was assumed in the Strategic Plan (£71 million).

Figure 7: Evolution of number of accounts per branch



Source: Collated from Metro's documents.

Figure 8: Evolution of deposits per branch



Source: Collated from Metro's documents.

35. Figure 9 shows that Metro's number of PCAs has also grown rapidly and between 2011 and 2014 saw a CAGR of [X]%. At the end of 2014, Metro had over [X] PCAs, and plans to grow these to over [X] by the end of 2015. In 2014, the PCAs accounted for about [X]% of its customer accounts, and applying this percentage to Metro's Strategic Plan of [X] million total number of accounts, it could potentially have over [X] million PCAs by 2020.

Figure 9: Growth in the number of PCAs

[X]

Source: Metro.

36. Similarly, Figure 10 shows that Metro's BCAs grew at a CAGR of [X]% between 2011 and 2014. At the end of 2014, Metro had about [X] BCAs which it plans to almost double in 2015.

Figure 10: Growth in the number of BCAs

[X]

Source: Metro.

37. In 2014, of about [X] new PCAs added, Metro is aware of the sources of customers switching to it for about [X] customers, which are shown in Table 1. Although this data on switching is only for a small subset of new PCAs added, it shows that customers are switching to Metro from many major banks, with Barclays, Santander, HSBC, Lloyds and NatWest accounting for [X]% of those switching in.

Table 1: Sources of switchers to Metro in 2014

	<i>Number of PCAs</i>	<i>%</i>
Barclays	[X]	[X]
Halifax	[X]	[X]
HSBC	[X]	[X]
Lloyds	[X]	[X]
Nationwide	[X]	[X]
NatWest	[X]	[X]
Santander	[X]	[X]
All other	[X]	[X]
Total	[X]	[X]

Source: Metro.

38. In its 2015 annual road map for retail proposition, Metro mentioned that although its business model offering superior service and convenience had proved popular, [X], Metro believes that it needs to continue to innovate to maintain itself as a customer focused banking brand. Regarding its SME business, Metro's focus for 2015 is [X].²⁰
39. Metro's CFO Michael Brierley believes that the bank is on track to make a profit in 2015/16 and stated that 'We will generate a greater long-term profit if we continue to invest in our infrastructure, IT and people.'^{21,22}

²⁰ Metro's Annual Road Map – Retail Proposition and 2015 Annual Strategy Plan for Business (SME) proposition.

²¹ [Interview with Metro CFO Michael Brierley](#). *Financial Director*, 19 September 2014.

²² While releasing its 2014 full-year results, Metro announced that its deposits had increased to £2.9 billion (annual increase of 118%) out of which deposits from business customers represented 64% or £1.9 billion. Total loans grew to £1.6 billion (an annual increase of 112%) with loans to business customers making up almost half

Barriers to entry and expansion

Authorisation process

40. Metro told us that the authorisation process it went through to get a banking licence was a challenging one mainly because a new bank had not been authorised in the UK in over a century. Metro stated that it 'navigated the process slowly but successfully alongside the FSA'. It also noted the FCA's subsequent work on streamlining the authorisation process, and hoped that it facilitated more new banks to enter the market.²³
41. In March 2013, the FSA and the BoE published a review of the requirements for firms entering or expanding into the banking sector which set out reforms to the authorisation process to make it easier for the new applicants. These reforms were designed to provide firms with greater clarity about the information required to be submitted to facilitate authorisation as rapidly as possible and, to provide firms clear milestones along the path to authorisation, with the possibility of authorisation before they committed major resources to infrastructure investments.²⁴
42. Another report of the PRA and the FCA, published in July 2014 provided an update on progress in implementing these changes and clarified some issues that had arisen following the original review. Some of the developments mentioned in this follow-up report included the following:²⁵
 - (a) Increase in the level of pre-application support to the new applicants by the PRA and the FCA.
 - (b) Streamlining of the application pack.
 - (c) A new 'mobilisation' option – where authorisation was granted when a firm had met essential elements but with a restriction on its activities due to some areas needing to be completed (for example, investment in IT systems).
43. Overall, the authorisation process does not appear to have been a significant obstacle for Metro to enter retail banking in the UK.

of total lending. The number of customers increased to 447,000, up 63% from last year. [Metro Bank 2014 results announcement](#), 21 January 2015.

²³ The FCA replaced the FSA from 1 April 2013.

²⁴ BoE/FSA (March 2013), *A review of requirements for firms entering into or expanding in the banking sector*.

²⁵ BoE/PRA (July 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*. pp5–8.

Capital requirements

44. Metro stated that it was currently required to hold around six to ten times more capital than the big banks and building societies when securing a mortgage for a customer, even if it was for the same customer, with the same deposit, on the same property – a situation which did not reflect a level playing field.
45. To elaborate this point, Metro told us that as a new entrant to the market, it had to use the SA to credit risk when calculating capital requirements, while the larger banks were permitted to use an IRB. Metro indicated that the IRB approach was based on many years of data, and enabled certain institutions to significantly reduce the value of their risk-weighted assets.
46. Similarly, in its submission to the PCBS, Metro had mentioned that:

The business plan we put together [at the time of its authorisation application] had a significant capital requirement in there because it seemed proportionate and appropriate that, as a start-up bank, we had that ... it is about how over time the capital requirement should reduce, as the risk of running an organisation reduces with longevity, and it is about the proportionality that is applied by a prudential approach that needed to be seen over time.²⁶
47. Metro pointed out to the CMA the difference between the SA and IRB by using an example of a low loan-to-value residential mortgage. Metro stated that such a mortgage carried the same risk profile regardless of the lending institution but the challenger banks risk weight these particular assets at 35% compared with 3 to 6% for the larger banks.
48. Metro suggested to us that there should be tighter bands for capital requirements for standard product sets, rather than allowing for the current wide differentiation in the market. It also mentioned that the approaches used by many existing banks allowed for too much variability in capital in order to promote a truly fair and competitive market. And, in order to promote a truly fair and competitive market, capital requirements for all product sets should be brought in line with each other using industry-wide indicators set by the regulators.
49. In March 2013, the FSA and the BoE announced a shift in approach to the prudential regulation of banking start-ups whereby the additional requirements (known as ‘add-ons and scalars’) previously applied to reflect the uncertainties inherent in start-ups were no longer to be applied. These

²⁶ [Craig Donaldson's oral evidence to PCBS](#), 13 November 2012. Answer to Q3.

requirements according to the two regulators often resulted in capital and liquidity requirements for start-ups being higher than for existing banks.²⁷

50. Metro mentioned in its Offer for Subscription in 2014 to investors that its capital and liquidity requirements had been further reduced reflecting the greater maturity of the company. However, it believed that as a new bank, it was required to hold disproportionately higher capital than an old, established bank. Metro's view was that capital requirements for all product sets should be brought closely in line with each other using industry-wide indicators set by the regulator. Metro told us that the way capital rules differed between larger banks and challenger banks made expansion and growth expensive.
51. The capital requirements did not prevent Metro from entering the UK retail banking market, and do not seem to have prevented it from growing at a fast pace so far. However, according to Metro, the requirement to hold higher capital than the larger banks may affect its expansion in the future.

Access to payment systems

52. Metro told us that access to payment systems continued to be a barrier for challenger banks, and the current payments infrastructure did not promote effective competition where small and new banks were heavily dependent on their competitors, to serve their customers.
53. Metro stated that the cost of developing and maintaining membership of one of the payment systems meant that any new bank wishing to provide a transactional service, such as direct debits or faster payments, had to accept an 'agency banking arrangement', essentially contracting an existing bank to provide its payment infrastructure.
54. According to Metro, this arrangement was anti-competitive since it meant that banks without their own clearing capacities were subject to the service levels and payment structures of existing players, and could be forced to provide the same or worse service to their customers. Metro pointed out that it had experienced many outages with some of the payment systems, which were not due to the payment systems but because of IT issues at one of the banks through which it accessed those systems.²⁸

²⁷ BoE/FSA, *A review of requirements for firms entering into or expanding in the banking sector*.

²⁸ Metro provided a specific example illustrating the effect of accessing payment systems through another banks on its customer service. It cited the outage of its Faster Payment functionality using the Direct Corporate Access (DCA) between 08:00 and 20:00 on 29 November 2014, during which time outbound DCA payments were rejected and payments were not stored.

55. Metro informed the CMA that at the start of its relationship with its clearing bank supplier, it was paying £[£] per outgoing Faster Payment, and given its growth over the last four years this had reduced to £[£]. Metro told us that the corresponding cost for the members of the Faster Payment Scheme was £[£] per transaction, and this ‘imposes a high cost on all small challenger banks, who may not be direct members, while acting as a clear and significant source of profit for the large incumbent clearing banks.’
56. Metro’s submission to PCBS regarding payment systems made the point that:
- If you look at the banking industry across the world, different models are applied, where you would have payments as a utility that banks link into. Therefore, everybody was starting from a level playing field and could then differentiate themselves, based on the proposition they wanted to offer customers, rather than having to rely on the proposition that the big banks wanted to offer customer. If we genuinely want competition, we need to create the level playing field, almost like a utility play, rather than forcing challenger banks to go to the lowest common denominator.²⁹
57. Metro suggested to us that the CMA, in conjunction with the PSR, should investigate the possibility of an independently run, licensed ‘Plug and Play’ payments platform with the same service levels for all banks, which could be funded according to volume.³⁰
58. Metro’s experience suggests that it has to rely on larger banks, ie its competitors, for accessing payment systems, which may have both cost and quality implications. Metro’s business model relies on high-quality service to its customers, but it cannot directly control the quality of the service of the payment systems since it accesses them through other banks.

IT system

59. Metro told the TSC that the biggest barrier to being a new bank in Britain was IT. It said that in the USA there were outsourced providers who were ready to put you in business almost immediately, while in the UK one had to build IT from scratch.³¹

²⁹ [Craig Donaldson’s oral evidence to PCBS, 13 November 2012](#). Answer to Q6.

³⁰ According to Metro, elsewhere in the world, such as in the USA, banking payment systems are run independently by a central organisation (such as the USA’s Clearing House Interbank Payment System).

³¹ [House of Commons Treasury Select Committee](#). Vernon Hill’s oral evidence, 14 December 2010. Answer to Question 460.

60. Metro's IT strategy was intended to minimise the size of initial capital outlay and manage the bank's cash flow and profitability.³² Metro chose to work with Temenos, which provided it with an IT platform with a single customer view that underpins its banking services. It selected Temenos because it offered an integrated IT solution which 'lowered the entry barriers by offering a flexible and massively scalable delivery model which reduced capital outlay and operating costs to a bare minimum.'³³ The implementation period for Metro's IT system was also relatively short at nine months.³⁴
61. According to a report by Temenos,³⁵ it was able to offer the T24 IT³⁶ platform to Metro on a Software as a Service (SaaS) model – where a vendor (in this case using a third party) hosts an application on behalf of a customer and provides access through the internet, normally in exchange for a monthly or quarterly rental.
62. A recent report by Temenos concluded that in the UK, computer systems may put larger banks at a disadvantage.³⁷ Another report by Deloitte and Temenos has found that over the past five years, banks using third party banking applications have enjoyed on average a 19% higher return on assets, a 28% higher return on equity and a 6.5 percentage point lower cost-to-income ratio than banks running legacy applications.³⁸
63. Metro seems to have overcome many of the scale advantages enjoyed by the large banks by deploying an integrated IT solution. It has taken the application on a hosted pay-per-use basis minimising the level of upfront IT investment needed and rendering IT as a variable cost.³⁹ Since Metro has focused on growing organically, it has not been burdened by legacy IT systems, and its IT system appears to be a key competitive advantage.⁴⁰

Need for branch network and availability of suitable sites

64. Metro's submission to the TSC pointed out the importance of a branch network to its business model: 'as a retailer, we know the more stores we put

³² [Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise](#), p15.

³³ *ibid*, p15.

³⁴ *ibid*.

³⁵ *ibid*.

³⁶ [Temenos T24](#) (T24) is a front- to back-office, Customer Relation Management and product life cycle management software platform that powers core banking operations.

³⁷ Succeeding through the digital revolution. Lessons from Banking Industry Disruptors. White paper 2014. Temenos. pp13 & 20.

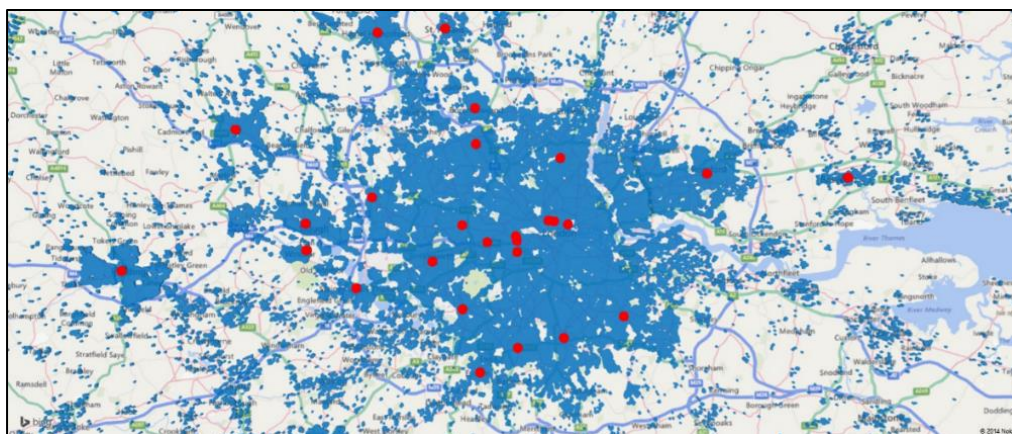
³⁸ Temenos and Deloitte. Restoring Profitability in the Digital Age. 2014.

³⁹ [Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise](#), p1.

⁴⁰ According to Temenos case study on Metro '...lower absolute technology spending as result of having a modern, integrated system offers Metro Bank not just the opportunity to achieve a minimum efficient level of scale with lower volumes, but also a source of enduring economies of scale and competitive advantage - which it could choose to invest in higher deposit rates. [Temenos Metro Bank case Study: Breaking the Mould but Breaking the Malaise](#), p19.

in the same market, the better those stores all do.’⁴¹ Metro told us that its customers’ feedback was that branches were important to them. It also made the point that, ‘Our customers tend to be based in the areas and communities surrounding our stores, as new customers have to open their first account in a store’, thus reinforcing the importance of its branches to its business model (see Figure 11 below).⁴²

Figure 11: Metro’s branches and customers (November 2014)



Legend: Red – Metro Bank branch. Blue – Metro Bank customer.

Source: Metro bank.

65. Although having branches was important, Metro stated that they made up only one part of its all-channel offering. As Metro mentioned in its response to the CMA’s issue statement:

... competition should be about banks offering different models to customers; some will take an all-channel approach (like us) and others will choose different strategies. As a result, we do not think that a branch network should act as a barrier to competition – banks must choose models that suit them and their customers, concentrating on differences and choice rather than more of the same.⁴³

Planning permission

66. Metro stated that prior to April 2014, the majority of prime sites on the UK’s high streets and in retail outlets were classified as A1 retail uses, while the Use Classes Order (1987) classified banks as well as other financial and professional service providers, as A2 users. This meant that in order to open

⁴¹ [House of Commons TSC](#), Vernon Hill’s oral evidence, 14 December 2010. Answer to Question 461.

⁴² Subsequent accounts can be opened online.

⁴³ [Metro’s response to the issues statement](#).

a bank in a prime retail location, significant time and money had to be spent applying for planning consent from local authorities for a change of use (from A1 to A2 use). Metro told the CMA that this had a significant impact on its ability to grow branch numbers, since in many cases, planning permission could take six to nine months.

67. Metro informed the CMA that in April 2014, the Department for Communities and Local Government changed the rules to allow greater flexibility for change of use. Under the new rules, Metro (categorised as an A2 Financial and Professional services use), no longer needs planning consent to take an existing shop (or an A1 Retail use) and convert it to a bank. Metro stated that it had benefitted from the change in planning rules, and as a result, was able to acquire eight new branches in 2014 without the need for a planning application.
68. Metro also informed the CMA that following a consultation carried out in 2014, the government proposed further amendments to the planning process that would effectively merge use classes A1 and A2. According to Metro, should these changes fail to take place, it would continue to encounter the following problems in acquiring suitable sites for opening branches:
 - (a) Where a new property was developed and a planning consent granted for A1 retail use, it was not possible to utilise it as a bank until it had first been used as a retail space.
 - (b) Some properties had restrictive planning conditions which limited their use to A1 retail uses only, despite the changes to the rules in April 2014.
69. In its Offer for Subscription in 2014 for raising additional capital, Metro mentioned its ability to acquire suitable sites for its branches as a business risk. It said that 'A cornerstone of Metro Bank's business strategy is prime locations for its stores ... any future inability to obtain additional properties could have a material adverse effect on Metro Bank's business, financial condition, performance, results of operations and/or prospects.'
70. It appears that the changes to planning rules that took place in April 2014 removed an impediment to Metro's ability to acquire suitable retail sites for its branches. Further changes to planning rules – for example, merging A1 and A2 user classes – can help Metro further in its ability to acquire suitable sites to grow its branch network. Since Metro plans to grow its branch network organically, if it cannot open new branches quickly enough, this may affect its ability to acquire customers and reach a certain scale.

Customer acquisition and advertising

71. Metro does not spend significantly on product marketing, sales incentives or introductory incentive offers, and does not make use of acquisition costs per customer or lifetime value per customer metrics. Metro stated that it relied more on word of mouth than advertising to attract and retain customers.⁴⁴
72. Metro stated that it did not target a particular customer segment. In its evidence to the TSC, Metro had stated that 'We do not believe there is such a thing as a high-profit customer or a low-profit customer ... We believe every customer has real value. They may have low value when they are students and they may have higher value over time but we're out to serve as wide a market as we can get, from wealthy people to students.'⁴⁵
73. Regarding the CASS, Metro's view was that its effect on switching would be limited until there was more competition and choice in the market. Although Metro viewed CASS as a helpful utility, it did not view it as a factor actively influencing its customers in their decision to switch.
74. Metro's decision not to advertise does not appear to have affected its ability to acquire customers and expand so far. This may be due to its decision to invest in a branch-based business model. It does not use retention as a measure of satisfaction, but pointed out to the CMA that many more people were joining rather than leaving Metro, and that its customers were switching to it from all the major high street banks.

Access to funding and capital

75. Metro stated that larger banks often competed unfairly with introductory switching bonuses and 'free banking', and they could do so due to cross-subsidy from small subsets of existing back book customers who paid significant fees on overdrafts.
76. Metro pointed out that the larger banks used the savings they made from offering lower interest rates to existing customers to cross-subsidise new customers, which effectively provided them with cheap deposit funding from their less active loyal customers. Metro stated that this created a barrier to entry in the market since the larger banks were able to use this cheap source of funding to drive down their cost of lending. Metro stated that the 'challenger' banks, with higher funding costs, were forced to compete at an

⁴⁴ Metro mentioned that, 'By keeping customers happy, building stores and surprising and delighting them, we create real advocacy. As a result, they [customers] will recommend us to their friends, and in our opinion this is much more powerful, and effective, rather than advertising.'

⁴⁵ [House of Commons TSC](#), Vernon Hill's oral evidence, 14 December 2010. Answer to Question 460.

unfair price for lending, and in some cases assumed higher-risk lending in order to compete.

77. Metro also told us that since it funded lending through customer deposits rather than through wholesale funding, it was adversely affected by the ability of large banks to drive up its cost of funds by being able to offer higher rates on deposits to new customers.^{46,47}
78. Metro suggested to us that ‘In the interests of transparency and treating customers fairly, banks should be obliged to give existing customers the same favourable rates and products offered to new customers.’ It also added that ‘Banks should also be obliged to keep fee structures simple, let customers know personally about every rate change and inform customers of any better suited products available to them.’
79. Despite this potential barrier, Metro has been able to rapidly grow its deposits to support its funding requirements. Metro has also been able to raise equity capital to fund its expansion, it appears, without any difficulties. So far, Metro has raised £641 million as equity capital from private investors, as is shown in Table 2 below:

Table 2: Equity capital raised by Metro

Year	Equity capital raised £m	Comments
2010	75	Initial equity capital
2010	51	Additional equity capital
2012	128	
2013	287	
2014	100	
Total	641	

Source: Metro's website.

Conclusions

80. Metro has overcome what obstacles it encountered in launching as a new high street bank, and has grown well so far. Its IT system appears to be a competitive advantage.

⁴⁶ PCAs and BCAs represent an important element of Metro's funding representing [X]% and [X]% of its deposits as at December 2014. Metro stated that it had never cut a variable interest rate for an existing customer or offered a bonus rate to a new customer – because it does not consider that to be fair treatment of its customers.

⁴⁷ Retail funding refers to the various types of deposits that households and small companies keep with a bank while wholesale funding is from external sources including other banks, large corporates, pension funds, and insurance companies. ‘Bank funding costs: what are they, what determines them and why do they matter?’ BoE Quarterly Bulletin, Q4 2014.

81. It considers capital holding requirements, the larger banks' ability to subsidise new customers and indirect access to payment systems to be key impediments to its further expansion. Metro has chosen to focus on expanding in the South East around the London commuter belt. Metro has also adopted a branch-based business model to promote itself and acquire customers. However, if it cannot open new branches quickly enough in these areas, this may affect its ability to acquire customers and reach a certain scale.

Nationwide Building Society's business current account

82. This case study focuses on the experience of Nationwide in considering the provision of a BCA and additional SME banking services.
83. In 2010, Nationwide was starting to explore diversification opportunities that would provide an improved experience for its members and an acceptable return on capital. Despite the poor macroeconomic conditions, Nationwide believed that the SME banking market was relatively resilient and appeared to be attractive (particularly given the perceived political support and apparent ease of leveraging Nationwide's existing personal banking infrastructure).
84. The intended operating model was [REDACTED]. This would be targeted at [REDACTED] to minimise the impact on the existing Nationwide branch network.
85. However, additional work in early 2013 revealed that providing a credible entry into the SME market through the provision of a BCA product would require significant further and sunk capital investment in IT. It was concluded that the project offered insufficient returns on this capital in a reasonable time period and could potentially impact other projects which were perceived as a higher priority for Nationwide.
86. Despite what Nationwide saw as the continued attractiveness of the SME market for an incumbent business, the decision was made not to enter organically with the launch of a BCA, [REDACTED].
87. [REDACTED]
88. Our preliminary assessment is that Nationwide's decision not to enter the SME market was primarily on the basis of capital prioritisation. Based on [REDACTED], there was a relatively long time period needed to build scale with only modest profits being made even at maturity. Hence this proposition appeared relatively unattractive compared with other opportunities to invest in Nationwide's retail operations. There were also risks associated with entry, primarily regarding integration of new IT systems, and the impact on Nationwide's branch network.

Introduction

89. In this case study we examine the analysis which Nationwide conducted when assessing whether to launch a BCA and additional SME banking services. We consider in detail the process by which Nationwide identified the opportunity and why it ultimately took the decision to put this work on hold.
90. In 2012, Nationwide launched a business savings product available to SMEs, although this represents a very small line of business.

Overview of Nationwide

Origins and development

91. Nationwide claims to be the world's largest building society, tracing its beginnings to 1846 when Provident Union Building Society was founded.⁴⁸ It subsequently underwent many mergers and acquisitions with other building societies, most notably with Anglia (1987), Portman (2007), and Derbyshire (2008) and Cheshire (2008) building societies.
92. As a mutual, Nationwide is owned by its members, primarily made up of its financial services customers (borrowers and savers⁴⁹) who are given voting rights for the election of directors as well as voting on resolutions, operating on a one-member one-vote system.
93. Nationwide told us that prior to 1987 it largely offered savings and mortgages to personal customers. It subsequently introduced PCAs and a number of other products to personal and business customers. Nationwide now offers a range of financial products, including:⁵⁰
 - (a) personal products: residential mortgages, personal savings, personal financial planning, insurance products, personal lending, and other general personal banking services; and
 - (b) other products: commercial lending.
94. In 2007 Nationwide launched a major IT investment programme ('Project Voyager') to update its digital infrastructure. The aim was to facilitate the

⁴⁸ [Nationwide background](#).

⁴⁹ Generally requires a minimum of £100 savings or deposits as well as being aged 18 or over, [Nationwide membership criteria](#).

⁵⁰ [Nationwide Financial Products](#).

launch of new products, but also to replace its PCA back-end systems with an SAP⁵¹ solution. This cost about £[redacted], and was completed in 2012.

95. Nationwide has grown its customer base and product offerings and describes itself as ‘a meaningful alternative to the established banks.’ In 2014 it generated a profit before tax of £677 million, and highlighted its performance in three specific areas:⁵²
- (a) £130.5 billion of member deposit balances;
 - (b) £166.6 billion of loans and advances to customers (Including £145.7 billion of residential lending through 1.5 million mortgage accounts); and
 - (c) 5.5 million current accounts.

Business description

96. Nationwide’s core business is providing personal financial services to more than 14 million of its members. Its strategic agenda is focused on increasing its share of the personal banking market, with a specific target of achieving a 10% share of PCAs. In addition to this core focus, it said that its activities include specialist lending in both the commercial real estate and buy-to-let sectors as well as deposit-taking from SMEs. It does not currently offer a BCA or complementary SME banking services. It told us that this model is not expected to alter significantly in the short term.
97. Nationwide states that many of its existing members owned/operated SMEs but are unable to carry out their business banking with Nationwide. It told us that it recognises this gap in its offering and regularly reviews how it could best support SMEs.
98. Historically, Nationwide has sourced its funding from the personal savings and wholesale funding markets. In March 2012, it fully launched (ie available to new customers) simple business savings accounts to both meet its members’ needs and to diversify its funding base. These catered to SME needs but were relatively simple, being postal-only.
99. By 2014, these business savings accounts amounted to £[redacted].⁵³ Nationwide said that it intended to grow its business savings to £[redacted] by [redacted]. However,

⁵¹ [SAP background.](#)

⁵² 2014 Annual Report, with quoted profit levels given as statutory profit before tax.

⁵³ [redacted]

[£] given that Nationwide's total funding⁵⁴ at 30 September 2014 was £185 billion.

Initial views on Nationwide's BCA project

100. In this section we consider Nationwide's reasons for delaying its BCA project.

101. Nationwide has consistently stated a number of reasons for entering the SME market through the launch of a BCA. Entering the SME market would:

- (a) provide a better service offering to its members;
- (b) diversify its business model (in terms of both revenue and funding);
- (c) allow it to further leverage its brand; and
- (d) provide an opportunity to cross-sell products between personal and business (eg using existing personal base as an entry point).

102. Nationwide chose to prioritise its investment in other projects ahead of developing its SME proposition. Four other factors caused Nationwide to de-prioritise entering the SME market once Nationwide had investigated in more detail, specifically:

- (a) developing the IT systems necessary to offer banking services to SMEs is complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. The original assumed ability to leverage existing IT investments from personal banking (ie Project Voyager) and thus minimise capital costs, was proved incorrect. Refined estimates indicated that an additional £[£] would be required;
- (b) based on the anticipated levels of switching and growth, the business plan illustrated modest returns for many years making the investment horizon long term (delivering low returns on capital) and unlikely to add any diversification benefit to its existing business model;
- (c) the distribution requirements and, in particular, the use of branch space potentially conflicting with retail requirements ie some of Nationwide's branches are currently too small or too busy to accommodate SME service requirements. This is expected to become less of an issue as more transactions are done through mobile and digital channels, but there

⁵⁴ According to Nationwide's 2014 Annual Report, 'Funding' includes customer deposits (72%), wholesale funding (20%), reserves (6%), other (2%).

is still a risk that counter service for personal customers would be impacted by servicing [REDACTED] SME customers ([REDACTED]); and

(d) Nationwide has limited SME expertise particularly in origination, service and risk management. IN Nationwide's view, this risk could be substantially reduced through [REDACTED].

103. Although the SME market remained attractive after additional research, the level of synergy that could be achieved with existing assets was determined to be significantly lower than initially believed. This implied much higher capex requirements to enter, and hence a significantly worse return on capital employed. Nationwide acknowledges that as its analysis progressed, the scale of the challenges faced by new entrants to the SME market became apparent.

104. [REDACTED]:

(a) [REDACTED];

(b) [REDACTED];

(c) [REDACTED]; and

(d) [REDACTED].

105. Nationwide did not rule out a potential acquisition in the future, but considered that it would be dependent on an attractive target becoming available, and external market developments such as the CMA investigation.

Details on specific barriers

106. Nationwide told us that the primary reason it put its SME project team on hold was that its board took the view that investment in personal banking products and services must take priority over attempts to develop SME banking. The scale of change taking place in Nationwide's personal banking business made it unfeasible for it to develop the required SME capabilities in parallel. Its analysis had shown that for successful entry to take place, the following costs/complexities would need to be overcome:

Set-up/capital costs

107. Nationwide concluded that developing the IT systems necessary to offer banking services to SMEs was complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. It also required significant technology management resource and expertise.

- (a) The Nationwide board believed ‘the Society could not afford to invest c.£[redacted] million at this time at the expense of other projects.’
- (b) At the point this statement was made (2013), SME banking appeared to be the lowest priority of the three ‘discretionary’ projects discussed.

Low financial returns

- 108. Based on the anticipated levels of switching and growth, the indicative business plan illustrated modest returns for many years making the investment horizon long term and unlikely to add any diversification benefit to the existing business model.
- 109. In 2014, the Nationwide board were ‘generally supportive [of SME proposal] particularly from a diversification perspective although some concern was expressed that given the relatively small forecast financial contribution by years 5 and 10 a stronger consideration was the ‘member needs’ argument’.

Distribution concerns

- 110. The distribution requirements and, in particular, the use of branch space potentially conflicted with personal requirements, ie some of Nationwide’s branches were currently too small or too busy to accommodate SME service requirements.
 - (a) [redacted]
 - (b) [redacted]
 - (c) Nationwide analysis has, however, suggested that this concern may become less important in the future as SMEs increasingly adopt digital banking solutions such as online and mobile. [redacted]

Limited expertise and risks

- 111. Nationwide was concerned that as a personal financial service provider it did not have sufficient SME expertise in the fields of origination, service and risk management and would thus need to recruit and establish these areas of specialisation.
 - (a) Although identified by Nationwide as being an area of concern early on in the process, [redacted] appears to have given Nationwide sufficient confidence that it would be able to build a credible offering.
 - (b) [redacted]

Awareness of opportunities for inorganic growth

112. [✂]

113. [✂]

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

External communications and regulatory pressures

114. [✂]

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

(e) [✂]

115. In August 2013, the Financial Times reported that Nationwide had:

Put on hold its plans to start offering loans to small- and medium-sized enterprises as it battles to meet tougher capital requirements set out by the financial regulator earlier this year [...] after the Prudential Regulation Authority revealed that Nationwide would have to strengthen its capital position after it fell short of the required 3 per cent leverage ratio.⁵⁵

116. The CMA notes that later in the same month *The Guardian* reported that the BoE 'rejected any suggestion that Nationwide's decision to hold off from a launch into the SME sector was due to its demands on capital strength', quoting a BoE spokesman as saying 'the plan agreed with Nationwide to meet the 3% leverage ratio in 2015 will not result in them restricting lending to the

⁵⁵ [Financial Times report \(£\)](#), 26 August 2013.

real economy. Therefore it is wrong to blame their SME decision on the regulator'.⁵⁶

117. Nationwide subsequently confirmed to us that the capital holding requirement was not one of the primary reasons for its decision to put its investigation of entry into the SME market on hold.

Tesco Bank's personal current account

118. This case study examines Tesco Bank's launch of a PCA in 2014.
119. Tesco Bank has its origin in a joint venture (the JV) between Tesco and RBS, which was formed in 1997. This JV offered various personal banking products such as credit cards and loans to its customers but not a PCA. After purchasing RBS's share of the JV in 2008, Tesco Bank established a stand-alone IT system and migrated its customers to this platform. In 2010, when most of this migration activity was complete, it began initial research on a PCA proposition with the objective of filling this gap in its banking portfolio.
120. After researching the market and enhancing its IT platform, Tesco Bank launched a PCA in June 2014. Tesco Bank's PCA is a direct, predominantly online product, and its main target market are existing Tesco Bank customers whom it plans to attract by emphasising the loyalty based rewards such as Tesco Clubcard points. Tesco Bank believes that its online proposition, coupled with providing basic transactions in some of Tesco's retail stores, is sufficient for it to succeed as a PCA provider, but it remains open-minded to assessing demand for different business models to meet customers' needs.
121. Tesco Bank did not face any significant regulatory hurdle to launch a PCA since it already had a bank licence which the JV had obtained in 1998. The main challenge it faced was the cost and complexity of developing an integrated IT platform to support its PCA offering. This took almost three years and [£] investment of about £[£] million. Tesco Bank also incurred £[£] million on user acceptance testing of the IT system, other programme costs, and developing and building business capability to run the product. Tesco Bank decided to spend heavily to promote its PCA at launch and may do so on an ongoing basis; it expects its marketing budget to normalise around £[£] million per year. It believes that it will take [£] before its PCA becomes

⁵⁶ [Guardian report](#), 27 August 2013.

profitable on a stand-alone basis, but expects to gain by selling other banking and non-banking products to its PCA customers.

122. Tesco's long term plan is to acquire [⌘]. According to Tesco Bank, factors that may inhibit its plans to expand include access to payment systems both in respect of quality of service and costs, the prevailing free-if-in-credit PCA model, and the larger banks' access to low-cost funding.

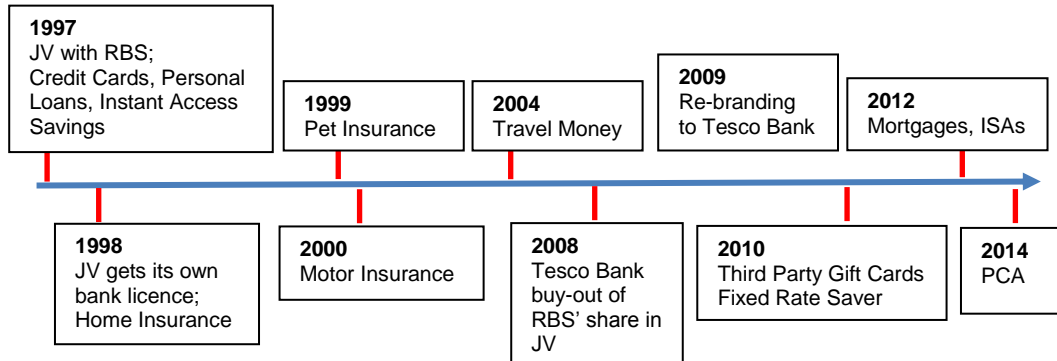
Introduction and background

123. This case study focuses on Tesco Bank's launch of a PCA in 2014 in Great Britain.⁵⁷ The paper begins with a brief history of Tesco Bank and the background to the launch of its PCA. Next, it discusses Tesco Bank's business model and strategy in relation to its PCA business, including an analysis of its growth since launch. Finally, the paper considers the extent to which Tesco Bank's experience suggests the presence of barriers to entry or expansion into UK retail banking.
124. Tesco Bank is the trading name of Tesco Personal Finance PLC (TPF), a wholly owned subsidiary of Tesco Personal Finance Group Limited (a holding company) which, in turn, is wholly owned by Tesco PLC. TPF was formed in 1997 as a JV between RBS and Tesco PLC, and obtained its banking licence in June 1998, having operated under RBS's until then. The JV initially offered various financial products including a credit card, personal loans but not a PCA.
125. In December 2008, Tesco PLC acquired RBS's 50% shareholding in TPF. In order to continue servicing its customers without the support of RBS, it had to establish the necessary business functions (including finance, risk management, treasury, etc), and acquire the required physical infrastructure (eg buildings for its operational teams). In October 2009, TPF was rebranded and changed its trading name to Tesco Bank.
126. To remove its dependency on RBS, Tesco Bank needed to build a stand-alone IT infrastructure, before embarking on a major customer migration project. This process took three and a half years and cost £[⌘]. The migration project was staged in three parts: general insurance followed by savings and loans and concluded with credit cards (in May 2012).

⁵⁷ Tesco Bank stated that the Northern Ireland PCA Banking Market Investigation Order 2008 ('NI Order') which was introduced by the then CC, provided specific rules governing the switching process of PCAs. This included, for example: suppressing interest and charges for three months following the opening of a new PCA and annual reminders to how customers can switch. Due to the additional time required to achieve compliance with the NI Order, a decision was taken by Tesco not to include Northern Ireland in the initial launch.

127. Tesco Bank launched a PCA in June 2014 which added to its range of other banking and insurance products for personal customers in the UK. Figure 12 shows Tesco Bank’s main products with launch dates, as well as key events since 1997.

Figure 12: Tesco Bank – product launches and key events



Source: Tesco Bank.

128. Since 2009, Tesco Bank’s strategic direction was to be a bank which provided customers with a full range of personal banking services, and the development of a PCA was seen as the key element of this strategy. Given its focus on personal banking, it stated that offering banking services to SMEs was not part of its long-term plan.

129. At the end of the financial year 2013/14, Tesco Bank reported assets of £[£] and customer deposits of £[£] (Table 3).

Table 3: Assets and deposits (2013/14)*

[£]

Source: Tesco Bank.

*[£]

Tesco Bank’s personal current account launch

130. Tesco Bank viewed a PCA to be the key relationship product for customers, and its decision to launch a PCA was driven by the natural progression of its business to meet the full financial needs of Tesco Bank customers. It stated that:

A major step towards delivering banking credibility for Tesco Bank will be established when we successfully launch current accounts and are able to provide a fuller banking relationship to Tesco loyals ... Current account provides a deeper understanding of a customers['] financial situation – allowing the provider to produce better risk analysis, more informed decisions about a customers' suitability for other products and ultimately wider product holding.

131. Tesco Bank had commenced initial research to understand the customer expectations of a PCA while its JV with RBS still existed. Tesco Bank said that once the initial products were launched by the JV, consideration was given to offering a PCA, but the long-term investment required at the time when RBS already had more than 20% of the PCA market share did not make it a priority over other opportunities. In 2010, once the banking IT platforms and operations were fully controlled by Tesco Bank, and most of the data migration from RBS was complete, a new focus was established on what Tesco Bank could offer to customers in the PCA market.
132. Tesco Bank's objectives for offering a PCA were:
- (a) to prove to loyal Tesco shoppers that Tesco Bank was a credible choice for a PCA and wider financial services products;
 - (b) to build momentum over time as it established a PCA reputation for excellent service and rewarding loyalty;
 - (c) to provide its customers with high-quality online, telephone and mobile banking services and to offer basic deposit and withdrawal services in Tesco stores; and
 - (d) to generate income to offset the cost of running its operation and rewarding loyalty.
133. Tesco Bank made the point that [REDACTED], there were tangible benefits of a PCA to the Tesco Bank and the Tesco Group, which included the following:
- (a) Broadening the appeal of Tesco Bank by providing a more inclusive choice in terms of how Tesco customers wished to shop at Tesco and earn and benefit from Clubcard rewards.
 - (b) Issuance of Clubcard points for debit card spend anywhere which was likely to lead to increased spend in Tesco stores when customers used their vouchers.
 - (c) Incremental sales uplift in stores ([REDACTED]) from PCA customers.
 - (d) Net debit interchange benefit of PCA customers paying with a Tesco Bank debit card [REDACTED].
 - (e) Lower likelihood for customers to lapse in-store loyalty as their engagement increased through ownership of bank products and services.
 - (f) Greater affinity of transactional (PCA) customers with other retail services, [REDACTED].

134. Tesco Bank also stated that the incremental value to the Tesco group to be generated from cross-selling was in the range of £[redacted] cumulative [redacted]-year contribution.
135. While considering whether to launch a PCA, Tesco Bank considered the product's contribution at three levels:
- (a) Stand-alone value where a PCA would enable it to participate in a large market, and be an anchor product for its customer relationships.
 - (b) Synergy value to Tesco Bank whereby a PCA could help to establish it as a 'real bank' in customers' minds. A PCA was also seen to help in increasing the potential for multiple product holdings, and improve the customer experience on other product journeys.
 - (c) Synergy value to the Tesco group by creating increased customer loyalty and increased spending in stores and reduced transaction costs as more transactions moved to contactless payments.
136. The Tesco Bank PCA was launched in June 2014 in Great Britain with the following main features:⁵⁸
- (a) Clubcard points on debit card spend;
 - (b) 3% AER interest on credit balances up to £3,000;
 - (c) £5 monthly fee, but only if customers deposit less than £750 per month;⁵⁹
 - (d) online and mobile banking;
 - (e) UK-based customer service centres which were open 24 hours a day, seven days a week; and
 - (f) ability to make deposits and withdrawals at 305 Tesco stores.

137. Table 4 shows that [redacted].

Table 4: Tesco Bank PCA – forecast and long-term plan (LTP)

[redacted]

Source: Tesco Bank.

138. Figure13 shows that [redacted].

⁵⁸ More details of Tesco Bank's PCA are provided in Annex F.

⁵⁹ Tesco Bank announced removal of £5 monthly account fee with effect from 17 September 2015. Source: [Tesco Bank website](#).

Figure 13: Depreciation expense projections

[REDACTED]

Source: Tesco Bank.

139. Tesco Bank estimates the net present value (NPV) of an individual PCA to be [REDACTED], but expects other benefits from the product in the form of lower cost of funds and cross-sell opportunities, and plans to review its forecast NPV per account as it acquires more customers. Tesco Bank stated that given the scale of (sunk) investment (mainly IT and promotion costs) required to launch and promote its PCA, it expects to break-even [REDACTED] after launch, [REDACTED].

Strategy and business model

140. Tesco Bank told us that its strategy was to be the bank for Tesco customers where it rewarded their loyalty and earned their trust. Tesco Clubcard is central to how Tesco recognises and rewards loyalty: it offers points on debit and credit card spend, mortgage repayments, and discounted pricing for Clubcard customers on Car and Home Insurance.
141. Tesco Bank told us that it had designed its PCA strategy and product offering to appeal to those customers:
- (a) who were happy not to have a face-to-face relationship with their bank since it determined that there was a sizeable customer appetite for a direct (branchless) proposition;
 - (b) who wanted a simple and transparent product, providing the payment and account servicing capability that were 'hygiene factors' for a current account, whilst allowing customers to take control and self-serve where possible;⁶⁰
 - (c) who wanted to be in control of their finances, avoid excessive charges and receive texts or emails to let them know when they needed to pay in or to confirm action taken on their account; and
 - (d) who wanted their bank to recognise them with ongoing rewards for doing their everyday banking.
142. Tesco Bank's research indicated that customers' overriding requirement of a current account was that it 'just worked'. This meant that customers did not

⁶⁰ The term 'hygiene factors' is usually used to refer to factors which do not give positive satisfaction but if absent can cause dissatisfaction.

want to spend time on their banking and wanted to be confident that their bank would take care of their money management needs.

143. Tesco Bank's research also found that there was a high level of 'emotional trust' (belief that a bank will do the right thing) in Tesco Bank but that customers had a 'higher transactional trust' (belief that a bank can do things right) in the existing banks. This made it challenging to persuade customers to move their PCA to Tesco Bank even if they did not feel valued or rewarded by their existing bank.

144. Tesco Bank stated that the differentiation and appeal of its PCA was the provision of points for the loyalty of its customers. As it put it:

The target proposition is a fully functioning Tesco Bank current account that rewards ongoing loyalty, has a simpler approach to fees and charges and offers feature rich servicing options ... The proposition is differentiated in areas that hold significant appeal to Tesco loyal customers and are difficult for our competitors to replicate, in particular the areas of convenience and reward.

145. Tesco Bank told us that its PCA was designed to fit with its strategy 'to be the bank for Tesco Bank customers'. It also mentioned that 'The customer segments and target market for the Tesco Bank current account proposition are young adults, young families and older families, typically those who are poorly served by current competitor offerings and have demonstrated a strong affinity to our proposition.' Tesco Bank believed that those customers who already had other banking services (eg credit card) with them would be more receptive to its PCA than non-Tesco Bank customers.

146. Accordingly, Tesco Bank developed a targeting model to identify which Tesco Bank customers should be targeted based on the customer insights described above. [✂]. Tesco's defined target market is shown in Figure 14.

Figure 14: Target market

[✂]

Source: Tesco Bank.

147. Based on the expected rate of PCA take-up from this target market, Tesco Bank's initial expectations were to gain about [✂] PCA customers [✂].

148. Tesco Bank's primary channels from a (PCA) customer acquisition perspective are as follows:

- (a) Above-the-line (television, outdoor and press) marketing: to reach out to customers in the switcher market that could be overlooked by direct channels.
- (b) In-store: Tesco Bank leverages the large store network primarily to raise consumer awareness of its PCA among Tesco shoppers.
- (c) Direct: Tesco Bank uses targeted mailing to Tesco Clubcard holders and Tesco customers using its insight and segmentation models.
- (d) Online: Tesco Bank has invested in search engine optimisation and implemented high-quality, easily accessible information on its website.
- (e) Mobile Banking App: which can be used to send messages, and be a customer servicing platform.
- (f) Public Relations: From January 2014 onwards, Tesco Bank engaged in a dialogue with journalists in the lead up to the PCA launch.

149. Tesco Bank stated that although its existing customers were always going to be its primary target market segment, with more than 20 million Tesco customers to reach, above the line – particularly television advertising – was the most effective and wide-reaching channel for building awareness of a new product with this customer group. Tesco Bank also made the point that whilst its PCA was designed with the needs of Tesco shoppers in mind, it expected the product to have a broader appeal, especially as it further developed its PCA product range.

Performance so far

150. Figure 15 shows growth in the number of Tesco PCAs since launch. [✂]

Figure 15: Number of PCAs

[✂]

Source: Tesco Bank.

151. Tesco's forecast and actual performance for PCA applications, new accounts and costs per account opened in the first year is shown in Table 5.

Table 5: Key performance indicators – Year 1*

[✂]

Source: Tesco Bank.

*[✂]

152. [✂]

153. Tesco Bank stated that based on the experience gained since the launch of its PCA, it was planning to make improvements to the application and account opening process in order to enhance the customer experience. It was also planning to review its product range to serve more customers. Tesco Bank mentioned that:

As such, our future product map will consist of a broader suite of products which will more than likely be segmented to meet the needs and desires of a wider range of customer, from lower affluence through to a more value adding higher affluences segment type.

154. As per Tesco Bank's latest PCA forecast shown in Figure 16, it expects to have about [X] PCAs by year [X].

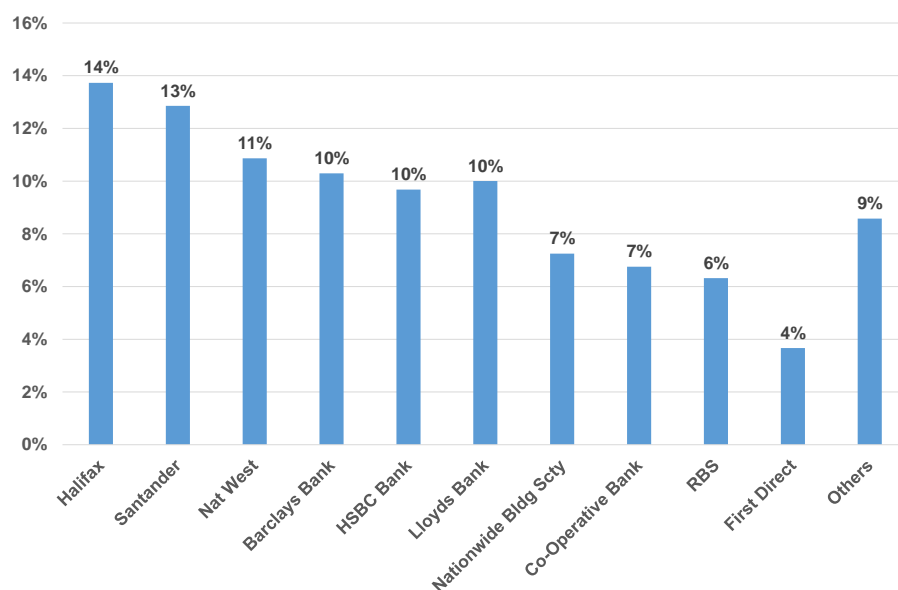
Figure 16: Forecast – PCA stock

[X]

Source: Tesco Bank.

155. Tesco Bank told us that it was too soon to determine reliably particular customer characteristics, demographics and the source of its new accounts. Some of the new accounts (around [X]%) included a full or partial switch via the current account switch service (CASS), which provided it with some information on the source of new customers. It stated however that it could not yet draw any firm conclusions from this data and its ongoing analysis would help to determine any notable trends. Tesco Bank's analysis of customers switching via CASS for the period July 2014 to January 2015 is given in Figure 17 which shows that it is gaining customers from many established PCA providers.

Figure 17: Tesco Bank PCA – sources of switchers



Source: Tesco Bank.

Barriers to entry and expansion

Regulatory requirements

156. Tesco Bank obtained its banking licence in June 1998 under the JV with RBS, and does not consider that the hurdles to get this licence were overly burdensome. It was not required to become authorised to launch a PCA since it already had the required permissions in place. Tesco Bank said that as part of launching the PCA, it held a number of discussions and engagements with the regulators, but did not face any significant regulatory obstacles.
157. Tesco Bank had to hold £[redacted] million in additional capital against the risks associated with the launch of its PCA. [redacted]⁶¹
158. Tesco Bank stated that during the development of its PCA offering, there were a number of regulatory changes which impacted the complexity and cost of the product development, and also led to a modest delay in Tesco Bank's launch of a PCA. As examples, it cited the introduction of CASS and the transfer of consumer credit regulation from the OFT to the Financial Conduct Authority (FCA), but did not consider these as significant competitive disadvantages.

⁶¹ [redacted]

Access to payment systems

159. Tesco Bank is an indirect (agency) member of the interbank payments schemes (such as Bacs, CHAPS, Faster Payments Service (FPS)), and the Cheque and Credit Clearing Company (C&CC) through [REDACTED]. It made the point that its ability to offer the same level of service as banks directly accessing the payment systems could be limited. As Tesco Bank put it: 'In practice, connecting to the UK interbank payment systems through a competitor means that the payments services we offer customers can be no better than our sponsor bank and, as we have experienced, a lesser offering in a number of instances'.
160. Tesco Bank told us that while the introduction of faster payments had been beneficial for its customers, agency banks were unable to process payments in real-time 24x7, making them less responsive to the customers' needs than banks with direct access to the payment networks. It also stated that this situation was exacerbated by the development of additional 'overlay' services utilising the faster payments infrastructure – such as Paym⁶² – which further exploited the asymmetry in real-time payments processing capability between agency banks and those accessing the UK interbank payment systems directly.⁶³
161. Tesco Bank stated that the direct members of the interbank payment schemes were notified in the event of either scheme-wide issues or in the case that a particular scheme member experienced difficulty. For FPS, this notification was supported by real-time Unsolicited Messages (USMs). Tesco Bank told us that being an indirect member, it did not receive notification directly from the scheme and could not receive USMs, and was therefore reliant upon its sponsor bank for such notifications.
162. Regarding the costs of accessing payment systems, Tesco Bank told us that it paid a cost premium for accessing payment systems through the agency relationship. [REDACTED]
163. Tesco Bank also made the point that direct members paid for the direct costs of running the interbank payment systems. These included the scheme operators' infrastructure, staff and administration costs, which were apportioned according to the direct member's share of transactions. It stated that agency banking, on the other hand, was a commercial service, and the providers of

⁶² Paym allows customers to make payments to account holders of other participating banks or building societies using their mobile number.

⁶³ Tesco Bank provided an example where its sponsor bank used Swift NET to transmit payments and since Swift gateways were closed for maintenance between 16:00 Saturday and 06:00 Sunday, no faster payments to/from Tesco Bank could be transmitted during this time. This, according to Tesco is an example of situations where it is unable to provide services, which other sponsor banks may be able to offer to their customers.

these services recovered direct costs and generated a commercial return from providing such services.

164. Tesco Bank believed that the prices being charged of the agency banks reflected the concentrated nature of the service provision within the market and the high costs of switching provider.

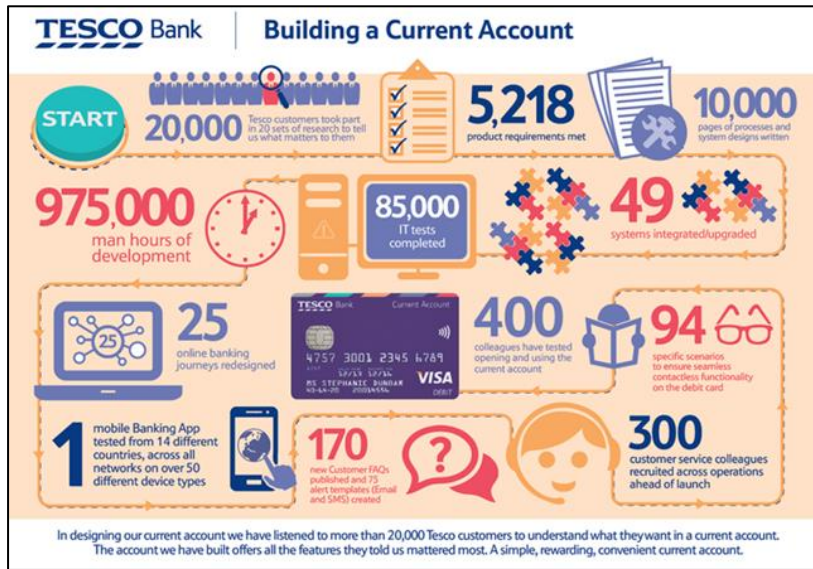
IT systems

165. Tesco Bank told us that the development of IT infrastructure necessary to support its PCA offering was both complex and costly. At the point of taking full control of the business from RBS in 2008, Tesco Bank had none of its own IT infrastructure or applications to support its banking products. In order to remove its dependency on RBS, it acquired and built a number of IT components before migrating the existing customer base to its own system.
166. To develop a PCA platform on top of its existing IT infrastructure, Tesco Bank needed to enhance and extend the capability of many internal and external applications, and build and acquire a number of new infrastructure components.
167. Tesco Bank said that the transactional nature of a PCA (compared with, say, savings and loans book) meant that it had to substantially increase the processing speeds for a number of different payment types.⁶⁴ In order to minimise the disruption to existing customers of Tesco Bank, an extensive process was required to implement the new processes as part of its IT systems. In summary, the development of Tesco Bank's PCA IT infrastructure involved:
- (a) approximately 15,000 man-days on design and build;
 - (b) 5,218 requirements being met;
 - (c) 89 detailed design packs written and delivered;
 - (d) 49 systems integrated/upgraded;
 - (e) 67,388 system integration tests completed; and
 - (f) 3,300 user acceptance tests completed.

⁶⁴ For example, card transactions processing were uplifted to process 30 times more transactions than Tesco Bank was processing pre-PCAs, and BACS payments 70 times faster.

168. Figure 18 illustrates the scale of the effort involved in building Tesco Bank's PCA.

Figure 18: Development of Tesco Bank's PCA



Source: Tesco Bank.

169. The development of Tesco Bank's PCA programme required investment of £[redacted] million over [redacted] years. [redacted].⁶⁵ Tables 6 and 7 show the details of the investment to support Tesco Bank's PCA development, by spend category and by functional work streams.

Table 6: PCA programme costs by year and major category

[redacted]

Source: Tesco Bank.

Table 7: PCA programme costs by business and IT work streams

[redacted]

Source: Tesco Bank.

170. Tesco Bank stated that in addition to the above programme costs, an additional £[redacted] million per year had been added to its existing IT support costs as a result of launching the PCA. Tesco Bank told us that the complexity (and the cost) of developing the IT infrastructure to support its PCA was compounded due to the need for the IT platform to be placed on top of an existing set of systems, and the need for it to also support Tesco Bank's other products and customers rather than being built in isolation.

⁶⁵ Tesco Bank told us that during the design, build and testing of the PCA proposition, resources and spending were not limited to the PCA in isolation. Much of the testing was to ensure enterprise wide reliability for existing customers while a range of deliverables included in the PCA launch had a benefit beyond purely the PCA.

171. Tesco Bank made the point that it would be an easier task and would require less investment for a new bank with no existing products, customers and systems to put in place the necessary capabilities and IT system to launch a PCA with robust online, mobile and telephone banking propositions and services.

Need for branch network

172. Tesco Bank's PCA is mainly an online offering but it told us that it had also experimented (pre-PCA launch) with different in-store branch formats and locations with little consumer usage, and remained open minded to assessing customer demand for different models.⁶⁶

173. Tesco Bank told the OFT in 2013 that 'Given our stores' footprint and their customer footfall, we have no interest in branch networks for sale or emulating those buying them. The overwhelming feedback from our customers is that they want a banking service which is convenient, easy to use and is available when it most suits them.' In a similar message, Tesco Bank said, in its response to the CMA's consultation on a potential market investigation reference for retail banking, that 'We believe [however], that the historically strong correlation between the number of branches a provider has and their PCA market share is breaking down'.

174. Tesco Bank believed that whilst a branch network might still be important for a certain market segment, there continued to be a migration away from branches and towards digital channels. Tesco Bank stated that it had achieved considerable scale in certain products – such as credit cards and personal loans – by pursuing an online and telephone-based strategy, and while developing its PCA proposition, it determined that there was a sizeable customer appetite for a direct (branchless) proposition that was only likely to grow.

175. Tesco Bank stated that as it developed its PCA offering, it recognised that some customers valued the convenience of being able to deposit and withdraw funds face-to-face. It has provided the facility to PCA customers to take advantage of the deposit and withdrawal functionality at some of its stores across the UK.⁶⁷ However, Tesco Bank stores do not in general operate like a bank branch, and it mainly makes use of the Tesco store network to raise consumer awareness about its banking products. In-store

⁶⁶ Tesco Bank told the CMA that its PCA was developed while taking consideration of the shift in customer behaviour towards digital channels, and it had not conducted research into alternative business models.

⁶⁷ Tesco Bank told us that these stores were predominately larger format stores with the exception of small formats in outlying geographical locations.

deposit and withdrawal capability for bank products is limited to its PCA and Instant Access Savings Accounts, and to only 305 of Tesco's 3,378 UK stores (see map in Annex E).

176. Tesco Bank made the point that its PCA was very much a direct, predominantly online account. Therefore, its limited in-store facilities were not intended to be a like-for-like offering with a branch network. Tesco Bank believed that its strong digital capabilities, coupled with some basic deposit and withdrawal facilities in store, would allow it to provide a strong service offering to its customers which would also be cost-effective. However, it planned to continue to assess whether its PCA proposition met its customers' needs, and review the offering and servicing channels accordingly.
177. Tesco Bank noted that the benefits of a branch network were heavily influenced by a bank's starting point: while for incumbents with an extensive physical estate, closing branches reduced cost significantly – for new entrants, opening branches added significant costs to their expense base. Similarly, Tesco Bank stated that any existing bank with a large customer user base that closed a traditional branch to open a smaller physical space in a retail environment would be reducing its operational costs. Tesco Bank believed that given the direction of travel in the market, its approach of offering primarily an online PCA was an appropriate starting point.

Brand awareness and advertising

178. Tesco Bank told us that its consumer research had referred to two types of trust in a brand: 'transactional trust' – the belief that the account would do what it said it would, and 'emotional trust' – the belief that a provider would act in the interests of its customers. It believed that the nature of a PCA was such that transactional trust was paramount and therefore customers favoured established brands with scale and experience in this market.
179. Tesco Bank made the point that it had been able to establish itself in financial services by leveraging the strength of its brand. It believed that for a new entrant without any existing customers or brand recognition, it would be more difficult to enter the PCA market and gain consumer acceptance.
180. Tesco Bank also stated that new entrants into the PCA market needed to make significant investment in marketing and promotion in order to grow brand awareness and consideration.
181. To grow its share of brand awareness and consideration, Tesco Bank decided to support the launch of its PCA by giving more weight to above the line

(mainly through TV) promotional strategy for the short to medium term.⁶⁸
Table 8 shows the distribution of Tesco Bank's Year 1 PCA marketing budget across different marketing channels.

Table 8: Year 1 PCA marketing budget by channel

[✂]

Source: Tesco Bank.

182. Tesco Bank told us that its approach towards marketing and promotional spend and the primacy of above the line advertising was largely in line with the approach taken by other PCA providers in the market, as is shown in Figure 19.

Figure 19: Spend on PCA marketing

[✂]

Source: Tesco Bank.

183. Despite having a well-known brand name, Tesco Bank believed that it needed to invest in building awareness of its PCA proposition and capabilities. The need to promote the PCA appeared to reflect the challenges it anticipates to overcome the 'transactional trust' barrier which means that established brands dominate. Tesco Bank expected its PCA marketing budget to normalise around £[✂] million per year.

Customer acquisition and retention

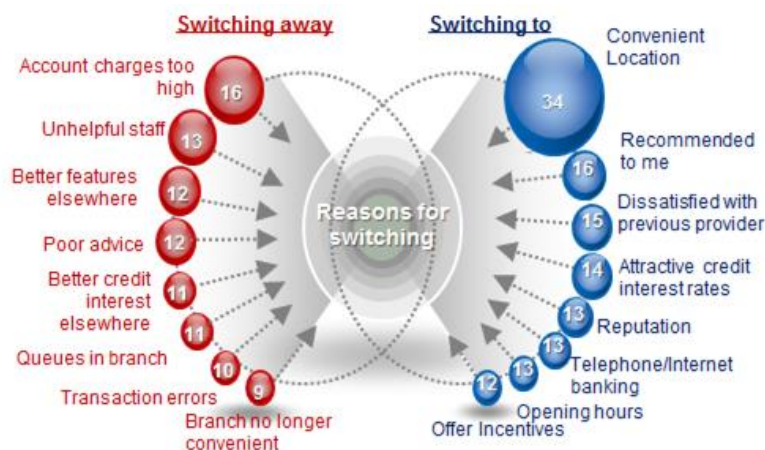
184. Tesco Bank pointed out that that its market insights drew out a linkage between customer satisfaction, service quality, and retention (see Figure 20):

(a) For those who do switch, 'push' rather than 'pull' factors dominate.

(b) Not feeling valued, high charges and poor customer service are the most frequent triggers for leaving a provider.

⁶⁸ Above-the-line promotion involves the use of advertising to reach a mass audience. It uses media such as television, cinema, radio and print to promote brands or convey a specific offer.

Figure 20: Factors facilitating switching



Source: Tesco Bank.

185. Tesco Bank mentioned the following challenges faced by it as a new entrant, in trying to acquire customers:

- (a) Lack of transparency and comparability in the market – Tesco Bank believed that there were issues with transparency, complexity and comparability of PCA product offerings making it harder for customers to shop around.
- (b) Use of loss-leading pricing and incentives, which could be used by incumbent banks to grow market share, usually in combination with aggressive marketing investment.
- (c) ‘Free if-in-credit’ model – Tesco Bank believed that this model created a barrier to entry which was very difficult for new entrants not to conform to, in order to compete. It had made a similar point in its response to the CMA’s consultation on a potential market investigation reference for PCA and SME banking services stating that, ‘...the perception that your PCA is “free” is a key contributing factor to the lack of customer engagement in assessing the value they derive from their account.’ Tesco Bank stated that this barrier was heightened by incumbents which were able to support competitive new business offerings at the expense of their existing customers. Tesco Bank [X] decided to enter the market with a £5 monthly fee which is waived if a customer deposited £750 a month.⁶⁹
- (d) Lower cost of funds for incumbent banks: Tesco Bank mentioned that incumbent banks paying high rates of credit interest on new business had significant current account and savings deposits in place that they were

69 [X]

paying little or no interest on. This, according to Tesco Bank, meant that the incumbent banks' cost of funds mix would be lower than for new entrants, which did not have such back books.⁷⁰

186. Tesco Bank noted that whilst initiatives such as CASS were starting to make an impact, the scale was still modest. It believed that more needed to be done to promote the service, and without additional promotional investment, it was unlikely that CASS would achieve its full potential as an enabler of competition in the PCA market.
187. Tesco Bank did not anticipate any customer retention issues since it believed that its PCA had been designed to meet customer needs, and offered an all-round proposition including credit interest, Clubcard rewards and a convenient account.

Conclusions

188. It appears that the development of an IT infrastructure was the main obstacle to Tesco Bank's launch of a PCA. It took about three years and a significant investment for Tesco Bank to build a PCA IT platform on top of an existing IT system.
189. Although Tesco Bank has launched a PCA, [✂] it is uncertain if it will be able to challenge the larger banks in the near future. The main factors identified for this limited scale are customer acquisition costs and inertia. As Benny Higgins, Tesco Bank's Chief Executive, recently remarked: 'I think that we can aspire to be a significant player but I think the nature of the market means it will take time ... I think the current account is going to be a long burner.'⁷¹

TSB's experience of entry

190. The TSB Banking Group plc (TSB) business comprised assets divested from Lloyds Banking Group (LBG) as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS.
191. When it entered the market in 2013, TSB possessed assets that other entrants did not: it owned over 600 branches (a 6.1% share of all UK bank branches), had 4.1% of the personal current account (PCA) market and retained access to the LBG IT platform. However, it faced the same potential

⁷⁰ Tesco Bank pointed out that over time, as base rates climbed, this dynamic would alter as easy access savings rates became more competitive against current accounts.

⁷¹ Reuters (11 February 2015), [Tesco Bank to grow current accounts market share – CEO](#).

barriers to expansion as other banks, in particular customer acquisition, including by persuading customers of other banks to switch to it.

192. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of market flow⁷² and added over 200,000 PCAs to its stock.
193. However, TSB put it to us that its performance in 2014 does not necessarily equate to it having a meaningful and lasting impact on the competitive dynamics of the sector in the future as:
- (a) rising costs resulting from the terms of its arrangements with LBG, in particular regarding the cost of the shared IT platform and the ongoing reduction of other, temporary profitability enhancements put in place following the recommendations of the OFT in September 2013 could constrain the amount it could afford to invest in customer acquisition in subsequent years; and
 - (b) PCA customers that TSB acquires from other banks may take several years to become profitable.
194. Subsequent to these submissions TSB was acquired by Banco de Sabadell

Introduction

195. In this case study we examine TSB's experience of entry and expansion into retail banking, with a particular focus on its PCA products.⁷³
196. At the time the business was launched TSB possessed assets the absence of which have been considered in past investigations to constitute barriers to entry or expansion and which other subjects of our case studies lacked. TSB owned around 6% of the UK banking branch network, had the authorisations and licences necessary to carry out a banking business and had an established and familiar brand name. It also began life with a share of the PCA market of just over 4%.
197. On the other hand it lacked advantages enjoyed by other entrants, such as a purpose built, modern IT platform, and it faced the same potential obstacles

⁷² 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock'.

⁷³ TSB told us that the main focus of its business strategy was the consumer sector and growth of the business current account business was not seen as a strategic priority. It said that the profile of its SME customers was weighted towards the smaller end of the segment with sole traders representing 40% of its business customers and clubs and charities almost 30%. Reflecting this it said that its share of the business lending market was less than 1%.

as all new entrants: in particular a low propensity of consumers to switch PCAs, sometimes characterised as ‘consumer inertia’.

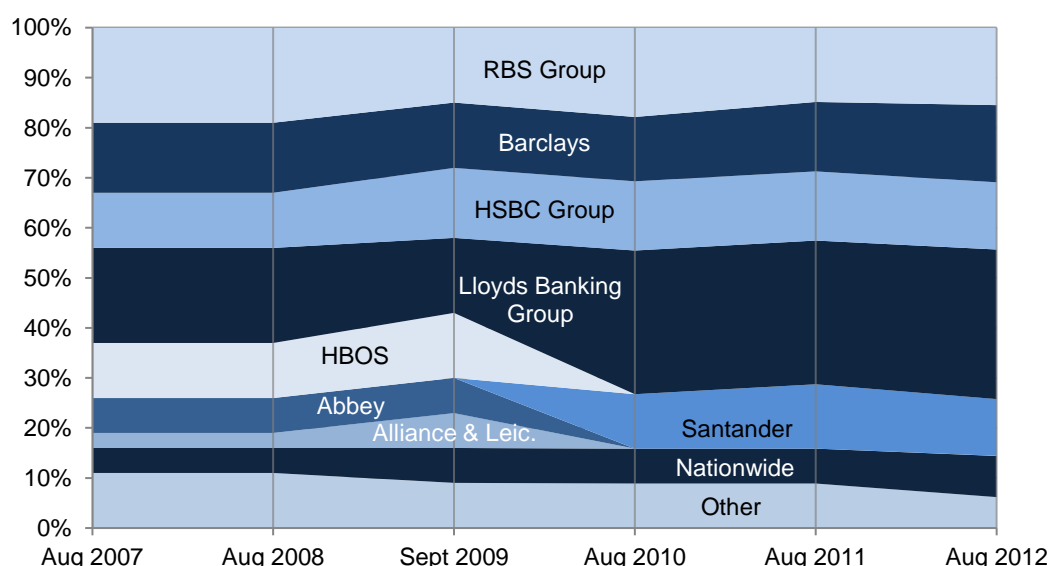
198. The main purpose of this case study is to set out and assess the relative importance of these factors in shaping TSB’s performance in the PCA market and the extent to which they can be considered barriers to entry or expansion.
199. We begin by explaining the circumstances that led to TSB’s launch. We then describe its PCA strategy, how this fitted into its overall business strategy, how successful TSB has been in acquiring and retaining PCA customers and the reasons for this. Finally we consider the extent to which TSB’s experience suggests the presence of barriers to entry or expansion in the retail banking market.

Background

The Lloyds TSB divestiture

200. The TSB business comprised assets divested from LBG as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS. The merger’s effect on concentration in the retail banking market, and the combined entity’s relative share, can be seen in the chart below.

Figure 21: Market shares for the largest PCA providers, 2007 to 2012, Great Britain



Source: Office of Fair Trading (OFT), State Aid Divestments by LBG and RBSG, Economic Advice, paragraph 49.

201. Lloyds TSB and HBOS, already large banking institutions, merged amid serious concerns that HBOS would collapse without some form of external

support. In the event, even this merger proved insufficient and the enlarged banking group required an injection of £20.6 billion⁷⁴ in taxpayer funds. This intervention gave rise to EU concerns as regards state aid and its impact on competition.⁷⁵

202. In its analysis the European Commission noted that the combined entity had a large market share of PCAs (20 to 30%⁷⁶) and that in Scotland it was even larger (40 to 50%). It said that Lloyds TSB's share of the PCA and mortgage markets had been strongly reinforced by the acquisition of HBOS, which had had a share of 10 to 20% and 20 to 30% of these markets respectively.⁷⁷ In addition, the Commission noted that not only had the acquisition allowed LBG to increase its market share, particularly in PCAs, it had also allowed it to 'eliminate a challenger in particular on certain segments of the market which were already concentrated and featured low switching rates among customers.'⁷⁸ Consequently, measures are necessary in order to remedy this distortion of competition which had been created by the aid'.⁷⁹
203. To address the Commission's concerns LBG was required to create and divest a ring-fenced business entity (code-named 'Verde') with assets of between £51 billion and £70 billion.
204. Verde was to consist of:⁸⁰
- (a) the TSB brand;
 - (b) the banking licence of Lloyds TSB Scotland;
 - (c) the Intelligent Finance business and brand;⁸¹
 - (d) the branches, including the banking business associated with all customers and all branch employees, of Lloyds TSB Scotland;

⁷⁴ [State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group](#), paragraph 178.

⁷⁵ TSB submitted that these concerns were limited to addressing the distortions to competition brought about by the UK government's support for LBG and that it was not the Commission's intention to create a scale challenger which would provide a disruptive competitive presence in the market. We do not agree entirely with TSB's analysis since we consider that the EC did take account of the fact that LBG had eliminated a 'challenger bank' and that the objective of the divestiture was to recreate 'a viable business in the future that can compete in the retail banking business in the UK' (paragraph 185).

⁷⁶ The non-confidential, version of the Commission's analysis used ranges to indicate market shares.

⁷⁷ [State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group](#), paragraph 179.

⁷⁸ Ibid, paragraph 181. A footnote makes clear this refers to the PCA market.

⁷⁹ Ibid, paragraph 181. It concluded that without the state aid, the merger would not have taken place and that, consequently, measures were necessary in order to remedy this distortion of competition created by the aid as well as the moral hazard created. (paragraph 182).

⁸⁰ As set out in [European Commission, 2009, State Aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group](#). Further detail on the package was contained in the Term Sheet setting out the commitments of the UK authorities (paragraph 97, *ibid*).

⁸¹ An online and telephone bank offering current account, mortgage and savings customers.

- (e) the Cheltenham and Gloucester (C&G) branches and branch employees, all C&G savings accounts and those C&G mortgages associated with branch-based customers;
- (f) supplementary branches and their branch business, selected by LBG, which:
 - (i) numbered at least 600;
 - (ii) together with the other branches and their business comprised at least a 4.6%⁸² share of the PCA market;
 - (iii) resulted in the average retail income per retail customer being not less than the average retail income of LBG;
 - (iv) had a 'reach' of at least 43%;⁸³
 - (v) resulted in the average gross ground floor space of all branches in the divested business being at least 220m².

205. LBG, in pursuit of a trade sale, committed to approaching potentially interested and suitable⁸⁴ buyers by 30 November 2011 and to completing the divestiture by 30 November 2013. If the disposal through a trade sale had not been completed by that date, the government said it would appoint a divestiture trustee to oversee the sale at no minimum price. LBG was also permitted to dispose of the business through an initial public offering (IPO).

Responses to the proposed divestiture

206. The Independent Commission on Banking (ICB)⁸⁵ expressed concerns over the size and nature of the Verde package. Its report concluded that a substantial enhancement of the proposed LBG divestiture provided the best opportunity to improve the structure of the PCA market and was the most cost-effective way available to ensure the emergence of a strong new challenger. It said this should be effected by ensuring that the entity resulting from the divestiture had a strong funding position and sufficient scale.⁸⁶

⁸² The EU originally envisaged a divestiture package equivalent to a 10% market share but this was opposed by HM Treasury, which argued that on the basis of previous OFT investigations, a 5% share would be a sufficient opening base for a challenger and that a 10% share could reduce the incentive of the new entity to acquire new customers aggressively. (HM Treasury, *Effective Challengers in UK Retail Banking*, 8 September 2009.)

⁸³ 'Reach' was defined as the proportion of the GB population that lived within 2 miles of a branch.

⁸⁴ The buyer was to have no more than 14% of the PCA market after acquiring the divestiture, for example. See [State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group](#), paragraph 190.

⁸⁵ For the background to the establishment of the ICB see [GOV.UK](#).

⁸⁶ [Independent Commission on Banking. Final Report](#) (2011), paragraph 8.13.

207. On the former, it said that a strong challenger required a sound funding position, both in terms of the amount of wholesale funding it needed to raise, and the price at which it could access such funds. With a weak funding position relative to its peers a bank would be unable to be a strong challenger because:
- (a) it would have an incentive to shed loans in order to reduce its reliance on wholesale markets, rather than competing hard to lend; and
 - (b) its cost of funding would be higher, making its customer offerings more expensive generally.
208. The ICB said that to be considered as having a stronger funding position, Verde's loan-to-deposit ratio should be better than its, then, 200% and comparable with particular banks it listed in its report, which varied between 98 and 148%.⁸⁷
209. As regards scale, it said that to have the best possible chance of becoming a strong, effective challenger, the entity resulting from the divestment should have at least a 6% share of the PCA market.⁸⁸
210. Evidence from the previous decade, it said, showed that small banks (below 5% PCA market share) on average had grown only slowly, with an average annual growth in market share of 0.07%. Banks with a PCA market share of between 5% and 12%, it said, grew significantly more quickly, with an average annual growth in market share of 0.34%, though it noted that given the relatively small number of challengers, this number was drawn from a small sample. Above 12%, banks begin to act as incumbents as their incentives changed with their market shares.
211. It said that with a PCA market share of 4.6% Verde was on the borderline of sub-scale banks that had failed to grow significantly in the past and was smaller than most previous challengers over the past decade, as measured by PCA market share.⁸⁹
212. Finally, the ICB noted that this enhancement in PCA share could either be achieved by the acquisition of Verde by a bank whose existing PCA share would bring the new entity's total share to above 6% or, were Verde to be sold via an IPO, increasing the number of PCAs divested by LBG. The former scenario seemed possible at this time as a bank, the Co-operative Banking

⁸⁷ Ibid, Table 8.2, p209.

⁸⁸ LBG argued to the ICB that the 6% threshold was inappropriate (Competition Slides for ICB Private Hearing, 20 July 2011). Similar data was presented to the OFT in the context of its advice to the Chancellor on the Verde package (Annexes 4 and 5). See paragraph 215 below.

⁸⁹ ICB, paragraph 8.22.

Group (CBG), whose acquisition of Verde would take the combined entity's share of the PCA market to 7%,⁹⁰ had emerged as a bidder.

The Co-operative Banking Group bid

213. Following discussions between LBG, CBG and the European Commission, the European Commission indicated in September 2012 that, because of the emerging difficulty in funding the business, it would agree to a reduction in the balance sheet of the divestment business to £23 billion. This is compared with the balance sheet implied by the original perimeter of £53–£71 billion, the £71 billion in the Information Memorandum and the reduction to £36 billion agreed by the European Commission in March 2012. Although under the original perimeter the business met the tests set down by the European Commission to demonstrate profitability, once LBG had entered into exclusive discussions with CBG, CBG sought further profitability enhancements through, in particular, the removal of: high loan-to-value, relatively low yielding mortgage assets; relatively expensive fixed rate deposits; and the Intelligent Finance online and telephone banking business – such that the Verde business's PCA market share fell by 0.3% to 4.3%. Changes to the cost of IT and systems support services from LBG were also discussed, although at this point they were not included in the amended divestment package.
214. However, in April 2013 the CBG withdrew from the process⁹¹ and LBG proceeded to prepare for, with the approval of the European Commission, an IPO of the Verde package.⁹² The Verde package, as we have seen, was originally designed to be consolidated with an existing retail bank rather than floated as a free-standing entity. It comprised a smaller share of the PCA market than the original package and fell significantly short of the 6% referenced by the ICB or the 10% originally contemplated by the European Commission. The Chancellor of the Exchequer asked the OFT for its advice on the impact of the divestment on competition in retail and SME banking and whether anything could be done to strengthen competition through enhancing the divestiture package.

The Office of Fair Trading's advice

215. The OFT provided its advice to the Chancellor of the Exchequer on the impact on competition of the LBG (and RBS) divestitures in September 2013.⁹³

⁹⁰ [House of Commons Treasury Select Committee Report on Project Verde](#), paragraph 300.

⁹¹ For a description of the events leading up to the withdrawal of CBG see the [House of Commons Treasury Select Committee report on Project Verde](#).

⁹² See: http://ec.europa.eu/competition/state_aid/cases/252285/252285_1558448_89_2.pdf

⁹³ [Letter dated 11 September 2013](#).

Regarding the scale of the divestitures being contemplated it referred to its own work on PCAs which it said identified effective competitor banks as occupying a market share of roughly 5 to 14% and having a network of around 700 or more branches. It said that such scale enabled banks to offset certain costs and maintain their incentive to compete because of the number of marginal customers they were likely to have.

216. It made a number of recommendations:

- (a) Steps should be taken to ensure that the service agreement (TSA) with LBG, under which it provided TSB with an IT platform, did not allow it to influence TSB's competitive behaviour or impair its profitability.
- (b) Measures to provide TSB with a higher income to enable it to invest in its legacy C&G network, possibly through a direct capital injection.
- (c) TSB's PCA opening market share should be increased to at least that level foreseen in the original package (4.6%) within two years of the divestment or IPO.

217. HM Treasury and LBG broadly⁹⁴ agreed the changes recommended by the OFT.⁹⁵ The European Commission indicated in May 2014 that proposals by the UK authorities to amend conditions for the divestment of LBG's UK retail business, in the context of LBG's restructuring plan, were in line with EU state aid rules.⁹⁶ On 9 June 2014, the IPO completed with the listing of an initial 38.5% of TSB's shares. TSB was now an independently managed, stand-alone 'challenger' bank,⁹⁷ with 4.5 million retail customers,⁹⁸ 8,600 staff, 631 branches, £23 billion of customer lending and deposits of £23.3 billion.⁹⁹ A further tranche of 11.5% was sold in September 2014 such that LBG owned 50.001% of TSB.¹⁰⁰

218. We next set out TSB's entry strategy, the extent of its achievements so far and, where relevant, the presence of factors which may have hindered its progress.

⁹⁴ TSB's share of the PCA market was not enhanced to a level closer to 6%, a move which had been strongly opposed by LBG. However, the annual charge for IT platform support was cut by 10% and a monitoring trustee was installed to maintain oversight of the arrangements with LBG. TSB's profitability was enhanced by the transfer of a £200 million mortgage bond and the provision of a £40 million customer acquisition fund. (Source TSB presentation April 2014.)

⁹⁵ See news story, '[Office of Fair Trading reports to government on Lloyds and RBS divestments](#)'.

⁹⁶ See [European Commission press release](#).

⁹⁷ Albeit having a continuing link with LBG via the shared IT platform.

⁹⁸ Plus 110,000 'micro' SME customers.

⁹⁹ TSB Overview of growth strategy, Presentation prepared for the CMA, 2 December 2014.

¹⁰⁰ In March 2015 LBG agreed to sell 9.99% of its remaining shareholding to Banco de Sabadell, and entered into an irrevocable undertaking in respect of the remaining 40.01%.

TSB's entry and expansion strategy

219. Growing its share of the PCA market was one of three strategic priorities for TSB. Its aim, as set out in the IPO Prospectus,¹⁰¹ was to grow its share of PCA 'market flow'¹⁰² to at least its share of branches, which was then around 6%, including the C&G branches which were part of the Verde package. Capturing 6% of PCA market flow would, it argued, eventually translate into a 6% share of the PCA market overall.
220. The Prospectus noted that the main driver of TSB's growth, along with its re-entry into the mortgage intermediary channel, was its share of PCA flow and associated cross-sales of savings accounts and unsecured lending products to these PCA customers. It said that not only was PCA growth an important enabler of medium-term profit growth it was also a critical enabler of long-term value as PCAs provided a key source of low-risk, low cost liabilities. In addition, the relatively high level of transactions associated with current accounts provided an opportunity to develop the customer relationship and over time meet more of their other banking needs. PCAs, therefore, were both a 'gateway' product, enabling cross-sales of other products, and a low-cost and low-risk source of funding.
221. TSB's Customer Plan for the PCA market set out its strategy in more detail. It said that while the PCA market was reaching maturity, with around 70 million accounts being held, consumers opened some 5.7 million new accounts each year and these consumers were its target. TSB estimated that switchers (2 million) represented the largest single segment within this group.¹⁰³
222. The Plan noted that customers increasingly expected to be rewarded for their loyalty and that just over 11% of current account holders had accounts that paid interest on their credit balances, up from 8% in 2013. It said that one-off incentives such as cashback had been successful but that long-term rewards, such as credit interest, were also becoming more popular.¹⁰⁴ Spend incentives, it said, were becoming more prevalent but their value to individuals was not always clear.

¹⁰¹ P90.

¹⁰² 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.' Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.

¹⁰³ These comprised both customers using CASS and those switching without using CASS.

¹⁰⁴ The TSB Classic Plus account would offer 5% interest on balances up to £2,000 but, unlike Santander's 1-2-3 account, for example, not cashback on payments.

223. TSB stressed the importance of the branch network in executing its plan and we consider its reasoning and the evidence underlying it in the next section of the paper.

The TSB branch network

224. The size and composition of the branch network inherited by TSB, which, as was noted earlier, accounted for about 6% of all retail bank branches in the UK,¹⁰⁵ is shown in the table below. It comprised a total of 631 branches, 164 of which were formerly branded Cheltenham and Gloucester, 185 of which were formerly operated by TSB Scotland and 282 former Lloyds TSB branches in England and Wales.¹⁰⁶

Table 9: TSB’s branch network

<i>Heritage</i>	<i>Number of branches</i>	
	<i>(freehold)</i>	<i>(leasehold)</i>
Cheltenham & Gloucester	13	151
Lloyds TSB (Scotland)	80	105
Lloyds TSB (England and Wales)	67	215
Total	160	471

Source: TSB IPO Prospectus, p77.

225. The importance of the branch network in generating PCA sales and the existence of a relationship between its share of branches and its share of the PCA market is a recurring theme in TSB’s policy documents.^{107,108} An example of its analysis of this relationship is shown in the table below which suggests an association between TSB’s share of branches and its share of flow¹⁰⁹ by country or region. As can be seen, TSB’s share of flow was highest in Scotland ([X]%), where it had its highest share of branches ([X]%) but lower, and roughly in proportion to its share of branches, elsewhere.¹¹⁰

¹⁰⁵ IPO Prospectus, p100.

¹⁰⁶ TSB has no branches in Northern Ireland.

¹⁰⁷ See, for example, the IPO Prospectus, p100.

¹⁰⁸ Other banks also told us there was a correlation between PCA share and share of branches. See, for example, [Nationwide’s response to the issues statement](#), paragraph 2.2(iii).

¹⁰⁹ ‘Market flow’ refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as ‘stock.’ Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.

¹¹⁰ The association between total TSB branches and its share of flow is slightly less evident in the South West, for example, where a higher proportion of branches were originally C&G and C&G did not provide PCAs.

Table 10: PCA and branch share

CACI region	%		
	TSB share of flow	TSB share of branches (w/o C&G)	TSB share of total branches
East Anglia	[X]	[X]	[X]
East Midlands	[X]	[X]	[X]
Greater London	[X]	[X]	[X]
North West	[X]	[X]	[X]
Northern	[X]	[X]	[X]
Northern Ireland	[X]	[X]	[X]
Scotland	[X]	[X]	[X]
South East	[X]	[X]	[X]
South West	[X]	[X]	[X]
Wales	[X]	[X]	[X]
West Midlands	[X]	[X]	[X]
Yorks & Humber	[X]	[X]	[X]

Source: TSB.

226. The underlying reasoning here was that as the majority of new PCAs were sold/opened in TSB branches¹¹¹ and as [X]% of switchers to TSB came through a branch,¹¹² the higher share of branches TSB had the more likely it was to win the locally available PCA business. Whilst online and mobile were growing in usage, the branch remained the most important channel for opening new accounts and servicing customers.
227. Further, as was shown in TSB’s consumer research, branch location was an important consideration for consumers who were planning to switch bank accounts. While consumers (other than Lloyds customers¹¹³) who had decided to switch from their current provider did so mainly (44%) because of bad service, the main reason they gave for switching to TSB (51%) was ‘convenient branches.’ 60% of switchers from Lloyds cited convenient branches as the reason for switching to TSB.
228. TSB’s analysis indicated that the same factors operated as regards traffic the other way: TSB customers (ie those originally transferred to Verde from LBG) switching back to Lloyds. It found that overall just [X]% of TSB customers who also had an account at Lloyds had switched (back) to Lloyds. However, where a customer’s accounts were split between Lloyds and TSB, and the nearest TSB branch was more than 10 miles away and where the customer

¹¹¹ Three out of four new TSB products were sold in branches, and [X]% of PCA switchers came through TSB’s branch network.

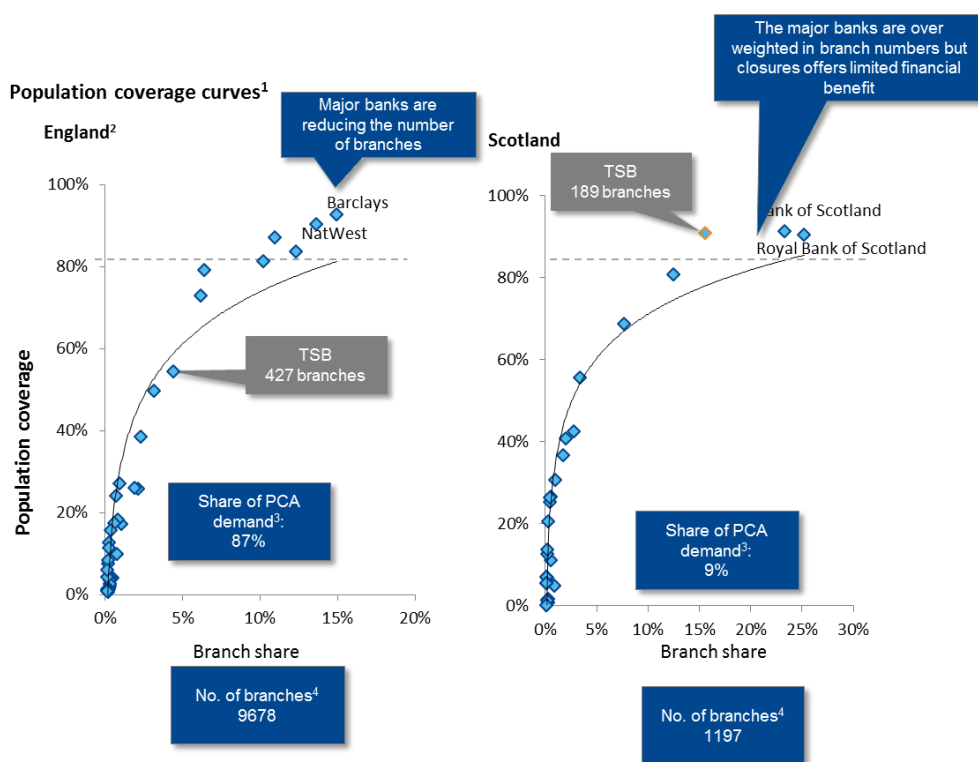
¹¹² TSB’s qualitative research on retention indicated that the majority of consumers switching to Santander (73%) and Halifax (80%) did so at a branch of their destination provider.

¹¹³ LBG’ customers were most likely to cite account consolidation as a reason for leaving LBG. They may, for example, have retained a deposit or credit card account with TSB even though their PCA had been switched. Nonetheless, the availability of convenient branches was the second most commonly given reason for leaving LBG, cited by 40% of respondents.

used a local branch on average once a month, the rate of switching back to Lloyds was ten times higher, over [redacted]%.¹¹⁴

229. TSB’s analysis suggested, however, that the relationship between a bank’s share of branches and the proportion of the population that the branch sales channel could address (its ‘reach’) was not linear: above a certain point the increase in reach achieved by an increase in share of branches began to diminish.
230. In Scotland, for example, TSB said increasing its reach would require a disproportionate increase in its share of branches. Conversely, a reduction in its share of branches would result in a less than commensurate fall in population coverage. In England, increasing reach would be less costly in terms of growing share of branches. The charts below show TSB’s and its competitors’ branch market shares in England and Scotland together with the reach of their branches.

Figure 22: Branch share, population coverage and PCA share



Source: TSB.

231. An internal TSB presentation assessed the potential for branch expansion in London and the South East, where it said switching rates were higher and where there were several catchment areas currently unserved by TSB

¹¹⁴. On this basis TSB forecast that it would lose 80,000 customers to LBG but gain only 40,000.

branches.¹¹⁵ The presentation stated that it would be necessary to open new branches in some areas as ‘powering up’ the legacy C&G branches would not on its own be sufficient to address the business potential identified.¹¹⁶ Nonetheless, because of the size of the catchment areas concerned, a comparatively large increase in reach could be accomplished by a relatively limited expansion of the network in Greater London, as illustrated below.

Figure 23: Branch expansion in Greater London

[✂]

Source: TSB.

TSB’s strategy implementation and results

232. In this section we examine how successful TSB has been in expanding its share of the PCA market.

Results overall

233. Between October 2013 and October 2014 TSB achieved a share of flow of around 8%, representing a net gain of around [✂] PCAs, growing its account base by [✂]%. However, because the annual flow represents such a small proportion of the overall PCA stock, this translated into an increase in its share of the PCA market of 0.3%: from 4.0% to 4.3%.

234. These net figures conceal quite large inflows and outflows, with total gains of around [✂] and losses of just under [✂] in the period between October 2013 and October 2014. Early on, TSB suffered losses arising from the departure of customers it had acquired from Lloyds, later on gaining new customers for its interest-bearing PCA. We show the overall pattern of gains and losses in Figure 24.

Figure 24: PCAs opened and closed, 2013 to 2014

[✂]

Source: TSB.

235. We next looked at data on the origin and destination of customers who switched either to or away from TSB in 2014, where this was known, and

¹¹⁵ It noted, however, that new branches took time to reach their full potential and that a period of about five years was required for local relationships with customers to mature.

¹¹⁶ In other words it was estimated that there was sufficient potential business to sustain profitable branches in addition to those branded C&G.

these are shown in full in the table below and for the largest movements in or out in the chart following it (Figure 25).

Table 11: Switchers in and out of TSB, 2014

<i>Bank</i>	<i>Switched in</i>	<i>Switched out</i>	<i>Net</i>
Adam & Company	[X]	[X]	[X]
Bank of Ireland	[X]	[X]	[X]
Bank of Scotland plc	[X]	[X]	[X]
Barclays Bank plc	[X]	[X]	[X]
C Hoare & Co	[X]	[X]	[X]
Clydesdale	[X]	[X]	[X]
Co-operative Bank	[X]	[X]	[X]
Coutts	[X]	[X]	[X]
Cumberland Building Society	[X]	[X]	[X]
First Trust Bank	[X]	[X]	[X]
Halifax	[X]	[X]	[X]
Handelsbanken	[X]	[X]	[X]
HSBC Bank	[X]	[X]	[X]
Isle of Man Bank Ltd	[X]	[X]	[X]
JP Morgan Europe Ltd	[X]	[X]	[X]
Lloyds Bank plc	[X]	[X]	[X]
Lloyds International	[X]	[X]	[X]
Lloyds Private Bank	[X]	[X]	[X]
Metro Bank	[X]	[X]	[X]
Nationwide Building Society	[X]	[X]	[X]
NatWest Bank plc	[X]	[X]	[X]
NBL T/A Danske Bank	[X]	[X]	[X]
RBS One Account	[X]	[X]	[X]
Reliance Bank	[X]	[X]	[X]
Royal Bank of Scotland	[X]	[X]	[X]
Santander	[X]	[X]	[X]
Secure Trust	[X]	[X]	[X]
Tesco Bank	[X]	[X]	[X]
Ulster Bank Limited	[X]	[X]	[X]
Virgin Money plc	[X]	[X]	[X]
Yorkshire Bank	[X]	[X]	[X]
Other	[X]	[X]	[X]
Total	[X]	[X]	[X]

Source: TSB

236. As can be seen, TSB made its biggest net losses to two LBG banking brands (Lloyds and Halifax)¹¹⁷ and Santander, all three of which offered PCAs incorporating rewards, for example interest on balances and/or cash on signing up. Halifax and Santander were also major sources of PCA customers for TSB but its largest net source of PCA customers was Barclays, which did not offer an interest-bearing PCA. TSB was also a net gainer from the two other major banks, NatWest and HSBC, neither of which offered an interest-bearing PCA.

Figure 25: TSB main PCA gains and losses by bank, 2014

[X]

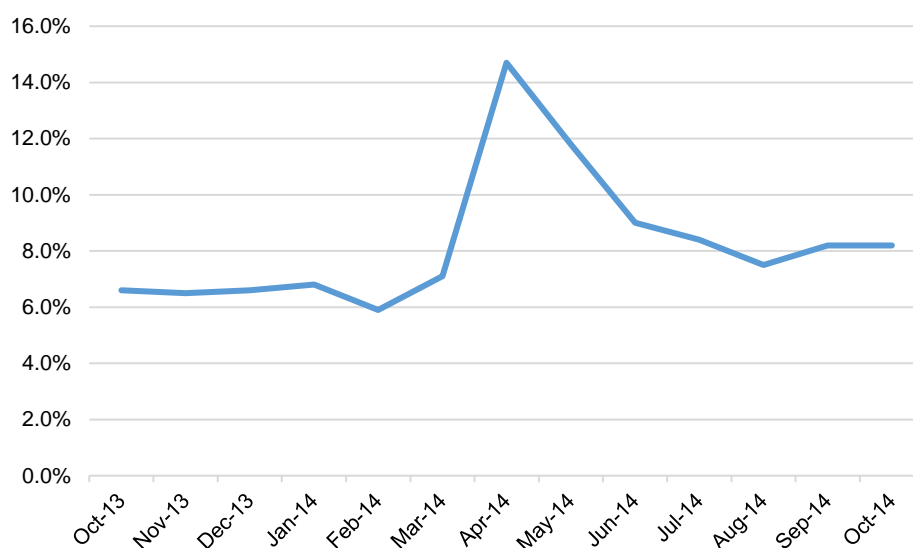
Source: TSB

¹¹⁷ Its position versus BoS was virtually neutral.

Customer acquisition

237. In April/May 2014 TSB acquired new customers in large numbers. Monthly volumes peaked at over [redacted] in April, driven by the launch of the advertising campaign for TSB's Classic Plus product, settling at around [redacted] subsequently.¹¹⁸
238. The impact of its Classic Plus campaign in April/May 2014 can also be seen in TSB's share of flow. Prior to the campaign, TSB's share of flow was, at around 6%, roughly in line with its plan (and with its share of branches). However, its share of flow more than doubled (to +14%) in April and May, then fell back to around 8%, still considerably higher than its share of the overall retail banking market: TSB was indeed 'punching above its weight.'

Figure 26: TSB share of PCA flow



Source: TSB

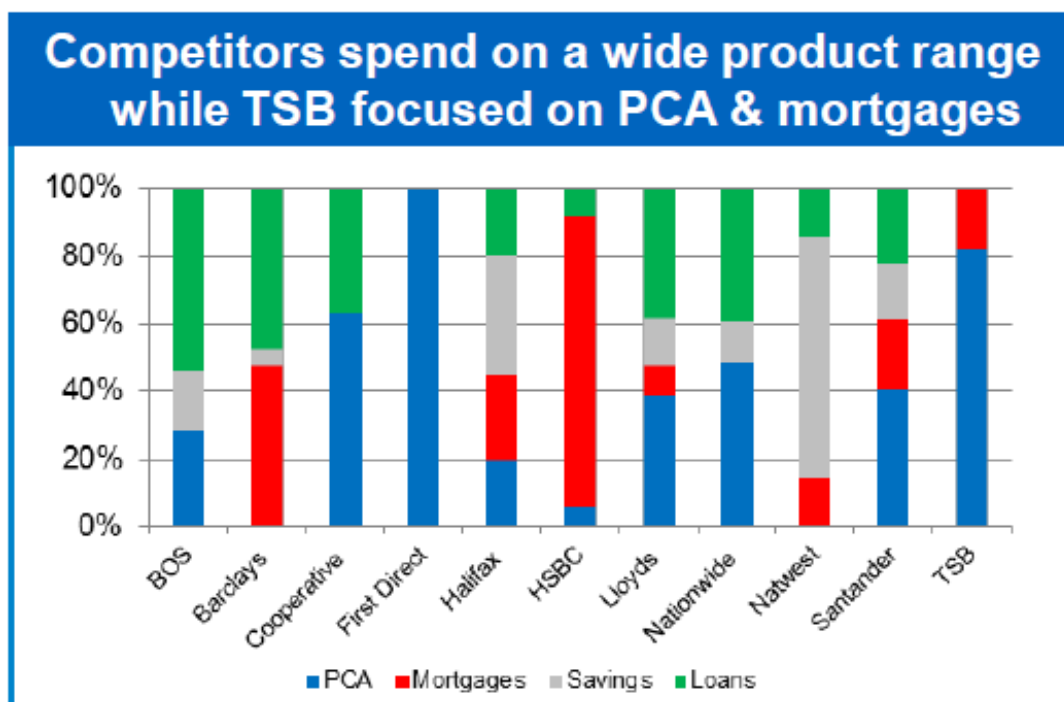
239. TSB allocated a substantial advertising budget to this campaign. Its 'share of voice'¹¹⁹ (SoV) in PCA advertising specifically was very high indeed and almost the same as its much larger rivals whose total advertising expenditure was about double TSB's.¹²⁰ In the first half of 2014 TSB spent £[redacted] million on PCA advertising compared with Santander and Lloyds, which each spent about £8.5 million on advertising their PCAs but which spent twice as much on advertising as TSB across all products.

¹¹⁸ This offered customers 5% interest on balances of up to £2,000.

¹¹⁹ TSB's expenditure on advertising as a proportion of the sum of its rivals'.

¹²⁰ The acceleration and then decline in weekly PCA sales volumes appears to coincide with TSB's television, press and outdoor advertising campaigns which commenced in April and ended in the last week of May.

Figure 27: TSB and competitors' advertising spend by product, January to June 2014



Source: TSB.

Figure 28: Total advertising spend of TSB and other banks, H1 2014

[✂]

Source: TSB.

Customer retention

240. In July 2014, at the same time that its new sales were stabilising, the number of non-LBG' switchers increased, particularly those switching to Santander and LBG's Halifax brand.¹²¹

Figure 29: PCA holder switching away from TSB, May to October 2014

[✂]

Source: TSB.

241. TSB attributed this to three main factors:

- (a) the end of co-servicing in LBG's branches in August 2014, which could have disrupted customers transferred from LBG to TSB but who habitually used a Lloyds branch;
- (b) the increasing awareness of the Current Account Switch Service; and

¹²¹ LBG positions Halifax as 'The UK's number one challenger bank.'

(c) competitor activity.

242. Research conducted by TSB among switchers to Lloyds, Santander and Halifax revealed quite different reasons for switching among the three groups of consumers. Those switching to Lloyds did so primarily¹²² because of branch location, because the Lloyds branch they had been using whilst co-servicing was available was more conveniently located than the nearest TSB branch. The research indicated that references to lack of convenience increased somewhat at a distance of 4 miles from branch but increased appreciably if the relevant branch was further than 8 miles away.
243. Switchers to Halifax, which offered a £100 bonus to new account holders, cited 'financial incentives' as their main reason for switching while most switchers to Santander said they thought the Santander product was better than TSB's.¹²³
244. It also appears that the offers being made by these three banks varied in their appeal to customers depending upon the size of the balances that they carried in their current account prior to switching. For accounts with average incoming payments of £500 per month switchers to Santander held the highest average balance (£[redacted]), switchers to the Halifax the lowest (£[redacted]) and those switching to Lloyds a level between the two (£[redacted]).
245. That said, there is some evidence that the switchers that TSB researched had one factor in common: a higher propensity to switch between other providers of services. 34% of TSB current account holders who switched to Santander and 30% of those who switched to Halifax had switched energy providers in the last 12 months, for example, which is roughly double the national average rate of switching.¹²⁴

Barriers to entry and expansion faced by TSB

246. We now consider whether TSB's experience suggests that there are features of the retail banking market which constitute barriers to entry or expansion. We look first at TSB's results to date and then at its submission that its future growth may be constrained by falling profitability of the business. Finally we set out our tentative assessment of the evidence we have seen so far.

¹²² 42% of switchers to Lloyds gave this as their trigger compared with 14% of Halifax and 4% of Santander switchers.

¹²³ The Santander account offered 5% interest on balances between £3,000 and £20,000 whereas TSB's Classic Plus offered 5% interest on balances up to £2,000. The report also noted the importance of Santander's 1-2-3 television advertising as a driver of switching to Santander.

¹²⁴ See CMA (July 2014), *Personal current accounts: Market study update*, p92.

TSB's results to date

247. We noted earlier that TSB clearly possessed assets the absence of which had been cited as potential barriers to entry: it already had the necessary licences and authorisations to conduct banking operations, a branch network, a familiar brand name and 4% of the PCA market. If TSB faced barriers to expansion these would either be factors faced by all entrants, such as 'consumer inertia', or the absence of certain resources, such as branches, in sufficient quantity. In either case we would expect to detect the presence of barriers through poor PCA customer acquisition or retention performance.
248. Since its launch as an independent bank TSB has added, net, over 200,000 PCAs, increasing its account base by 6.5% and, at its peak, was securing 14% of PCA flow. It has done so despite the quite significant loss of customers back to LBG and in the face of competition for flow from larger rivals such as LBG and Santander.
249. The launch of its Classic Plus product in April/May 2014 in particular allowed TSB to grow its PCA sales, driven forward by an advertising campaign with a budget comparable to those of much larger banks. TSB did not, therefore, appear to lack funds to invest in new customer acquisition.

TSB's submission on rising costs and new customer profitability

250. TSB has submitted that its progress as witnessed to date may not be sustainable in the future for two reasons:
- (a) Rising costs, as a result of its arrangements with LBG and the ongoing reduction of other temporary profitability enhancements put in place following the recommendations of the OFT in September 2013, may constrain its ability in future to invest in new customer acquisition and this will make its position as a challenger bank less effective.
 - (b) The PCA customers that TSB is likely to acquire from other banks may take several years to become profitable.
251. We set out and consider both arguments below.

Rising costs

252. TSB told us that the marketing campaign which had driven its sales in 2014 had been funded in large part by the reduction in the cost of its IT services agreed by LBG for the initial years of its operations and the enhancements to profitability which were put in place following the recommendations of the OFT

in September 2013.¹²⁵ It said that without that funding TSB would not have been able to invest to the same extent in attracting new customers. It said that if these profitability enhancements were excluded, TSB's underlying profitability would be significantly reduced: in the nine months to October 2014, if reductions in the cost of the IT services under the transitional arrangements with LBG and the benefit of the mortgage enhancement are excluded, TSB would have [REDACTED].

253. Furthermore, it said that these profitability enhancements were temporary and would decline year-on-year. As a result of the make-up of the mortgage portfolio, the annual income was greatest in the first year and then reduced year-on-year as the portfolio ran off. This decline in mortgage income coincided with the step up in the costs of its IT services from LBG in 2017.
254. In summary, it said that TSB's credentials as a disruptive competitive force had been fundamentally affected by a period of low profitability in its early years as a result of both the changes made to the business during the attempted Verde trade sale which saw the bank's balance sheet reduced without a commensurate reduction in its cost base and an economic environment with low interest rates, contrary to expectations at the time of the bank's design. It said that these changes had introduced a drag on TSB's underlying profitability and may reduce the business's potential to be a sustained disruptive force in the market against the large incumbent banks once the benefits of the various profit enhancements had ended.

New customer profitability

255. TSB told us that, in general terms, [REDACTED]% of a bank's customers generated around [REDACTED]% of its income and that its analysis indicated that these customers were half as likely to switch as others. It told us that the reason for this was that these high-value customers were most likely to be overdraft users but would be less likely to switch banks because they considered, probably correctly, that a new bank might be unwilling to provide them with equivalent facilities without the depth of customer history held by their current provider. TSB customers who did decide to switch were, therefore, likely to be less profitable. It inferred that the same was true for other banks' customers.

¹²⁵ The long-term service agreement, which is due to operate from 2017, is expected to increase TSB's cost base by more than £100 million a year. In addition, TSB received, with effect from February 2014, the benefit of a £3.4 billion portfolio of mortgage loans which was assigned to it by LBG. This was designed to enhance TSB's profitability by a cumulative £230 million over approximately five years. This portfolio is subject to a call option exercisable by LBG after the £230 million profit target has been achieved. ([TSB Preliminary Results Announcement 2014](#), p7). LBG also provided TSB with an additional £40 million capital to enable future customer acquisition and develop its branch network.

256. It pointed out that the less valuable customers who did switch would not become profitable for some time and this would be even more marked where a cash incentive had been offered as an inducement to switch. It said that in these circumstances it could be several years before a customer acquired through switching became profitable. It illustrated this model in the figure below.

Figure 30: Customer profitability model where cash inducement provided

[✂]

Source: TSB.

Our assessment of TSB's submission

Rising costs

257. Clearly, a lack of sufficient funds to invest in customer acquisition would handicap a potential entrant but this would not constitute a market feature unless other potential entrants were faced by the same prospect. We considered whether TSB's arguments as to the sustainability of its status as a challenger bank were specific to the Verde divestiture arrangements or whether they could have wider application.

Falling customer profitability

258. PCA customers switching to a new provider may be unprofitable either because they generate less value for the bank than it costs it to service them or because they leave the bank before they have become profitable. We considered what evidence was available to assess both these possibilities.

- *Customer value*

259. TSB argued that lower-value customers were more likely to switch PCA providers and that, generally, these would be customers who did not make use of overdraft facilities.¹²⁶ Challenger banks would therefore, if this were the case, acquire relatively lower-value customers, leaving incumbents with the more profitable ones.

260. LBG submitted that its own analysis had concluded the opposite and that it was its higher-value customers whom it was most in danger of losing.

¹²⁶ We note that PCA customers, by holding money in their accounts, also generate value by providing a bank with a low-cost source of funds.

261. Data from LBG on the characteristics and value¹²⁷ of customers it had lost to rivals does not tend to support TSB's argument that higher-value customers were less likely to switch than others. LBG's concern was that it was losing customers with higher credit turnover (CTO) and balances to rivals, [REDACTED]. It illustrated the relative propensity of its customers to switch to [REDACTED] in the matrix reproduced below.

Figure 31: Characteristics of account holders switching from LBG to Santander

[REDACTED]

Source: LBG

262. This suggested that switching [REDACTED] became more likely as a customer's CTO increased and that there was also a positive association, albeit less clear, between switching propensity and the size of account balances.¹²⁸

263. [REDACTED]

Figure 32: Net switching behaviour of Lloyds' higher-value customers

[REDACTED]

Source: LBG.

264. We note that propensity to switch may depend on the salience of the offer to particular customer groups.¹²⁹ The Santander 1-2-3 offer, for example, which pays relatively high rates of interest on credit balances of between £3,000 and £20,000, may have appealed in particular to LBG's higher-value customers since the segmentation used above segmentation is based on a combination of a customer's CTO (as a proxy for income); and investable deposits and home value (both as a proxy for wealth). Our switching analysis and findings on the characteristics of switchers are set out in Section 6 and Appendix 7.2.

- *Customer lifetime*

265. The 'lifetime value' of customers will depend partly on how much income they generate for the bank and on how long they stay with it. We considered it plausible that customers who have switched bank accounts previously may have a higher propensity to switch subsequently if, for example, a more attractive offer became available.¹³⁰ Customers switching early in their 'life'

¹²⁷ LBG's categorisation takes account both of a customer's use of its credit facilities and how much money they keep in their current account.

¹²⁸ LBG had a retention strategy which aimed to predict which of its customers might be at risk of switching and to target them with pre-emptive retention activity.

¹²⁹ Salience may be determined not just by the monetary rewards on offer but also by the quality of service provided.

¹³⁰ This behaviour is sometimes described as 'rate chasing'.

may, therefore, never become profitable and, clearly, the higher their acquisition cost¹³¹ the more likely this would be.

Conclusions

266. At the time the business was launched, TSB possessed assets the absence of which have been considered in past investigations to constitute barriers to entry or expansion and which other subjects of our case studies lacked. TSB owned around 6% of the UK banking branch network, had the authorisations and licences necessary to carry out a banking business and had an established and familiar brand name. It also began life with a share of the PCA market of just over 4%.
267. On the other hand it lacked advantages enjoyed by other entrants, such as a purpose-built, modern IT platform, and it faced the same potential obstacles as all new entrants: in particular, a low propensity of consumers to switch PCAs.
268. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of flow¹³² and added over 200,000 PCAs to its stock. We considered that this indicated TSB had not encountered insuperable obstacles to expansion.
269. It is not yet clear whether TSB's growth is sustainable or whether the issues that it has drawn to our attention that it claims may threaten its sustainability, in particular the cost of an IT platform, would similarly constrain other firms seeking to enter or expand in this market. Since this case study was undertaken, TSB was acquired by Banco de Sabadell.

Virgin Money's personal current account

270. This case study focuses on Virgin Money's launch of its (Essential) current account in the UK. Virgin Money was established (as Virgin Direct) in 1995, and initially offered a personal equity plan, the forerunner of Individual Savings Accounts and investment plans to its customers. It added credit cards and personal loans in 2002, car and home insurance in 2004 and life insurance a year later to its portfolio, but did not have a PCA offering. In 2010,

¹³¹ In terms of marketing spend per customer acquired and any reward offered on joining.

¹³² 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.'

with the acquisition of Church House Trust plc, a small private bank, Virgin Money acquired a banking licence.¹³³

271. Virgin Money acquired Northern Rock plc (NR) in January 2012, which transformed it from being a comparatively small online bank to having a high street banking presence with 75 branches. Through this acquisition, it also gained a pool of NR PCA customers, an IT platform and access to relevant UK payment systems. Virgin Money continued to service the acquired NR PCA customers, but after a review, decided to close the offering to new customers in June 2012, since it had plans to launch a higher specification PCA when it considered the market and regulatory conditions to be favourable.
272. Thereafter, Virgin Money considered a number of different strategic alternatives, and launched its 'Essential Current Account' (ECA) – a type of basic bank account, in Scotland and Northern Ireland in July 2014, and in the rest of the UK in March 2015.^{134,135} It [✂] considers this launch to be the first step towards offering more PCA products in the future.
273. Although Virgin Money has launched an ECA, and has plans to offer a wider range of PCA products, it does not intend to substantially grow its current account business in the near future. It told us that it faced some impediments to further expansion. These included: the free-if-in-credit PCA model, a lack of product diversity in the market, perceived difficulties of account switching, and the competitiveness of payment systems.
274. According to Virgin Money, the free-if-in credit PCA model leads to 'systemic issues' such as product and customer cross-subsidisation, cost and liquidity advantages for the larger banks, and therefore it is difficult for new entrants to achieve scale in the market, since the cost of entry is high, and cannot be easily recouped from a 'free' PCA offering.
275. Developing an IT platform was not considered to be an impediment by Virgin Money to enter the PCA market because it acquired much of the required

¹³³ BBC News (17 November 2011), [Virgin Money looks to join the mainstream](#); *The Guardian* (8 January 2010), [Virgin Money moves into retail banking](#).

¹³⁴ A basic bank account is a simple account which does not have an overdraft facility but allows the customers to receive payments, pay in cheques, withdraw money, and set up a direct debit or standing order. It does not carry a monthly fee, does not usually offer any in-credit interest but may provide customers with a debit card. [Money advice service](#); [British Bankers' Association](#).

¹³⁵ A major agreement was announced in December 2014 between the UK government and the banking industry to establish new basic bank accounts that will end bank charges if a direct debit or standing order fails. According to this agreement, nine high street banks agreed to offer these accounts to customers. HM Treasury news story: [New basic fee-free bank accounts to help millions manage their money](#).

capability from acquiring NR. It does not consider its limited network of 75 branches to be an obstacle to its further expansion.

276. Through its launch of an ECA, Virgin Money appears to have adopted a cautious and phased approach towards offering PCAs, and has attempted to identify areas where it considers it will not face head-on competition from the major PCA providers.
277. In light of its views on the current market and regulatory environment, Virgin Money does not expect to become a major PCA provider in the near future, and is likely to remain predominantly a retail-funded mortgage bank.

Introduction and background

278. This case study focuses on Virgin Money's launch of its ECA in the UK. The paper begins with a brief background of its businesses, which is followed by a chronological analysis of events leading up to the launch of its ECA, including Virgin Money's strategy and business model. Finally, the paper considers the extent to which Virgin Money's experience suggests the presence of barriers to entry or expansion.
279. Virgin Money is a UK-based retail bank, which was established in 1995.¹³⁶ It initially offered a personal equity plan, the forerunner of Individual Savings Accounts, and investment plans to its customers. It added credit cards and personal loans in 2002, car and home insurance in 2004 and life insurance a year later to its portfolio, but did not have a PCA offering. In 2010, with the acquisition of Church House Trust plc, Virgin Money acquired a UK banking licence.¹³⁷
280. Virgin Money acquired NR in 2012, which transformed it from being a comparatively small online bank to having a high street banking presence. This acquisition included 75 branches, one million customers, £14 billion mortgage book, £16 billion retail deposit book and 2,100 employees.¹³⁸ Virgin Money also gained around 100,000 NR PCA customers, an IT platform, and access to relevant UK payment systems.¹³⁹

¹³⁶ Virgin Money is part of Virgin family of companies which have businesses in sectors ranging from mobile telephony, travel, financial services, leisure, music, holidays, and health and wellness. [Virgin Money website](#).

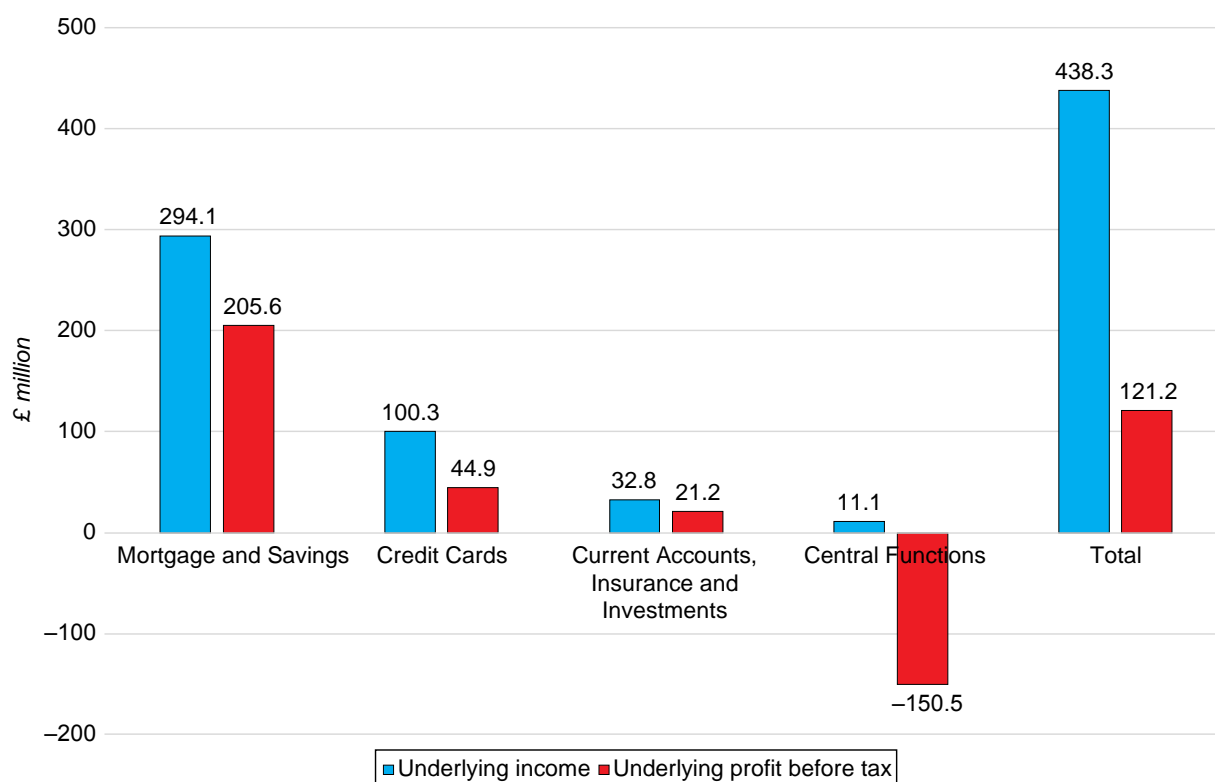
¹³⁷ BBC News (17 November 2011), [Virgin Money looks to join the mainstream](#).

¹³⁸ [Virgin Money completes the acquisition of Northern Rock](#).

¹³⁹ Virgin Money's response to case study questionnaire. 19 December 2014. Answer to Q1.

281. At the end of 2014, Virgin Money had 2.8 million customers which it serviced through a range of channels, including online and mobile, and a network of 75 branches and five customer Lounges.^{140,141}
282. Virgin Money operates exclusively in the UK with the exception of wholesale funding and liquidity management activities which it undertakes both in the UK and limited overseas markets. Its operations are broken down into three business units: Mortgages and Savings; Credit Cards; and Current Accounts, Insurance and Investments, all of which are supported by Central Functions which provide support services to these business units.¹⁴²
283. Figure 33 shows the underlying income and profits of Virgin Money's business units in 2014.¹⁴³ As can be seen, Mortgage and Savings is its largest business unit, accounting for 69% of underlying income and 76% of underlying profit before tax in 2014.¹⁴⁴

Figure 33: Income and underlying profit of Virgin Money business units



Source: Based on data in [Virgin Money Group Annual Report 2014](#), p27.

¹⁴⁰ [Virgin Money Group Annual Report 2014](#), p20.

¹⁴¹ The location map of Virgin Money's branches (called stores) is provided in Appendix A.

¹⁴² [Virgin Money Group Annual Report 2014](#), p27.

¹⁴³ Highlights of Virgin Money's financial performance during 2011–2014 are provided in Appendix B.

¹⁴⁴ Excluding Central Functions.

284. Virgin Money believes that its business model positions it well for cost-effective growth in an increasingly digital world.¹⁴⁵ It considers its brand, customer-focused culture, financial strength and the fact that it is unburdened by legacy as key enablers in providing a distinctive customer proposition.¹⁴⁶ According to Virgin Money, its ability to grow has been enhanced by a successful listing on the London Stock Exchange following an Initial Public Offering (IPO) in November 2014.¹⁴⁷
285. In its IPO prospectus, Virgin Money stated that its strategy was focused on:¹⁴⁸
- (a) continuing strong growth in its core mortgages, savings and credit cards businesses, along with further product extensions over time;
 - (b) maintaining high asset quality and a low cost of risk through a robust risk management approach; and
 - (c) delivering strong returns by increasing net interest margins, driving operating leverage, growing non-interest income and optimising capital efficiency.
286. In the IPO prospectus, Virgin Money also stated that it was targeting a return on tangible equity in the mid-teens range by the end of 2016, and expected to deliver continued improvement on this measure beyond 2016.¹⁴⁹

Launch of Essential Current Account (ECA)

287. In its submission to the House of Commons Treasury Select Committee ('Select Committee') in 2010, Virgin Money had referred to the difficulty of launching a PCA; it stated that since PCA switching rates were low, it would take some time for a new entrant to achieve scale – during which time the incumbent banks could respond to threats from new entrants.¹⁵⁰ It began exploring its options to launch a PCA after its acquisition of NR in January 2012, since it felt that as a mass consumer brand, it should make clear its intention to become a competitor in the wider PCA market.
288. Virgin Money launched its ECA in Scotland and Northern Ireland in July 2014, and in the rest of the UK in March 2015. It designed the ECA as a type of basic bank account which could meet the product specifications as set out in

¹⁴⁵ [Virgin Money Group Annual Report 2014](#), p20.

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*, p12.

¹⁴⁸ Virgin Money IPO prospectus (November 2014) pp109–110.

¹⁴⁹ *Ibid.* p110.

¹⁵⁰ [House of Commons Treasury Select Committee. Competition and Choice in retail banking. Written evidence submitted by Virgin Money](#) (September 2010), paragraph 3.6.

the new voluntary agreement between the government and the major banks on basic bank accounts.

289. Virgin Money's strategy has been evolving since it acquired NR, and currently includes (subject to the regulatory landscape being favourable) launching more PCA products in the future that will be fee paying, have more digital functionalities, and cater to a wider target market including customers who use overdrafts, mortgages, and look to build their savings.

290. A chronological summary of key events leading up to Virgin Money's launch of its ECA is provided in Figure 34.

Figure 34: Launch of ECA – key events



Source: Collated by the Competition and Markets Authority (CMA) based on information provided by Virgin Money.

Cessation of sales of NR current account, June 2012

291. After the NR acquisition, Virgin Money began a detailed evaluation of the acquired current account book and systems. Its assessment identified a number of challenges which led to a decision (in June 2012) to close the (NR)

current account offering to new customers.¹⁵¹ These challenges included a recognition that the NR PCA proposition lacked some basic functionalities (eg online capability), and a desire to avoid confusion in the market through the conflation of the Virgin Money and NR brands.

292. Virgin Money stated that ceasing sales of the acquired NR PCA product to new customers also enabled it to devote efforts on improving its systems and processes, whilst building an enhanced PCA product proposition.

Board approval of PCA strategy with CAD as the entry product, September 2012

293. A board paper of September 2012 noted that:

‘We appear to be an inflexion point for the PCA market where the powerful incumbents may no longer be able to resist pressure for change. This will create an opportunity for new products and participants, but only if

- Customer and regulators can be convinced the provision of basic banking is safe and reliable;
- All observers can be assured of the transparency and fairness of charging;
- The standards of service, including speed and reliability of switching, is high.

294. Virgin Money believed that while the acquired NR PCA had been withdrawn in June 2012, it provided a foundation for building a future PCA product. At that time, it was considering launching a product called the Current Account Deposit (CAD) which combined its existing deposit capability with current account functionality, and which could be the first of a range of its current account related products.

295. [REDACTED]. Figure 35 illustrates [REDACTED].

Figure 35: PCA programme

[REDACTED]

Source: Virgin Money.

¹⁵¹ While it ceased its sale of current accounts, it continued (and continues) to service the acquired NR customers.

296. [REDACTED]¹⁵²

297. [REDACTED]

Revised approach – to launch a basic bank account, February 2013

298. In February 2013, Virgin Money revised its strategy and proposed to launch a basic bank account, offering a ‘quicker and less risky’ launch, addressing the most ‘underserved’ part of the market and supporting its ‘Building Better Banking’ philosophy (see Figure 36).

299. It made the decision to launch a basic bank account ‘after considering a number of different strategic alternatives and discounting them on the basis of the scale of investment required in an unfavourable regulatory environment.’ The proposed basic bank account was a free product but was thought to support Virgin Money’s positioning on monthly fees for subsequent, more functionally rich PCA propositions when it considered the market and regulatory conditions to be favourable.

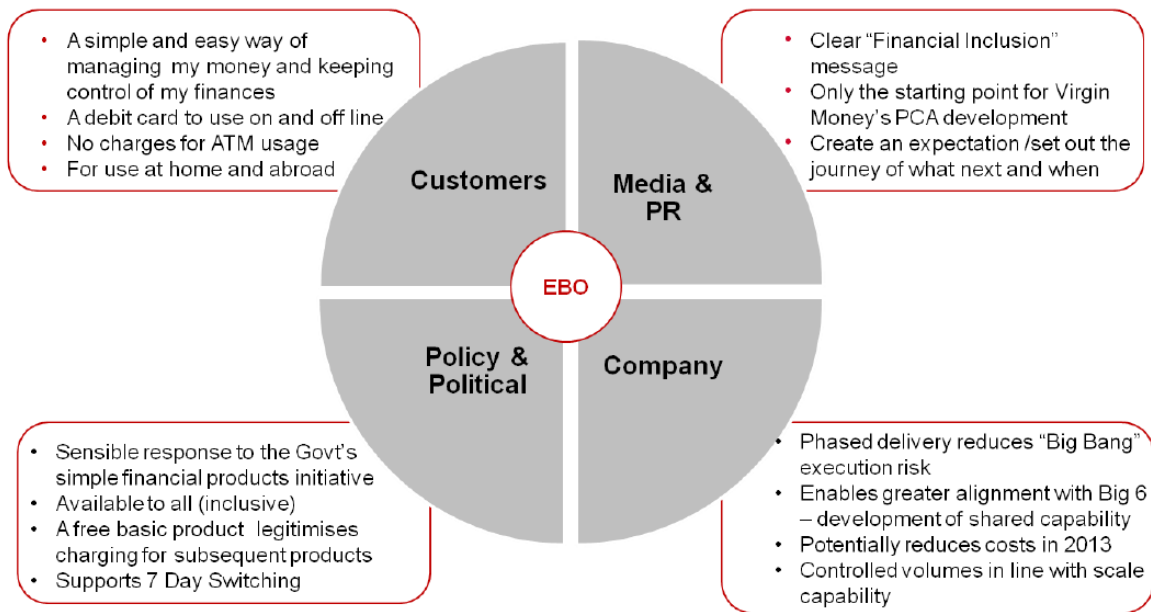
Figure 36: PCA strategy

[REDACTED]
Source: [REDACTED]

300. An internal strategy paper of February 2013 noted that alternative delivery options needed to be explored in order to get to the market more quickly and cheaply, whilst still making a sensible first step on the road map to a full PCA offering. Key to this revised strategy was the launch of a basic bank account, which was to help ‘reduce the execution risks’ and ‘enable a stronger Virgin narrative for customers, the media and the political environment.’ Figure 37 shows Virgin Money’s strategic rationale for proposing to launch a basic bank account.

¹⁵² [REDACTED]

Figure 37: Virgin Money basic bank account – strategic rationale



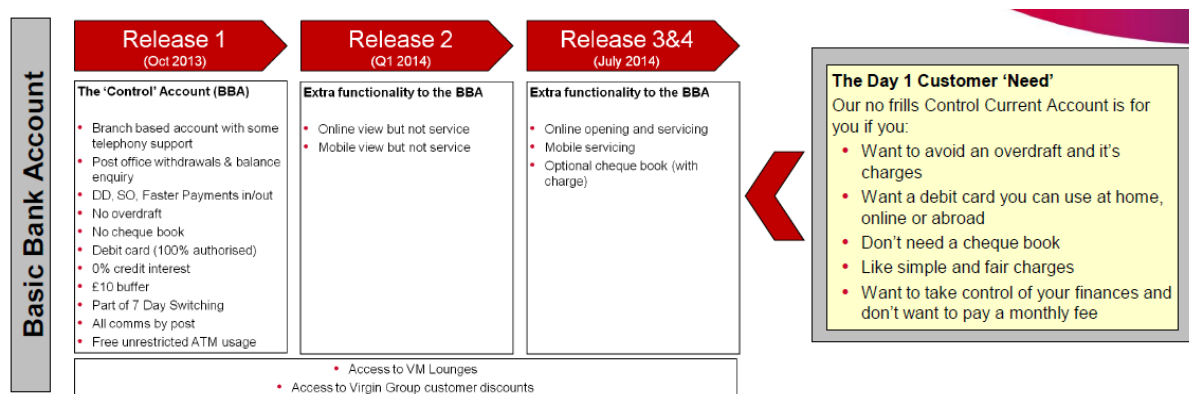
Source: Virgin Money.

301. The strategy paper explained the background and purpose of a basic bank account as follows:

- (a) A current account with limited functionality.
- (b) Originally designed to cater for the financially excluded but now accepted as an account which enabled customers to take better control of their finances, since it did not offer an overdraft.

302. The strategy paper noted that a phased delivery of current account products de-risked the original CAD launch plan and enabled costs and resources to be re-planned. Figure 38 shows the proposed road map to Virgin Money's proposed phased delivery of PCAs, as well as how the different products were intended to meet the requirements of the target market segments.

Figure 38: Scope of PCA programme



Source: Virgin Money

303. The strategy paper also stated that the primary driver for Virgin Money’s PCA programme was not profitability but rather enabling a broader customer relationship strategy. However, according to its estimates, the programme was expected to deliver a neutral to positive contribution in its own right – see Table 12.

Table 12: PCA programme – high level financial assessment



Source: Virgin Money.

304. [✂]

Figure 39: Contribution comparison



Source: Virgin Money.

Board approval of new strategy to launch the Essential Bank Account (later renamed the Essential Current Account (ECA), March 2013

305. A board paper of March 2013 set out the plan for launching Virgin Money’s Essential Bank Account (EBA) in October 2013, which was to be a ‘simple and free current account without an overdraft facility, for those who want convenience and control.’ This product was not to offer credit interest, was to be sold only through Virgin Money branches, although it could also be operated through other channels – post offices, online and via mobile (view only), enabling careful control of volumes.

306. The paper pointed out that the EBA was the first step of Virgin Money's PCA road map, which was to deliver a range of fee-paying current accounts to savers, spenders and homeowners in the future – see Figure 40.

Figure 40: PCA road map

[✂]

Source: Virgin Money.

307. [✂]

Table 13: Indicative financials – PCA programme

[✂]

Source: Virgin Money.

308. [✂]

Current account programme delivery and customer research, March to September 2013

309. During March to September 2013, Virgin Money worked through its product proposition, design, process mapping etc, and carried out primary research to ensure that its offering was in line with the requirements of the target market.

Board approval to roll out strategy for the ECA with limits on volumes, September 2013

310. In a board update of September 2013, Virgin Money stated that it was ready to launch its ECA in November 2013. It mentioned that the ECA was being built on its existing infrastructure, thus ensuring a low risk of delivery, and would establish the engine for the future product launches.
311. The update also stated that being a type of basic bank account, the ECA did not carry a monthly fee, and therefore posed a profitability challenge for Virgin Money.
312. As a mitigation measure, Virgin Money proposed an annual cap of 6,000 to 10,000 on ECA volumes which limited the negative contribution of the ECA to less than £[✂] million a year until 2017. Echoing this point, Virgin Money 2014 Annual Report stated that 'our current account offering will be extended, although we will carefully control volumes ahead of expected future market

changes such as those that might be introduced following the decision of the CMA to refer the PCA market for a full market investigation'.¹⁵³

313. An initial staff pilot during November and December 2013 was to be followed by a phased public roll-out of the ECA starting in Scotland and Northern Ireland in Quarter 1, 2014. The board update stated that 'The ECA enables us to take a strong challenger position with a best of breed Basic Bank Account for a large but underserved part of the market.' It went on to say that entering the market with a brilliant Basic Bank Account strengthened Virgin Money's voice in the political debates about competition, switching and "free in credit" banking.
314. The board update spelt out the benefits of launching the ECA, which included the following:
- (a) closed a product gap in its portfolio;
 - (b) enabled low risk market entry;
 - (c) was very hard to criticise; and
 - (d) helped to build future charging products.
315. Virgin Money believed that an ECA was likely to be the first bank account for customers, who were likely to manage their money closely checking their balance regularly.
316. Although Virgin Money expected its ECA to make a loss on a stand-alone basis (see Table 14), it expected the product to serve as a platform for the launch of its future PCA offerings. The annual running cost of ECA started at approximately £[redacted] per account due to low volumes, and was expected to reach approximately £[redacted] by 2020. [redacted]

Table 14: Financials – Essential Current Account (ECA)

[redacted]

Source: Virgin Money.

317. The board update stated that the next step on Virgin Money's PCA strategy was the delivery of an account which was to charge a monthly fee and offer a richer functionality; this offering was expected to appeal to a broader range of customer groups including savers and spenders, and be the vehicle through which it planned to drive higher PCA volumes. [redacted]

¹⁵³ [Virgin Money Group Annual Report 2014](#), p22.

Figure 41: PCA strategy and roadmap



Source: Virgin Money.

ECA launched – in Scotland and Northern Ireland, July 2014 and in the rest of the UK, March 2015

318. Virgin Money's ECA which was launched in Scotland and Northern Ireland in July 2014 and in the rest of the UK in March 2015,¹⁵⁴ has the following key features:¹⁵⁵
- (a) can only be opened in a Virgin Money branch;
 - (b) designed to be managed through Virgin Money branches and at any post office, with some services available online and over the phone;
 - (c) no overdraft facility;
 - (d) free withdrawals at almost all high street cash machines; and
 - (e) 1% gross (variable) interest on the balance held in the account.¹⁵⁶
319. According to Virgin Money, launching an ECA enabled it to ensure that it had fully tested and robust capability to drive its further expansion at an appropriate time. It told us that the ECA volumes so far had been in line with its expectations.

Barriers to entry and expansion

320. Although Virgin Money has launched an ECA, it does not plan to grow its current account portfolio at scale in the near future. It told us that it faced some impediments to further expansion. These related to:
- (a) free-if-in-credit banking;
 - (b) a lack of product diversity in the market;

¹⁵⁴ Virgin Money told us that the phased launch enabled it to manage PCA volumes and test its systems and processes.

¹⁵⁵ [Virgin Money Essential Current Account](#), January 2015.

¹⁵⁶ According to Virgin Money, credit interest (currently 1%) was applied to all ECA balances without restriction. However, the maximum balance allowed under the ECA terms and conditions is £100,000. Virgin Money stated that where customers exceeded this limit, it continued to pay the interest on the total balance but insisted that the balance was brought down below £100,000 within a reasonable period. Virgin Money reply to the CMA 15 May 2015.

(c) the account switching process; and

(d) access to payment systems.

321. These impediments, in Virgin Money's view, had constrained the ability of the 'challenger' banks to compete with the incumbent banks. It said, 'despite our powerful brand and acquired systems capability, the cost and barriers to entry at scale into the full current account market would be prohibitive.'

Free-if-in-credit banking

322. Virgin Money believes that product cross-subsidisation is inconsistent with treating customers fairly. It said: 'We believe that cross-subsidisation within financial services has the potential to create conduct risk and consumer detriments, as has been shown by banks selling profitable PPI to subsidise personal loans with low interest rates.'
323. Virgin Money told us that larger banks derived cost and liquidity advantages from credit balances in PCAs especially since these tended to be stable and long term, and had lower costs than the other short-term sources of funding. This, according to Virgin Money incentivised the larger banks to maintain the status quo rather than to engage in innovation and competition, which might undermine their incumbency advantages.
324. According to Virgin Money, the above 'systemic' issues (related to product and customer cross-subsidy and cost and liquidity advantages for the larger banks) primarily arose from the free-if-in-credit banking model, which made it difficult for the 'challenger' banks to achieve scale in the PCAs, since the cost of entry was high, and could not be recouped from a 'free' PCA offering.
325. It appears that perceived disadvantages arising from the dominant free-if-in-credit PCA model contributed to Virgin Money's cautious and phased approach towards developing its current account proposition. Its strategy seems to be driven by a desire to avoid investing heavily (eg in new branches, advertising, switching incentives etc) due to its belief that it was difficult to achieve the required scale to recover these costs.

Lack of product diversity, account switching process

326. Virgin Money said that since the main incumbent banks had not changed or improved their primary PCA offering for many years, current accounts were broadly indistinguishable between one bank and another. It noted that this had resulted in a static market where customers did not want to change their

PCA provider, thus providing the incumbent banks with a source of stable funding, and driving their profitability.

327. It made the point that a static market was due to the combination of perceived difficulties in switching, the lack of product differentiation, and the difficulty for consumers in assessing costs and benefits of a PCA.¹⁵⁷

Access to payment systems

328. Virgin Money stated that although having acquired NR¹⁵⁸, gaining access to payment systems had not been an impediment to entering the PCA market, but it questioned if a system could be competitive and open to new providers with new ideas, when access to that system was controlled by the incumbent banks. It also pointed out that it was not clear if the fee for accessing payment systems was loading a 'penalty' on new entrants, thereby increasing the economic barriers to entry.¹⁵⁹
329. In an internal note prepared in 2013, Virgin Money mentioned that for a new entrant, it was probably quicker, cheaper, easier and more practical to interface through a sponsor bank (agency banking) rather than building and maintaining costly infrastructure for lower volumes. However, it also elaborated issues which it thought were caused by agency banking relationships:
- (a) Service standards whereby the agency bank could find it difficult to offer the same standard of service on payments as its sponsor bank.
 - (b) Potential brand damage which could result if payments were delayed.
 - (c) Delay in hearing about industry-wide issues since agency banks relied on their sponsor banks to keep them informed of any industry-wide issues.
 - (d) Project delays which could result due to reliance of agency banks on sponsor banks during a project life cycle.
 - (e) Inadequate new initiatives since these tended to be directed by direct members, and therefore solutions could end up fitting the requirements of those banks.

¹⁵⁷ To address the perceived difficulties of account switching, Virgin Money is in favour of the introduction of full account number portability.

¹⁵⁸ As a result of Virgin Money's NR acquisition, it benefitted from access to access to UK payment systems.

¹⁵⁹ Virgin Money stated that pricing was different from bank to bank and subject to individual negotiations.

330. In response to a query by the CMA, Virgin Money made the following comments regarding its indirect membership of the following payment systems:
- (a) **Faster Payments:** Virgin Money stated that although it was happy with the service provided and did not feel that costs were egregious, some capability gaps existed since no payments were possible during weekly SWIFT outage (between Saturdays 3pm and Sunday 6am).¹⁶⁰ Further, the indirect membership did not allow it to join Paym or Zapp.¹⁶¹
 - (b) **Cheque and Credit:** Virgin Money said that it was happy with the service provided, and the costs were reasonable.
 - (c) **CHAPS:** According to Virgin Money, costs and service were reasonable, and there were no proposition gaps by being an indirect member.
331. Thus, although Virgin Money pointed out a few issues that could be caused by agency banking relationships and the ownership of payment systems by the incumbent banks, it did not appear to have any major concerns regarding the cost and quality of service of its indirect membership of payment systems.

IT system

332. Virgin Money told us that developing a suitable IT platform had not been an impediment to its entering the PCA market, since it acquired much of the capability from its acquisition of NR in 2012. However, it told us that it had subsequently needed to spend approximately £[~~£~~] million to support its PCA programme.¹⁶²
333. Since Virgin Money did not have a PCA offering when it acquired NR, there were no integration costs per se. It stated that the need to integrate the NR IT platform with its IT systems was limited because its other major businesses – mortgages and savings – were also run on systems acquired from NR.
334. Virgin Money said that further investment in IT (1.5 to 2 times the amount it had already invested) would be required if it sought to create a ‘me-too’ PCA product and compete directly with the larger banks (which according to Virgin was not the best approach for them). That said, Virgin Money stated that the

¹⁶⁰ **SWIFT** stands for Society for Worldwide InterBank Financial Telecommunications. It operates a network which facilitates the exchange of payment and other financial messages between financial institutions and eligible corporates throughout the world. A SWIFT payment message is an instruction to transfer funds; the exchange of funds takes place over a payment system or through correspondent bank relationships. KPMG (31 August 2014), *UK Payments Infrastructure: Exploring Opportunities*, p91.

¹⁶¹ **Paym** and **Zapp** are services that enable making payments using a mobile phone.

¹⁶² [~~£~~]

obstacle was not the ability to fund this investment, but rather that the features of the PCA market did not justify making this investment.

*Need for branch network*¹⁶³

335. In its comments on the CMA's statement of issues, Virgin Money stated that while a branch network appeared to be important for a significant proportion of customers, it believed that this factor was of declining importance for many retail banking products, largely due to the growing popularity of alternative channels such as the internet.¹⁶⁴
336. Virgin Money told us that in the future, customers would want to access its services through all available channels. It felt that although branches were important to enable some customers to build personal relationships, it expected the majority to want to access its services through digital and the online technologies. It stated that in 2014, it had over 47 million interactions with customers, of which 38 million (81%) were via digital (website or email) channels. Similarly, 71% of its service interactions and 78% of its product sales took place through digital channels.¹⁶⁵
337. Virgin Money believes that through its 75 branches, it already has a good coverage of the major urban centres in the UK, and it was also working to provide more advanced digital banking capabilities to its customers.¹⁶⁶ Virgin Money stated that while it had considered different scenarios while finalising its PCA roadmap, an extension of the branch network had never been part of this strategy.
338. Virgin Money has no plans to expand its branch network in the near future, but it does not consider this to be an obstacle to its further expansion.

Capital requirements and regulatory barriers

339. Virgin Money told the Treasury Select Committee that:

Given the riskiness of the business model of large banks, and the limitation of their risk models, our conclusion is that a level playing field should be achieved by requiring large banks to hold at least

¹⁶³ Virgin Money does not currently use any advertising to promote itself, and instead relies on its branches and word of mouth to acquire customers.

¹⁶⁴ [Virgin Money's response to the issues statement](#), paragraph 12.

¹⁶⁵ Digital Touch points 2014. Follow up information submission by Virgin Money. 24 April 2015.

¹⁶⁶ Virgin Money's ECA has been designed to be managed through Virgin Money branches and at any post office, with some services available online and over the phone.

as much capital (proportionately) as new entrants- and perhaps more at some times in the economic cycle.¹⁶⁷

340. It told us that capital requirements were not a major concern for PCAs, but it was something that larger banks could manage more optimally due to their greater experience/sophistication, with better historical data and models.¹⁶⁸
341. Virgin Money stated that there were no obvious regulatory impediments to growing its PCA business, and it had all regulatory approvals necessary to build on its current capability.¹⁶⁹ Similarly, in its response to the CMA's statement of issues, it had stated that 'the [banking] authorisation process has been simplified and capital requirements for new banks have been reduced – which should have positive consequences in terms of barriers to entry and growth in the PCA market.'¹⁷⁰

Conclusions

342. Virgin Money gained a bank licence in 2010, but began exploring its options to launch a PCA after its NR acquisition in 2012 which also included a PCA product, a pool of PCA customers, 75 branches, an IT platform and access to relevant payment systems. After closing the NR PCA offering to new customers, it considered a number of alternative strategies to enter the PCA market before deciding to launch an ECA in 2014.¹⁷¹
343. Although Virgin Money has launched an ECA, and has plans to offer a wider range of PCA products, it does not intend to substantially grow its current account business in the near future. It told us that impediments which stand in its way include the free-if-in-credit PCA model, a lack of product diversity, perceived difficulties of account switching, and the competitiveness of payment systems. It does not consider its limited branch network to be an obstacle to its further expansion.
344. It appears that Virgin Money has chosen to target the basic bank account market segment, due to its belief that it would be difficult to succeed in directly competing with the larger, more established banks in the provision of non-

¹⁶⁷ House of Commons Treasury Select Committee, Competition and Choice in retail banking. Written evidence submitted by Virgin Money, (September 2010), paragraph 3.27.

¹⁶⁸ After acquiring NR, Virgin Money uses the IRB approach of capital requirements.

¹⁶⁹ Virgin Money did not need formal approval to launch a current account since it already had the necessary bank licence and current account permissions in place following its acquisition of NR.

¹⁷⁰ [Virgin Money's response to the issues statement](#), paragraph 12. It went to say (para 33) that 'retail banking is highly regulated, and the complexity of the regulations and costs of ensuring compliance with them may still form a barrier to entry and growth in retail banking.' Virgin Money clarified this comment in a teleconference on 10 April 2015 by stating that regulation was not a PCA-specific issue but more generally something that was a challenge for smaller banks with less advanced risk management infrastructure to address.

¹⁷¹ Its ECA was launched in Scotland and Northern Ireland in July 2014 and in the rest of the UK in March 2015.

basic bank account PCAs. It stated that 'We aspire to be a major player in the PCA market, but only when market and regulatory conditions allow.'

345. Virgin Money's PCA strategy appears to be driven by a desire to avoid investing heavily (eg in new branches, IT advertising, switching incentives etc) due to its belief that it was difficult to achieve the required scale to recover these costs. In light of its views on the current market and regulatory environment, Virgin Money does not expect to become a major PCA provider in the near future, and is likely to remain predominantly a retail-funded mortgage bank.

Potential new entrants

346. In the last two years there has been a sharp increase in the number of firms seeking authorisation to provide banking services. As part of our case study work, we also held discussions with five potential new entrants that were at the time of these discussions either in the process of seeking authorisation or that have recently been authorised. At the time of these discussions none of them had begun trading, limiting the level of detail available on performance.

347. Based on the views of the companies with whom we spoke there appear to be a number of potential barriers which they have encountered/expect to encounter:

(a) **Customer inertia:** The potential entrants generally believe that this is largely down to a lack of differentiation in the existing offerings, which results in apathy from customers. However, even with their new models, the potential entrants are aware of the risk from continued customer inertia. Many have designed their customer acquisition strategy to address this; for example, Fidor intends to first build an online community of financially interested consumers, and then over time convert these individuals to customers. We also note that even the perception of customer inertia may be a sufficient impediment to deter some potential entrants.

(b) **Physical presence/branches:** Launching a new branch network is acknowledged by some as prohibitively expensive, and none of the potential entrants is doing so. However, they all acknowledge that cash/cheque handling is generally important (and vital for current accounts) so are relying on agency agreements with incumbents (banks) to use their branches. Alternatives do exist (eg the Post Office), but these appear to be considered inadequate due to issues with identifying customers and ability to handle larger cash sums.

- (c) **Capital requirements:** Respondents gave mixed opinions on whether capital requirements represented a barrier to entry, which we note may be related to the products they are intending to offer. The specific area of concern was the methodology for risk-weighting assets (RWA).
348. It is also interesting to note a number of specific areas which appear to present lower barriers than might be expected:
- (a) **Access to payment systems:** The potential entrants highlighted that access to Faster Payments (specifically) is often key for a compelling proposition and could potentially present a significant barrier. They believe that agency agreements have a number of issues, including cost, speed (real time vs near real time), and whether some information is stripped out. However, we note that a recent announcement from Faster Payment Scheme Limited (FPSL) and the Payment Systems Regulator (PSR)¹⁷² that it intends to develop an independent technical direct access solution. This would allow direct access for all market participants which may address the issues discussed, if it is implemented well.
- (b) **Licence application process:** Recent changes to the licence application process including the introduction of the 'authorised with restrictions' have greatly reduced the barriers to entry. Process is not without challenges, but most potential entrants believe that this is proportionate to the level of responsibility necessary to be a bank.
- (c) **IT platform:** IT costs for start-ups are substantially lower than they are for incumbents due to the latter's high costs of maintaining legacy systems. In addition to this, the introduction of off-the-shelf SaaS IT solutions has resulted in a lower proportion of fixed costs and higher levels of scalability. This results in relatively low barriers to entry for new start-up entrants.
349. Overall, prospective entrants are optimistic about their ability to enter the retail banking market. However, there are some concerns with regards to subsequent expansion; in particular, whether online-only banks' penetration of the market will be limited by the requirement of some customer segments for certain branch/counter services, especially the ability to deposit cash.

¹⁷² [FPSL announcement](#), 11 May 2015.

Company views on barriers

Table 15: Summary of views on barriers to entry for potential entrants

	<i>Atom</i>	<i>Fidor</i>	<i>Starling</i>	<i>OakNorth</i>	<i>CivilisedBank</i>
Brief description of company	Digitally led, full service for personal and SMEs	German-based bank offering online financial service platform (including PCAs), with other services through connected third party partners	Offering online PCAs only	SMEs (No BCA) focus, with a digital proposition extending across SMEs and personal deposits	Branchless, relationship-led (bank managers) for SMEs, including BCAs with small digital personal proposition
Potential barriers					
Customer inertia	Primary concern is consumer perception of the industry, which may be hard to change. However, novel propositions may help address this	Community-based model is intended to result in a conversion funnel over time	PCAs currently treated as commodities, so unsurprising customers don't switch as can only compete on price	Major potential barrier, particularly due to incumbents using current accounts to lock in customers, and propensity to buy or 'kill' any significant new competitors. Also, limited credit information compared with the incumbent bank who has current account data	Certainly a concern, particularly if incumbents are artificially increasing barriers to transfers (eg high costs for break clauses), although some anecdotes which imply may not be too hard to address
Physical presence (eg branches)	No concern as using a competitor to provide	The UK uses relatively little cash (vs Germany), so not intending to launch with any physical branches	Necessary for proposition, so using a competitor to provide	Believes barriers are vast to build your own, and reticent from partnering, so prevents OakNorth from offering a BCA (cash handling)	Necessary to handle cash and cheques, using a competitor to provide
Capital requirements	RWA methodology may disadvantage new start-ups in some areas	No concern as meeting requirements in Germany already	Not mentioned	Capital requirements for operating risk charge is penal for new start-ups due to forward-looking 3 years calculation methodology	No concern

	Atom	Fidor	Starling	OakNorth	CivilisedBank
Access to payment systems	Have to use an agency agreement which results in inability to offer real-time processing	Takes time, and sponsor banks have understandably high compliance requirements even for 'safe' European regulated banks. Different from centralised continental Europe system	Very concerned previously due to cost and loss of information from using an agency agreement. Recent changes by PRS should address this	A major barrier to transactional banking	Access to Faster Payments is key and was a concern until the recent announcement. If this is successful, no concerns
Licence application	No concern with regulator, but very difficult to manage capital over an unclear timetable. Similarly, capital allocation becomes more difficult, particularly when needing to commit to third party suppliers	No concern as operating on EU passport. FCA and PRA were very helpful with this	No concern since improvements implemented	The costs, time, and uncertainty of the process is a barrier. However, the barrier is appropriate given retail deposits are being taken	Significant improvements made to process means fine so far, with slight concern it may become more opaque once submitting formal documents
IT systems	Had to find the right partner	No concern as using existing German platform	No concern – multiple options available. Starling is using a combination of package software and bespoke build for [X]	Regulatory concerns when using a new provider, particularly when proposing more innovative or recent developments (eg use of cloud computing)	No real concerns. Intending to spend [X], which is significantly less than incumbents would need
Marketing costs	No concern, [X]	No concern, as based on building a community then converting community members interested in retail banking products. [X]	Business model requires scale, so allocating [X]	Not mentioned	No concern as largely based on word of mouth via social media, with small amounts of central spend
Ongoing regulatory burdens	Not mentioned	Not mentioned	Not mentioned	Concerned about the next step of growth, in particular if political support of new entrants is withdrawn, then regulator could introduce severe ongoing burdens	Not mentioned
Staff recruitment	Not mentioned	No concern as London labour pool is entrepreneurial and well qualified	Not mentioned	Finding senior staff who have the start-up mentality is difficult, as people with experience have largely worked in large banks	No concern with finding bank managers for launch

	<i>Atom</i>	<i>Fidor</i>	<i>Starling</i>	<i>OakNorth</i>	<i>CivilisedBank</i>
Initial funding	Not mentioned	Not mentioned	Not mentioned	Not mentioned	Regulatory risk pre-application is difficult to manage, particular with PE/VC-type investors who are used to greater levels of control
KYC/AML	Not mentioned	No concern, and actually part of business model as ensures consumers are KYC/AML approved for its financial services partners	Not a concern, since incumbents' processes are not optimally implemented. More effective processes can be delivered using more customer friendly technology	Not mentioned	Not concerned, and investigating how detailed actually needs to be as incumbents may be overly stringent
Geographic coverage	No concern	Not mentioned	No concern	No concern	No concern as lack of geographical overhead allows a gradual rollout, testing new areas

Source: Interviews with companies, regulatory business plans, investor presentations and CMA analysis.

Annex A: List of Metro's branches at the end of 2014

<i>No.</i>	<i>Store location</i>	<i>Date of opening</i>
1	Holborn	Jul-10
2	Earl's Court	Sep-10
3	Borehamwood	Oct-10
4	Fulham Broadway	Oct-10
5	Tottenham Court Road	Mar-11
6	Kensington High Street	Apr-11
7	Bromley	Jun-11
8	Croydon	Jun-11
9	Uxbridge	Oct-11
10	Hounslow	Dec-11
11	High Wycombe	Mar-12
12	Chiswick	May-12
13	Reading	Nov-12
14	Hemel Hempstead	Dec-12
15	Romford	Dec-12
16	Sutton	Feb-13
17	Guildford	Apr-13
18	Slough	May-13
19	Ealing	Jun-13
20	Staines	Sep-13
21	Kingston	Oct-13
22	Cheapside	Nov-13
23	Edgware	Dec-13
24	Windsor	Dec-13
25	Milton Keynes	Jan-14
26	Epsom	Mar-14
27	Milton Keynes Oakgrove	May-14
28	Wood Green	Oct-14
29	Basildon	Nov-14
30	St Albans	Nov-14
31	Orpington	Dec-14

Source: Metro website.

Annex B: Metro's main products

Personal banking¹⁷³

- Current Accounts
- Savings Accounts, eg ISAs, Young savers account
- Mortgages
- Borrowings – eg Credit card, Overdraft, Personal loans professional studies loan

Business banking¹⁷⁴

- Business Bank Accounts
- Deposit accounts, eg Business Instant Access Deposit Account
- Borrowings, eg Small business loans
- Commercial Banking, eg Not-for-profit banking
- SME finance services, eg Invoice and Asset Finance
- Cash management services

Other

- Safe Deposit Boxes

¹⁷³ www.metrobankonline.co.uk/Personal/.

¹⁷⁴ www.metrobankonline.co.uk/Commercial/.

Annex C: Nationwide - Timeline of events

1. A summary of the timelines is laid out in Figure 1 below, along with the key figures as they were presented to the executive committee/board:

Figure 1: Summary timeline of events

[X]

Source: CMA analysis.

2010

2. At Nationwide's September 2010 Strategy Conference, an initial document assessing the prospects of Nationwide's entry into the provision of SME banking services (including BCAs) was presented to the board. This included an overview of the SME sector and the main competitors, a channel and product strategy, indicative financials and independent market research.
3. Specifically, the paper highlighted that entry into the market should be possible, based on a strategy of [X]. It stated that [X].
4. The overall recommendation of the paper was that a full business case should be developed for presentation to the board in early 2011.
5. The board sought further clarification on a number of areas including:
 - (a) the size and nature of the target market;
 - (b) the impact of the SME product suite on the Nationwide operating model including its branch network;
 - (c) the impact on Nationwide's 'transformation agenda' (its IT platform, facilitating multi-channel service delivery);
 - (d) the business case for parallel IT developments to support the SME business;
 - (e) the credit process for SME customers; and
 - (f) further refinement of the product proposition.

2011

6. The subsequent paper presented to the board in April 2011 sought to clarify these issues. It proposed that [REDACTED].¹⁷⁵ It recommended a project team be assembled ([REDACTED]) and that the team work towards a pilot launch [REDACTED] and a full launch [REDACTED].
7. The paper explained that Nationwide should [REDACTED]. It considered that these businesses tended to [REDACTED].
8. [REDACTED]
9. The paper set out the breakdown of the [REDACTED] market ([REDACTED]).

Figure 2: [REDACTED]

[REDACTED]

Source: [REDACTED]

10. [REDACTED]¹⁷⁶
11. [REDACTED]¹⁷⁷
12. The paper also concluded that [REDACTED]

Figure 3: [REDACTED]

[REDACTED]

Source: [REDACTED]

13. The proposed operating model for serving SME customers would utilise Nationwide's internet, branch, telephone and ATM channels. [REDACTED]
14. The proposed SME products at this time were:
 - (a) [REDACTED];
 - (b) [REDACTED];
 - (c) [REDACTED];
 - (d) [REDACTED]; and

¹⁷⁵ [REDACTED]

¹⁷⁶ [REDACTED]

¹⁷⁷ [REDACTED]

- (e) [REDACTED].
15. One of the questions highlighted by the board in response to the original proposition in 2010 concerned the distribution requirements associated with serving the SME market and, in particular, the use of branch space. This was of particular importance, since this board paper forecast that the SME customer base would grow to [REDACTED]. Supporting analysis estimated that this could have potentially generated up to [REDACTED] branch counter transactions a year. It stated that it was clear that entering the market with no controls could place undue pressure on branches as SME customers could increase transaction levels by about [REDACTED].
16. The board paper therefore set out the controls that it believed should be put in place from the outset:
- (a) [REDACTED]
- (b) [REDACTED]
- (c) [REDACTED]
- (d) [REDACTED]
17. Nationwide stated that the business case was based on an assumption that [REDACTED]% of accounts would be opened in branch, about [REDACTED]% of accounts would be opened online and about [REDACTED]% through the telephone channel. As a new entrant in this sector Nationwide believed it would look to demonstrate continuously improving account opening capabilities through [REDACTED] channels, so these opening percentages were viewed as conservative.
18. The paper stated that adopting this recommended approach, with its focus on attracting [REDACTED], the forecasted transaction levels at Nationwide branches would rise by about [REDACTED] and the number of branch-based customer representatives required to service this [REDACTED]. It said that the cost of this (worst-case) scenario was included in the business case.
19. However, the paper estimated that [REDACTED], so the argument was made that this cost (provision for which was made in the business case) might not have materialised since [REDACTED].
20. The paper also stated that the proposition might require an additional [REDACTED]. As with branch servicing, it stated that these costs were included in the business case but might not have materialised [REDACTED].
21. The business case accompanying the board paper showed a £[REDACTED] contribution by year 5 and a £[REDACTED] contribution by year 10. This assumed an

estimated set up cost of £[redacted] and that it could grow to [redacted] BCAs ([redacted]) by year 5 and [redacted] ([redacted]) by year 10. The paper stated that it considered this achievable, considering that [redacted].

22. The major areas of operating costs were forecast as:
- (a) product costs ([redacted]);
 - (b) channel costs ([redacted]);
 - (c) attributed costs ([redacted]); and
 - (d) provisions ([redacted]).¹⁷⁸
23. The Nationwide board agreed to support in principle entry, and approved the creation of the formal project team to further develop the business case. It raised a number of further questions and challenges including:
- (a) the possibility of accelerating the launch date or initially launching an SME deposit account;
 - (b) the benefits of a large branch network with managers having a strong understanding of the business needs of the target market;
 - (c) differences in the training requirements relating to the product T&Cs; and
 - (d) cross-selling opportunities and the need to avoid value destructive activities.

2012

24. Another paper was presented to the executive committee in April 2012, and subsequently the board in May 2012, which provided an update on the SME project team's progress in assessing the options available to Nationwide. In particular, it discussed:
- (a) an update on the market conditions which indicated that despite the economic downturn, the SME sector remained broadly stable;
 - (b) [redacted]; and

¹⁷⁸ See Annex D for the details of the business case.

- (c) the assumption that the required SME IT infrastructure could be developed in parallel to the significant investment taking place to support Nationwide's personal banking operations.
25. The board also heard that within the SME market, the government had been actively encouraging competition and lending; and received information on the newly launched Commercial Deposits (business savings) accounts, which were piloted to existing Nationwide Commercial customers in 2011 and were launched to the external market for the first time in March 2012.
26. The paper included an updated business case based on the latest assumptions, which showed the [REDACTED]. However, no additional details on the expected set-up costs were provided. Nationwide highlighted the main changes in the business case assumptions as the following:
- (a) [REDACTED]¹⁷⁹
 - (b) [REDACTED]
 - (c) [REDACTED]
 - (d) [REDACTED]
27. Nationwide provided us with an initial Experian presentation from November 2012 which supported previous size estimates and gave more detailed information regarding the make-up of the SME market.
28. The board paper shows that in this period Nationwide completed a programme of competitor benchmarking [REDACTED]. It stated that [REDACTED].
29. The paper stated that Nationwide [REDACTED].
30. Nationwide designed a BCA product whose features included:^{180,181}
- (a) [REDACTED];
 - (b) [REDACTED];
 - (c) [REDACTED];
 - (d) [REDACTED];

¹⁷⁹ [REDACTED]

¹⁸⁰ [REDACTED]

¹⁸¹ The CMA notes that subsequent work was commissioned which questioned the feasibility of parts of this delivery model, (eg SME1.08) and recognises that the exact proposition would likely evolve before reaching market.

(e) [REDACTED];

(f) [REDACTED]; and

(g) [REDACTED].

31. During this period Nationwide was also aware of a number of inorganic entry options, [REDACTED].

32. In October 2012, alternative IT solutions were proposed to support the delivery of an organic SME proposition:

(a) Option A (Original): [REDACTED].

(b) Option B (Alternative): [REDACTED].

2013

33. In 2013, after assessing these supporting IT options against a number of criteria including: strategic fit to the business and IT strategy; timeline to deliver; delivery and operating costs; risk profile of delivery, IT solution 'Option B' was adopted as the recommended solution should Nationwide decide to enter the SME market.

34. In 2013 it also became clear that developing the required business banking infrastructure would have an impact on the investment taking place in personal products and services as IT resource would need to be diverted.

35. In March 2013 Nationwide papers were presented to the executive committee and subsequently the board which showed that the latest business case estimated the programme cost as being significantly higher [REDACTED]. Therefore what was anticipated to be a relatively modest investment of capital (£[REDACTED]) and resource turned out to be more onerous. Most of this requirement was in the form of capital expenditure ([REDACTED]), with the majority consisting of IT design and development, [REDACTED]:

(a) [REDACTED];

(b) [REDACTED];

(c) [REDACTED];

(d) [REDACTED];

(e) [REDACTED]; and

(f) [REDACTED].

36. Although some board members expressed concern that Nationwide was missing an opportunity to broaden the services it offers to its members, it was agreed that Nationwide could not afford to invest around £[redacted] at that time and at the expense of other projects.
37. The board considered that, due to the levels of profit at the time, some discretionary programmes would need to be deferred. [redacted]:
- (a) [redacted];
 - (b) [redacted]; and
 - (c) [redacted].
38. It was agreed at the board meeting that [redacted] should be progressed, and it was generally accepted that the preference would be to invest in [redacted] ahead of SME banking. The SME proposition would be deferred and reviewed in 12 months' time.
39. The work of the SME project team was therefore put on hold, [redacted].

2014

40. In June 2014, another board paper gave an updated overview of the SME market which showed the following:
- (a) There were [redacted] SMEs, [redacted], of which [redacted] used a BCA.
 - (b) The number of SMEs was expected to show steady growth over the next [redacted] years.
 - (c) The BCA market was still 'dominated' by the major banks with 90% held by the Big 5.
 - (d) There was no current tangible alternative to the Big 5, although there were a number of new smaller/niche players entering the market, for example Williams & Glyn, and TSB, which were looking to grow their market share. The paper specifically highlighted the levels of political support and the ongoing Office of Fair Trading investigation as factors which encouraged these entrants.
 - (e) SME customers were becoming more digitally active [redacted].
 - (f) [redacted]

41. The paper recommended that the preferred Nationwide proposition should be [REDACTED]:
- (a) [REDACTED];
 - (b) [REDACTED];
 - (c) [REDACTED];
 - (d) [REDACTED]; and
 - (e) [REDACTED].

42. The recommendation to the board was that [REDACTED]

43. [REDACTED]

Figure 4: [REDACTED]

[REDACTED]

Source: [REDACTED]

44. The Nationwide board reviewed the above, considering [REDACTED] with regard to the appropriateness of developing a business banking offering in the context of their new 2014–2019 Corporate Plan.
45. The board was told that since the update in 2013, [REDACTED]. The business plan predicted [REDACTED].
46. [REDACTED]
47. In conclusion, the board agreed that the SME market still represented a market opportunity in the medium term but [REDACTED].

Latest statements

48. Nationwide has told us that developing an organic entry into the SME market remains an option and it is retaining the SME project team's deliverables, which provide insight into how to overcome key challenges such as maximising synergies from IT integration, distribution requirements and supplementing Nationwide's personal expertise with SME experts.
49. Nationwide estimated that the project had cost about £[REDACTED] to reach this stage ([REDACTED]) and the paper identifies [REDACTED] based on incorporating the required bridging of gaps in Nationwide's IT functionality whilst also taking advantage of relevant existing IT infrastructure.

50. [✂]

(a) [✂]

(i) [✂]

(ii) [✂]

(iii) [✂]

(b) [✂]

(i) [✂]

(ii) [✂]

(iii) [✂]

Annex D: Nationwide - Details on 2011 business case modelling

[✂]

Annex E: Map of Tesco stores with (limited) personal current account services



Source: Tesco Bank.

Annex F: Features of Tesco personal current account

1. Tesco's PCA was launched with following key features:
 - (a) Clubcard points on Visa debit card spend both in and out of Tesco stores.
 - (b) 3% AER interest on credit balances up to £3,000.
 - (c) £5 monthly fee if customers deposit less than £750 per month. No monthly fee for customers who deposit more than £750 per month.
 - (d) Free 'overdraft control' feature to make managing the account easier.
 - (e) Automatic text and email alerts and extended grace period to help customers avoid unarranged transactions fees.
 - (f) Variable EAR of 18.9% for customers who use an arranged overdraft facility (no fixed monthly fee).
 - (g) A set £5 fee for payments made using an unarranged overdraft or if Tesco rejected a payment.
 - (h) Capped charges for paid and unpaid transaction fees at £50 per month.
 - (i) Online and mobile banking.
 - (j) UK-based customer service centres which were open 24 hours a day, seven days a week.
 - (k) Ability to make deposits at over 300 Tesco stores.
 - (l) Contactless Visa debit card which doubled as a Clubcard.

Annex G: Location map of Virgin Money branches in the UK



Source: Virgin Money.

Annex H: Virgin Money 2011 to 2014 performance

Results 2011-14		2014	2013	2012	2011 ¹
Growth					
Gross mortgage lending	£bn	5.8	5.6	4.9	3.7
Mortgage balances	£bn	21.9	19.6	16.8	13.9
Credit card balances	£bn	1.1	0.8	–	–
Deposit balances	£bn	22.4	21.1	18.0	16.2
Total assets	£bn	26.5	24.6	21.8	19.6
Quality					
Cost of risk ²	%	0.11	0.15	0.02	–
Fully-loaded Common Equity Tier 1 capital ratio	%	19.0	15.5	15.5	18.7
Leverage ratio	%	4.1	3.8	3.6	4.0
Loan-to-deposit ratio	%	102.8	96.4	93.1	85.8
Returns					
Underlying total income	£m	438.2	361.5	234.6	161.7
Underlying profit/(loss) before tax	£m	121.2	53.4	(2.5)	(59.1)
Statutory profit before tax	£m	34.0	185.4	160.2	23.5
Underlying net interest margin	%	1.50	1.26	0.54	0.36
Underlying cost:income ratio	%	68.7	77.2	100.2	148.1
Underlying return on tangible equity	%	7.4	2.3	(1.1)	(5.2)
Underlying basic earnings per share	p	21.4	8.1	17.0	(33.9)

¹ The 2011 results of Virgin Money Holdings (UK) plc have been presented as if Northern Rock plc had been part of the Group during 2011.

² Cost of risk excludes benefit of debt sale of £8.9 million.

Source: Virgin Money Group Annual Report, p2.



Annex I: Cost to deliver the Virgin Money personal current account programme



Source: Virgin Money.

Appendix 9.2: Parties' views on barriers to entry and expansion

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Parties' views

1. Appendix 9.1 sets out details of the seven case studies that we undertook into entry and expansion and the views of the banks that were the subject of those case studies on the barriers to entry and expansion they encountered. In this appendix we set out additional views of parties submitted during the course of the investigation in relation to barriers to entry and expansion.
2. In response to our [provisional findings](#), respondents were generally in broad agreement with our assessment of barriers to entry and expansion and we received little further evidence on most of the potential barriers to entry and expansion we considered. In our [provisional findings](#) we stated that we would undertake further work on capital requirements and on the recently introduced CTS and changes to the bank levy. We subsequently published a [working paper](#) on the bank levy and an [addendum to our provisional findings](#). In this appendix we therefore focus on the views of parties expressed in response to those consultations rather than views expressed on other potential barriers to entry which we have reflected where relevant in our analysis of the relevant potential barriers to entry. We first set out the views of banks followed by those of relevant regulators and finally other parties.

Banks

Aldermore

3. Aldermore considered that capital requirements, together with the CTS, the differential access to payment systems and the higher costs of funding, were the biggest challenge for small banks. It submitted that regulation fell disproportionately on smaller banks and that the greatest differential in capital risk weights arose in the vital mortgage market and in particular in lower LTV mortgages. Aldermore stated that competitive imbalances exist between providers using model-based approaches for estimating risk weights relative to those on standardised approaches. Aldermore was therefore at a competitive disadvantage against IRB banks in the low LTV mainstream mortgage market due to its having to hold much higher levels of capital for such lending. [✂]. In relation to the costs of funding for lending, Aldermore suggested that extending the FLS whilst limiting eligibility so that small banks would benefit could further stimulate competition.
4. Aldermore also made a number of additional submissions as part of a group of smaller 'challenger' banks which are summarised further below.

Atom Bank¹

5. Atom told us that it considered that the reforms to the authorisation process had created a more attractive environment for potential banking entrepreneurs and the pre-Brexit performance of new banks funded by private equity such as Metro, Aldermore and OneSavings Bank had further stimulated investor interest. While there remained challenges in attracting investment and competing against other opportunities that offered better returns more quickly, access to finance had not been an insuperable barrier. Market conditions post-Brexit are less certain and it remains to be seen whether this adversely affects the fortunes of new or ‘challenger’ banks.
6. Atom submitted that the higher capital requirements on SA banks fundamentally constrained new entrant banks from competing for lending and meant that new entrants, in order to compete, had to specialise in higher risk lending segments of the market. In doing so this, in its view, was likely to lead to such banks having even higher capital requirements under Pillar II to reflect the increased risk of such lending. In addition, SA banks had to supply some lower LTV mortgages in order to have a balanced portfolio of risk and to offer a sufficiently broad customer proposition but such business was not attractive in terms of available returns because of the higher capital requirements putting such banks at an overall competitive disadvantage.
7. Moreover, Atom did not consider that it was necessary for there to be any differential between IRB approach and SA risk weights in order to incentivise better risk management – all banks were required to maintain high standards of risk management irrespective of whether they were SA or IRB banks. Whilst ‘challenger’ banks had been successful in attracting new capital, the business models had been quite specialised despite the mortgage market offering more than £200 billion of gross low risk new lending per annum. The absence of any major new entrants in the residential mortgage market was telling and could be contrasted with the SME lending market. In Atom’s view this reflected the fact that the levels of return in the mortgage market were only attractive to a limited set of IRB banks.
8. Atom also submitted that we should not include in our analysis of the differentials between the SA and the IRB approach the additional capital requirements imposed on systemically important banks as such requirements were intended to offset the implied support such banks received from government. Moreover, even if it only took three to five years for an SA bank to achieve IRB status, Atom commented that this was a significant period to

¹ [Atom’s response to the addendum to provisional findings.](#)

expect investors to accept sub-standard returns. Banks that depended in large part on mortgage business typically had NIM of 100 to 150 basis points and around 50% of that income would generally be accounted for by operating costs and normal credit losses resulting in an indicative pre-tax return on assets of 50 to 75 basis points. As a result a bank could not successfully absorb a 40 to 50 basis points squeeze in NIM under the capital requirements regime.

9. Atom also stated that in addition new banks struggled to translate cost efficiencies and compelling customer service propositions due to loss-leading practices of established banks including free current accounts and zero rate credit cards. New banks were also restricted in the wholesale market compared to incumbent banks due to TBTF and had to rely on incumbent banks for access to payment systems.

Bank of Ireland

10. In relation to the bank tax regime, BoI told us that, by introducing additional taxes on small banks that were previously outside the scope of the existing bank levy, the changes did not seem consistent with an objective of greater competition. It also said that the changes would slow the repair of capital and returns on equity across the sector and impact on the attractiveness of the UK banking sector. It argued that this latter effect could be particularly marked for smaller players and new entrants.

Clydesdale

11. Clydesdale (which uses SA) said that it had an average risk weighting on its mortgage book that was [REDACTED]. A solution suggested by Clydesdale was for regulators to make accrediting SA banks with IRB status easier and more proportionate in terms of the cost and the process involved. Clydesdale could apply for IRB approval, [REDACTED].²
12. Clydesdale gave an example of a differential for a mortgage between an SA and an IRB approved bank. It said that [REDACTED]

[REDACTED]

13. [REDACTED] suggested that it was important that the effect of mortgages with an LTV higher than 100% and investment home loans were considered as part of an analysis of banks' mortgage portfolios, particularly when the financial climate

² Clydesdale hearing summary.

could lead to some banks having a higher proportion of loans with negative equity than was usual.

HSBCG

14. In relation to the bank tax regime, HSBCG told us that it welcomed the shift in tax burden from a global balance sheet based levy to a smaller levy on a UK balance sheet base that is accompanied by the CTS. It argued that it was more equitable that the levy was applied only to its UK business. In addition, HSBCG considered that the changes would benefit new entrants and small and medium sized banks because of the deduction of the first £20 billion of balance sheet liabilities before application of the levy and the £25 million annual tax surcharge allowance. It argued that the annual allowance would lead to the surcharge having a greater effect on larger banks. Overall, HSBCG considered that it would continue to be placed at a financial disadvantage compared with its UK-focused competitors until 2021 as the existing bank levy will continue to be based on the HSBC's global balance sheet until this time.
15. HSBCG stated that the PRA was best placed to deal with any residual issues under the capital requirements regime relating to residential mortgage lending, given that: (a) several smaller banks were IRB-approved for mortgages by the PRA; (b) the PRA had indicated that reforms on the regulatory agenda would increase capital requirements on larger banks relative to smaller banks; and (c) the PRA was already exploring the extent to which it could be made more feasible for new entrants to develop IRB models.³

LBG

16. In relation to potential regulatory barriers, LBG submitted that it was necessary to look at the cost of the whole of the regulatory regime and not individual elements. Larger banks were subject not only to additional capital requirements including additional capital buffers and to higher banking taxation through the bank levy but also to additional costs relating to for example the provision of fee free basic bank accounts and funding of CASS.⁴
17. In relation to the bank levy, LBG submitted that the relevant question in a competition assessment of the CTS was not whether it would increase costs for smaller providers or impact on all providers' lending decisions, but rather whether it would lead to a restriction or distortion of competition between

³ HSBCG response to provisional findings, footnote 9.

⁴ LBG response to addendum to provisional findings.

banks by having a disproportionate impact on smaller, less well established providers and/or new entrants versus larger, established providers. LBG noted that corporation tax applied almost universally to businesses of varying size across the economy. It argued that since this was not considered to be distortionary, there was no reason why an increase in corporation tax should introduce a competitive distortion in the banking sector.⁵

18. LBG also highlighted that even following the bank tax changes, larger banks, including LBG, would remain subject to the bank levy, whereas banks with liabilities below £20 billion would not. Furthermore, until 2021 the bank levy would continue to be applied to the worldwide balance sheet of UK headquartered banks but only to the UK balance sheet of foreign headquartered banks. Larger banks would also be affected by the tax surcharge. Following the budget changes to the bank levy and CTS, LBG's tax burden would increase significantly by over £[£]. In contrast, while the surcharge would apply to smaller banks for the first time, the effect on new entrants would be mitigated by the surcharge only applying to profits above £25 million.
19. LBG also cited evidence that recent smaller entrants to retail and SME banking were typically earning higher equity returns than more established banks.⁶ It attributed this to cost advantages derived from newer, simpler IT systems and more modern (or low cost digital only) distribution networks and the absence of legacy costs. LBG argued that this suggested there was no evidence for the hypothesis that an increase in taxation would impact the ability of smaller banks to expand, relative to larger banks.
20. In relation to the CMAs analysis on capital requirements, LBG submitted that the PRA was best placed to deal with any issues. LBG emphasised that the CMA's analysis of the differential in capital requirements in respect of residential mortgages needed to be interpreted with care and that any conclusions should reflect the full capital requirements regime (and not only the risk weighted assets requirements). It emphasised the complexity of assessing mortgage risk and the impact of additional capital requirements from Pillar II and stress analyses of the portfolio. In comparing data between banks, LBG pointed out that each bank's asset portfolio mix would differ for a number of reasons including differences in risk appetite. Any pricing analysis was complex, driven by legacy pricing considerations, portfolio term, age of book and other factors. Also, mortgages would move between LTV bands as

⁵ [LBG response to provisional findings](#), paragraphs 5.3 & 5.4.

⁶ [LBG response to provisional findings](#), paragraph 5.4.

a loan was repaid and house prices changed, which would complicate any comparison of price and risk weightings over time.

21. In relation to the PRA's analysis of mortgage prices, LBG submitted that it was not appropriate for the CMA to pre-judge the PRA's ongoing work in this area. It did not consider that the PRA's analysis on mortgage prices was at this stage robust enough for the CMA to draw any conclusions regarding the link between mortgage pricing and capital requirements and that the PRA's current analysis had a number of significant limitations. Moreover, the CMA had failed to consider sufficiently the cost of becoming and maintaining IRB status and had not provided sufficient evidence of any adverse outcomes in the PCA or the SME retail banking markets (in the form of higher prices or lower investment in quality and innovation) as a result of SA banks having higher mortgage risk weights. It submitted analysis suggesting that any impact on PCA revenues of the differential in capital requirements was in the region of 2% to 3%.

Metro

22. In addition to the views expressed in its case study (see Appendix 9.1), Metro told us that there should be tighter bands for capital requirements for standard product sets, rather than allowing for the current wide differentiation in the market. In particular, the IRB approach used by many existing banks allowed for too much variability in capital. In order to promote a truly fair and competitive market, capital requirements for all product sets should be brought more closely in line with each other using industry wide indicators set by the regulator. This would make the market more transparent. Metro also told us that it was required to hold around six to ten times more capital than the IRB banks and building societies when securing a mortgage for a customer, even if it was the same customer, with the same deposit, on the same property.
23. Metro also made a number of further submissions as part of a group of smaller 'challenger' banks which are summarised further below.

Nationwide

24. Nationwide submitted that the CTS would have a disproportionate effect on building societies because of the business model they operated, in which profits are held as retained earnings on capital to maintain the strength of their balance sheets, meet prudential requirements and, re-invested into the development of new products and services. Nationwide also provided an

estimate of the financial impact of the CTS which amounted to an increase in its tax liability of approximately £300 million over the next five years.⁷

RBSG

25. RBSG submitted⁸ that the PRA had been active in ensuring a level playing field for new and more established banks, in particular, relating to different methods of calculating relevant credit risk (ie whether SA or the IRB). While the SA and IRB approach may give rise to significantly different risk weightings for similar credits (and not always lower for IRB), RBSG argued that that did not necessarily result in equally large differentials in capital requirements relating to those credits. This was because effective capital requirements were determined not only by reference to the risk-weighted capital framework but also by, among other things, the leverage ratio and the BoE stress testing framework. As regards the latter, RBSG noted that the 2014 stress test was applied only to the eight largest banks and building societies, and not to newer or smaller banks. In addition, RBSG risk weights under the IRB approach were subject to a number of floors. The PRA had, for example, applied a ‘slotting’ regime to commercial real estate credits, while the Basel Committee was consulting on a capital floor framework based on standardised, non-internal modelled approaches. Finally, RBSG stated that the IRB approach entailed added costs, such as the development and maintenance of the model, and also reflected capital buffers which larger banks were required to maintain, but which did not apply to new entrants.

Santander

26. Santander stated that the CMA should look at the regulatory regime as a whole and assess the cumulative effects of each set of regulations and how they affected competition between banks and not individually as was the approach in our [provisional findings](#). In assessing regulations, the CMA should look at whether individually or collectively the rules and requirements for each regulatory area are proportionate to their aims. Santander considered that the CMA’s provisional conclusion in its provisional findings that the rules “balance each other out” was misconceived. It submitted that the regulatory regime as a whole had disproportionate effects on smaller banks including Santander. This is because to win customers, particularly when those customers are largely inert, smaller banks must offer innovative and attractive service propositions, operating on finer margins than the incumbent big four banks. It is therefore much harder for ‘challenger banks’ including ‘scale

⁷ [Nationwide response to provisional findings](#), Appendix 1, paragraphs 5.4–5.6.

⁸ [RBSG response to provisional findings](#), paragraph 7.

challengers' to accommodate increased regulatory costs in a way it did not consider to be comparable to the larger banks.

27. In relation to capital requirements, Santander noted the design of the IRB model was to reward banks for better risk management. However, Santander stated that (as a new entrant in SME lending), it suffered from the lack of IRB model approval and was required to hold more capital for SME lending than, for example, RBSG would for the same unit of lending. The main reason Santander could not be IRB approved for SME lending is the lack of data history. In its view the data history requirements are too onerous. While it is relatively easy to collect sufficient data to support an IRB application for a mortgage portfolio, it is far more difficult for an SME portfolio as the number of customers and loans in the UK market that any 'challenger bank' can capture is very small. Santander said that, when it started its SME operations in 2008, in the absence of legacy books which it could rely on, and as it did not have good data for the prior seven years, it could have bought data to underpin an IRB model. However, this would have distorted its numbers significantly as it would not have been indicative of its underwriting standards and did not reflect its lower risk. Therefore the IRB requirements and the term required for statistical accuracy do not assist new entrants. Instead they create an advantage for established market participants. An example of the impact of the differential in capital financing regulation was that, had Santander bought Williams & Glyn, it would immediately have had to put approximately 30% more capital behind the same assets as RBSG did.
28. Moreover, Santander disagreed with the CMA's analysis that the differential in risk weights in SME lending was not significant. Santander stated that (as a new entrant in SME lending) it was required to hold more capital in relation to SME lending than, for example, RBSG would for the same unit of lending. In its view Pillar II and other capital buffers should not be looked at as they were not intended to 'offset' the differential between the SA risk weights and IRB. In its view the differential between the IRB approach and the SA for residential mortgages and SME lending were broadly similar.
29. Santander told us⁹ that the CTS disproportionately affected smaller banks and scale challengers which typically operated on narrower margins than the incumbent banks because of their need to offer innovative and attractive service propositions to compete with incumbent banks (which had an inert customer base). It argued that it was therefore more difficult for 'challenger banks' to accommodate increases in their cost base, such as that arising from the CTS. The introduction of the CTS therefore reinforces incumbency

⁹ [Santander response to corporation tax surcharge and bank levy working paper.](#)

advantages in retail banking. In hitting small banks and 'scale challengers' the hardest. Santander told us that the CTS penalised those institutions that had been extending their lending to UK SMEs over the past few years, compared to the largest incumbent banks which had been retrenching.

30. Santander was also concerned about the medium- to long-term impacts of CTS on the ability of growing 'challenger banks' to continue to expand. In particular it considered that the CTS would have a suppressing effect on potential margins from new lending which would make credit expansion less attractive. This in turn would hinder the ability of 'challenger banks' banks to continue to invest in products and services to compete with the incumbent banks.
31. Santander stated that because the CTS was a new tax it was likely that any unintended consequences would become clear over time. It therefore considered that relevant policymakers such as HMT and the CMA should monitor and regularly review its competition implications over time.
32. Santander also noted that smaller banks which derived a greater share of profits from the UK would see an increase in their tax cost whereas those UK headquartered banks with mainly foreign operations would see a decrease. Furthermore, it believed that the tax changes disincentivised inward investment into UK banking, which in its view, was important in enhancing externally sourced competition.

Secure Trust Bank

33. In response to our [provisional findings](#) and at a [roundtable](#), Secure Trust reiterated its view that there was not a level playing field in UK banking. Unless the un-level playing field arising from inadequate access to payment systems, disproportionate capital requirements, higher funding costs in particular due to the implicit 'too big to fail' government subsidy and a largely once size fits all regulatory regime, new entrants and smaller banks could not challenge the incumbent banks.
34. In relation to payment systems, it stated that because it was reliant on larger banks for access to payment systems, it was limited in the level of service it could offer its customers. It argued that the only way to address the problem would be to have a single clearing system owned by a common use facility where all banks received exactly the same service on a pay-as-you-go basis.

35. In relation to capital requirements, Secure Trust said¹⁰ that, in practice, only the largest firms could commit the resources necessary to meet the criteria required to qualify to use the IRB approach, which gave them an immediate and substantial capital advantage. Secure Trust referred to an ICB report which noted that Nationwide was able to risk weight its mortgage assets at 5%, while Barclays and LBG had risk weights of 16%. This meant that banks on the SA risk weight of 35% had between a 218% and 700% capital disadvantage relative to banks on the IRB approach. This differential was completely disproportionate and locked smaller banks out of the largest, safest and most profitable lending markets.
36. Secure Trust also submitted¹¹ that, whilst it was technically correct that the additional buffers and leverage ratio reduced the capital requirements differential, this was very much at the margin and in practice had no competitive impact. The 'TBTF banks' dominated the best buy league tables for personal loans, motor finance, mortgages and credit cards. Their broad range of products and enormous back book made it easier for IRB banks to optimise the composition of their overall asset portfolio maximising their advantages under the capital regime. As a result, new entrants were not going to seek low cost sources of funding through current account products.
37. In addition, Secure Trust stated that new entrants had to focus their approaches on particular market segments more through necessity than choice – they must concentrate in areas where they had some ability to compete. This in turn meant that it would be very difficult to become IRB approved, for example in relation to mortgages, as they would not be able to collect the necessary data. In its view the proposed new Basel rules would dramatically increase rather than lessen the capital disadvantages suffered by SA banks.
38. Secure Trust also submitted that the ongoing TBTF subsidy would persist. The ring-fencing and resolution regulations were designed to reduce the risk of such firms failing but in practice wholesale funders knew that banks such as LBG and RBSG would not be allowed to fail. Such banks would therefore continue to derive an annual multi-billion pound benefit on the back of this implicit government subsidy. This enabled, along with their dominance of the inert current account and deposit account markets, such banks to lend profitably at rates lower than smaller banks paid for their funds. A look at the best buy league tables for fixed rate mortgages and fixed rate deposits confirmed that the best buy mortgages were the systemic banks and for

¹⁰ [Secure Trust response to addendum to provisional findings.](#)

¹¹ [Secure Trust response to provisional findings.](#)

deposits the smaller banks. A customer could therefore borrow from a TBTF bank for two years and more than double its return by placing the money on deposit with a smaller bank.

39. In relation to the CTS and changes to the bank levy, in its response to our [provisional findings](#), Secure Trust also submitted that the size of the CTS tax-free annual allowance should be increased to prevent CTS revenue from smaller institutions being used to offset a reduction in bank levy from the systemically important, larger banks.¹² Similarly, at the roundtable hearing with Secure Trust, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society,¹³ Secure Trust stated that smaller institutions that were not subject to the bank levy were effectively subsidising the reduction in the rate of bank levy for the so-called 'too-big-to-fail' banks.
40. In its response to our [working paper](#) on CTS and the bank levy, Secure Trust re-iterated its view that smaller banks, which did not cause the financial crisis and were therefore excluded from the bank levy, were hugely important for the recovery after the financial crisis by demonstrably increasing their net lending at a time when TBTF banks were reducing their balance sheets. Whilst it had no objections to being put on the same footing as the large incumbent banks with respect to taxation, this was provided it had the ability to compete on a level playing field which was not currently the case. Secure Trust argued that the tax changes therefore made the playing field more biased towards larger incumbent providers and that the smaller banks were subsidising the cost of reducing the bank levy for the incumbent banks. However, it welcomed the CMA flagging that the government should keep the tax regime under review and that any such review should examine the broadest market context.
41. Secure Trust also made a number of further submissions as part of a group of smaller 'challenger' banks which are summarised further below.

[REDACTED]

42. [REDACTED] said that it had noticed a reaction from investors following the CTS announcement and that the relative attractiveness of 'challenger' banks as a target for investment had been reduced versus FinTech companies not subject to the CTS.¹⁴

¹² [Secure Trust response to provisional findings](#), p6.

¹³ [Transcript of roundtable hearing with Secure Trust, Starling, Tesco, Virgin Money and Yorkshire Building Society](#), p81 line 23 – p82 line 1.

¹⁴ [REDACTED]

Tesco Bank

43. Tesco Bank said that the changes to the bank tax regime were unhelpful in the context of expansion insofar as the CTS limited the extent to which it could re-invest profit.¹⁵ It argued that the tax would reduce the ability of new entrants to accumulate capital reserves to support business and market growth, and indirectly impact on profitability and investor appetites.
44. Tesco Bank also told us that the structure of the tax disadvantages banks that had extended into areas outside traditional banking, eg insurance broking or money services. These banks would be less able to compete with non-banking companies such as general insurers in the provision of insurance and related services.
45. Tesco also made a number of further submissions as part of a group of smaller ‘challenger’ banks which are summarised further below.

TSB

46. TSB (which uses IRB for mortgage lending) cited capital requirements as a possible obstacle for a new bank, although it stressed that there were other more significant factors which impinged on ‘challenger banks’ ability to compete effectively in retail banking.¹⁶ It said that banks that use the IRB approach have significant capital advantages over those banks that used the SA, most significantly on residential mortgages. On unsecured lending, it was broadly neutral, although in some instances, the IRB approach gave a higher capital requirement than the SA. TSB said that a new bank with a small number of customers and a small infrastructure did not have the data to do the internal modelling and so would use the SA. TSB said that much of this was caused by a ‘scale mismatch’ rather than a problem with the IRB system itself. The IRB processes and systems were expensive and there were high maintenance costs as well.¹⁷

Virgin Money¹⁸

47. Virgin Money noted that Andy Haldane, Chief Economist at the BoE, had observed a striking fall in the average risk weights of large banks using the IRB approach since the 1990s. It also noted previous comments by the BoE about changes in measurement methodology that had led to reductions in

¹⁵ Transcript of roundtable hearing with Secure Trust Bank, Starling Bank, Tesco Bank, Virgin Money and Yorkshire Building Society, p81, lines 19–22.

¹⁶ Transcript of roundtable hearing with LBG, RBS and TSB.

¹⁷ TSB hearing summary.

¹⁸ Virgin Money response to provisional findings.

reported risk-weighted assets, but which may not have been associated with improvements in underlying resilience. It considered that there needed to be a more level playing field between larger incumbent banks, smaller banks and new entrants (with some of the very low risk-weight outcomes of the larger banks being challenged). It submitted that higher risk weights in residential mortgages for SA banks was a barrier to entry and expansion; these made it more difficult for SA banks to raise capital as the expected returns on their larger amounts of capital would be significantly lower than for large banks using the IRB approach. It said that this might explain that while there had been new entrants in retail banking, no new banks were focusing exclusively, or largely, on residential mortgages. It also noted that the suggested 'overheating' of the buy-to-let market, to the extent that it was true, might be in part a consequence of firms using the SA driving up their buy-to-let business in order to achieve the higher yields that had been available in this market relative to other assets. Virgin Money noted the FCA's observation that competition in mortgages was largely price driven. While it suggested that SA banks could choose to match IRB banks' pricing, it did not think this approach would be sustainable given the ongoing pressure there would be to pass on to consumers at least part of the higher costs associated with higher capital requirements.

Yorkshire Building Society

48. Yorkshire Building Society considered that access to payment systems, the imposition of the bank surcharge, access to funding and capital requirements were the reasons preventing it from expanding in the provision of PCAs.
49. Yorkshire Building Society also noted that the CTS would impact mutuals in particular as they tended to use a business model that relied on offering higher savings rates. As such, it argued that a higher rate of taxation would reduce their ability to finance such rates.¹⁹

Multiparty submissions from a group of 'challenger' banks

50. In a multiparty submission in response to our [provisional findings](#), a group of ten 'challenger' banks²⁰ said that in their view capital requirements, access to payment systems, the cost of funding and proportionate regulation were among the most significant impediments to competition. The CTS would compound the impact of these existing barriers to expansion making it even

¹⁹ [Transcript of roundtable hearing with Secure Trust, Starling, Tesco, Virgin Money and Yorkshire Building Society](#), p82, lines 18–22.

²⁰ Aldermore, Charter Savings Bank, Close Brothers, Hampden & Co. Bankers, Metro, Secure Trust, OneSavings Bank, Shawbrook, Tesco Bank and Paragon.

more difficult for smaller banks to expand relative to larger banks.²¹ The CMA should review all regulations to make greater use of de minimis thresholds and provide greater firm discretion on how to achieve high level objectives rather than imposing detailed requirements designed for systemically important banks which imposed disproportionate costs on ‘challenger’ banks.

51. The differences in risk weights in particular in the area of residential mortgages, they submitted needed to be addressed and the CMA needed to work with the PRA to develop proposals to facilitate access by smaller banks to the IRB approach, to increase access to aggregate data for small banks to use for modelling under IRB and to reduce the differential between the SA and IRB approach.
52. In relation to access to payment systems, the group agreed that access to payment systems was a competitive barrier to indirect participants and whilst the PSR had primary responsibility, the CMA should make concrete proposals to the PSR in this area. In respect of cost of funding for lending, the group disagreed that the TBTF subsidy had been reduced by regulatory changes and requested that the CMA propose an extension to the FLS beyond January 2016 with enhancements to facilitate participation by smaller banks.
53. In response to our [working paper](#) on CTS and the bank levy,²² the same group of smaller ‘challenger’ banks submitted that the assessment of the tax changes should not be undertaken in isolation from other policy settings. In particular, the group told us that ‘challenger’ banks were willing to be taxed on the same basis as large banks provided other policy settings provided a level playing field. It was the group’s view that the taxation regime provided some limited counterbalancing of larger banks’ competitive advantages and that this counterbalancing would be significantly reduced by changes to the tax regime. The group considered that the CMA needed to take a more robust position against a policy change that would reduce the ability of small UK banks to compete. It also submitted that the CMA should urge HMT to establish and follow a clear timeframe for completing a review of the competition impacts of the bank tax system.
54. More generally the group reiterated its view that the CMA should go beyond its current draft remedies and make concrete proposals addressing the core underlying impediments to competition namely access to payment systems, disproportionate regulation, capital requirements and cost of funding.

²¹ [Letter from group of challenger banks in response to provisional findings](#), p2.

²² [Letter from a group of challenger banks in response to our CTS and the bank levy working paper](#).

55. The same group of ten banks in response to our [addendum to our provisional findings](#)²³ recognised that the CMA's powers were limited and that forcing changes to the capital requirements regime set by international institutions was not directly possible. However, the CMA in the group's view should continue its work in this area and make clear recommendations in its final report that the PRA and HMT should actively pursue a proportionate capital regime with international institutions. In addition, the group submitted that the impact of the capital rules extended more widely than mortgages. A key motivation for offering PCAs and BCAs was as a source of low cost funding in particular low risk lending. However, if smaller banks could not engage in low risk mortgage lending economically because of the capital requirements regime this reduced the incentive on them to seek sources of funding from PCAs and BCAs.

Further submission from a group of 'challenger' banks²⁴

56. In response to our [provisional decision on remedies](#), a group of eight smaller 'challenger' banks submitted²⁵ that the main impediment to the growth of 'challenger' banks was the lack of a level playing field due to the huge disadvantages that 'challenger' banks had in respect of the cost of funding and disproportionate capital requirements relative to the largest banks. The group highlighted the differential in risk weights on residential mortgages identified in our analysis. They submitted that these differentials result in challenger banks having to set aside ten times more capital for the same residential credit risk than the six biggest banks that controlled 80% of the mortgage market. In their view this stranglehold on the low LTV mortgage market and other lending markets in turn had given such banks significant funding advantages. High quality/low risk lending assets were used as collateral to support low cost wholesale funding lines including under the FLS. This virtual circle of the large banks using low risk assets to access low cost wholesale funding to originate new low risk loans coupled with their huge capital advantages enabled them to price their competitors out of the mortgage market. As a result, they argued, the incumbent banks taking lower risks were able to generate higher levels of profitability. The group also reiterated their concerns around the advantages of TBTF, commenting that in the 1990s there was a level playing field resulting in a highly diversified market when banks could fail without doing systemic damage.

²³ [Letter from a group of challenger banks in response to addendum to provisional findings.](#)

²⁴ Aldermore, Charter Savings Bank, Hampden & Co. Bankers, Metro, Secure Trust, OneSavings Bank, Shawbrook and Paragon.

²⁵ [Letter from a group of challenger banks in response to our provisional decision on remedies.](#)

57. In the group's view the most effective and sustainable way to foster competition across the board in the UK retail banking market was to create a truly level competitive playing field especially in respect of capital and funding. Whilst the group acknowledged that the CMA could not force a change to the capital requirements regulations unilaterally, the CMA should make a clear recommendation setting out 'a detailed roadmap' to a truly level playing field to add momentum to reforms to improve the proportionality of capital rules and ensure that competition is at the top of the reform agenda.
58. At the end of June 2016 seven of the smaller 'challenger' banks²⁶ wrote to the TSC following Secure Trust's appearance at the TSC on 7 June 2016. The letter was also submitted to the investigation.²⁷ In the letter the banks reiterate their views on the need for a level playing field in particular in respect of capital, funding and taxation. They proposed that the CMA makes a number of recommendations to address their concerns:
- (a) Capital requirements: their preferred option would be for 'established smaller banks' to risk weight their lending assets at the average of the ten largest IRB banks. However, they stated that the PRA was not in favour of such an approach²⁸ but was in favour of allowing smaller banks to use anonymised lending data of the IRB banks to build their own internal models.²⁹ They therefore requested that the CMA directs HMT and the PRA to develop a framework for the sharing of key data from the bigger banks that could be used to build suitable internal models.
 - (b) Cost of funding: the banks suggested that a solution would be to require banks to pay a minimum of the base rate on all current account and savings products including off market back book products. Alternatively the existing FLS could be evolved to allow smaller banks to borrow via the government at the same effective funding costs as those enjoyed by the systemic banks as a result of the TBTF subsidy and their control of the current account market. They therefore requested that the CMA directs HMT and BoE to extend a suitably amended FLS scheme.
 - (c) Taxation: they submitted that the tax regime should reflect the lack of a level playing field by applying differential tax rates. Accordingly the CMA should recommend to HMT a substantial increase in the level at which the CTS became payable.

²⁶ Aldermore, Shawbrook, Metro, Secure Trust, OneSavings Bank, Hampden & Co and Charter Savings Bank.

²⁷ [Letter from a group of challenger banks to the TSC](#).

²⁸ The PRA confirmed to us that it considered that such an approach would weaken the incentives to continuously invest in better risk management systems in order to be IRB compliant.

²⁹ See paragraph 63 below for PRA's views on its use of pooled data.

Regulators

PRA

59. The PRA, however, recognised that the use of different approaches to calculate risk weights generates wide gaps in relations to some assets, in particular lower LTV residential mortgages and that such gaps are larger than could be considered appropriate or justified on prudential grounds. It also recognised that such differences may have had unintended consequences by encouraging some banks on the SA to compete on assets where the gap between IRB and SA risk weights was narrower, which were usually riskier assets.
60. From a regulatory perspective, the PRA explained that it was difficult to design a regulatory system that optimally aligned capital requirements with the underlying credit risks held by banks. Asymmetric information between the regulator and banks naturally meant that there would be some divergence between the regulatory capital set by regulators and banks' own estimates of the risks on their balance sheet. Ultimately, this meant that there would be differing impacts on banks under any regime.
61. The introduction of the IRB approach (as part of Basel II) was aimed at ensuring that levels of capital better reflected the inherent risk held by banks and at incentivising better risk management and decision making within banks. However, as regulators were effectively handing over some of the responsibilities of capital setting to banks the PRA explained that the requirements to become IRB approved were set high. Regulators needed sufficient confidence that the risk models used to calculate risk weights were sufficiently robust, there was sound governance in maintaining and using the models, and that banks were using this for their own internal decision making.
62. Moreover, the PRA also explained that while the IRB approach had its advantages in being more risk reflective, it also had limitations to the extent that not all banks were capable of developing risk models and it could lead to risk gaming. For those banks (without IRB approval) the SA was the fall-back option. Moreover, the PRA submitted that some gaps between banks on the SA and the IRB approach were desirable as they incentivised banks to invest in better risk management.
63. While smaller and newer banks on the SA may face disadvantages on individual assets compared with IRB banks due to the differences between the IRB approach and the SA, the PRA explained that a number of recent measures had been introduced since the financial crisis such as capital buffers for large systemically important banks, total loss absorbing capacity,

the leverage ratio and stress testing for large banks. The PRA considered that these measures had largely offset the apparent capital advantages of the IRB approach compared to the SA in most asset classes, although this was not the rationale for the introduction of such measures. In order to address the larger disparities between the risk weights under the SA and the IRB approach, the PRA explained that it was necessary to address it at international level from both sides. On the one hand, the modelling under IRB should be improved to make it more robust in the face of uncertainty, particularly for low default assets and on the other hand the SA should be more reflective of UK risk, in particular for smaller banks. In relation to the 'challenger' banks' suggestion that the PRA (and HMT) develop a framework for the sharing of key data between the larger IRB banks and smaller banks wishing to become approved, the PRA noted that the use of pooled data may assist in data availability. However, data availability is not the only requirement for a bank to successfully implement IRB modelling. For example, an IRB applicant bank would need to know with confidence whether pooled possession data from the 1990s, for example, was fully comparable with its current book and lending practices. In addition senior management would need to understand and have oversight of the bank's models even if pooled data was made available.

64. The PRA told us it had very little discretion to move away from the existing regulatory framework set by Basel and implemented in the UK through EU legislation. However, the PRA confirmed that wherever possible it exercised its discretion to apply the framework proportionately to seek to level the playing field between SA and IRB banks and to give adequate weight to competition.³⁰ For example, supervisors may exercise judgement for small firms where they identify that the credit concentration risk methodology under the Pillar II new regime could overstate risks, or could incentivise risk-taking behaviour.
65. The EU is currently consulting on whether some greater flexibility in the capital regime would be appropriate. The PRA stated that, in its view, the EU's approach of applying the regime to all banks irrespective of size and business models should be reviewed. It recognised that the costs of the regime bore more heavily on smaller banks and that the benefit of applying the regime in full to small banks was proportionally less. In its view more proportionate and differentiated rules were more likely to help promote competition and in particular the growth of smaller banks.

³⁰ These have included greater flexibility when setting capital requirements for new entrants and the PRA is currently undertaking work looking at the impact of the capital requirements regime in the mortgage markets.

66. In relation to Sir John Vickers' concerns (see below) regarding the framework to be introduced for the systemic risk buffer, the FPC stated that whilst there would always be some distortions at or near any thresholds a flat rate of 3% would mean that firms below the £175 billion threshold would face a sharp increase in capital requirements were it to expand. The gradient of rates across buckets is relatively shallow, with equally sized steps of 0.5 percentage points above the initial 1.0% bucket, the minimum permitted under the relevant legislation. The graduated approach means that SRB rates faced by firms are more proportionate to the scale of systemic risks that they pose. The FPC stated that though there are pros and cons to the income tax style approach as suggested by Sir John, this is precluded under the relevant regulations.³¹

PSR

67. We have set out the PSR's views in the relevant section on payment systems and in Appendix 9.4.

Other parties

Challenger Bank Panel of the BBA

68. The Challenger Bank Panel of the BBA³² told us that smaller banks in the UK were at a disadvantage in relation to larger banks due to the uniform application of the Basel rules to all banks, and the difficulty involved in moving from the SA onto the IRB approach. Banks using internal ratings were able to apply lower risk weightings to many asset classes, enabling them to make more productive use of their capital. They said that the issue was also faced in other European jurisdictions, and the European Commission had launched a public consultation on the impact of capital regulation, more specifically CRR and CRD IV,³³ which considered the question of the proportionality of regulation for different types of bank.

Building Societies Association

69. The Building Societies Association (BSA) told us that there were potential competition concerns in relation to the proposals for bail-in requirements as part of bank resolution.³⁴ As it set out in its response to the BoE consultation

³¹ http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp260516.pdf

³² [Challenger Bank Panel of the BBA response to addendum to provisional findings.](#)

³³ [European Commission public consultation](#) on the possible impact of the CRR and CRD IV on bank financing of the economy.

³⁴ [BoE consultation](#) on its approach to setting a minimum requirement for own funds and eligible liabilities (MREL).

on this topic, the BSA argued that the compliance costs of the proposed regime would add to existing barriers to entry and expansion. The BoE's proposals included an exemption only for banks with fewer than 40,000 transactional accounts.³⁵ The BSA was concerned that the requirements were structured in a way that discouraged PCA growth for banks that were either currently just below the threshold, or contemplating entering the PCA market. The BSA argued that a higher threshold and a more gradual transition would strike a more appropriate balance between competition and prudential concerns.

New Economics Foundation

70. In response to our [provisional decision on remedies](#),³⁶ New Economics Foundation submitted that the implicit taxpayer subsidy that large 'TBTF' incumbent banks benefited from put such banks at a competitive advantage. This subsidy enabled such banks to borrow at lower interest rates than they would otherwise be able to. In addition, incumbent banks with a lending history of more than five years were able to use the IRB approach for risk weighting enabling them to do 10 times more low LTV mortgage lending than a small bank or building society using the SA. As a result smaller new entrants were at a competitive advantage.

Professor Alastair Milne

71. In response to our [provisional decision on remedies](#),³⁷ Professor Milne agreed that the wide discrepancy especially in low LTV mortgage products was a competition concern. However, in his view, the banking industry was not technologically static and therefore the competition concerns from the wide discrepancy in capital requirements were not as significant.

Sir John Vickers

72. Sir John Vickers raised competition concerns in relation to the Financial Policy Committee's proposals for the implementation of the systemic risk buffer for large ring-fenced banks. Sir John submitted³⁸ that the current proposed framework for the systemic risk buffer could blunt the incentives on ring-fenced retail banks to compete for new business and could incentivise such

³⁵ The PRA proposed to base its definition of transactional banking services on 'an appropriate definition of "current accounts"'. However, the exact definition is one of the questions for consultation. See [BoE consultation](#) (paragraphs 3.7–3.12).

³⁶ [New Economics Foundation response to provisional decision on remedies](#), p4.

³⁷ [Professor Alistair Milne response to provisional decision on remedies](#).

³⁸ [Sir John Vickers response to provisional decision on remedies](#).

banks to shrink their business thereby weakening and/or distorting competition between retail banks. In particular, Sir John argued that the proposed stepped thresholds for the rates of the systemic risk buffer, and the 'empty bucket' policy towards the top rate, might deter growth as banks approached each threshold, in particular as the higher rate was applied to all assets and not only to the value of assets which exceeded the threshold (unlike income tax).

Appendix 9.3: Regulatory barriers

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Bank authorisation

Overview

1. To carry on a regulated activity in the UK, firms must apply for permission from the relevant UK financial regulator(s) under Part IV of the FSMA.¹ This applies to new firms entering the retail banking market organically, to existing firms wishing to vary their permissions to undertake new regulated activities, and to firms operating in the EEA seeking to expand activities to the UK.²
2. The regulated UK financial activities include accepting deposits, which applies to all PCA and BCA providers.³ The PRA is responsible for the prudential regulation and supervision of all deposit-taking institutions (banks, building societies and credit unions), insurers and major investment firms. These firms are regulated by the FCA for the way they conduct their business (that is, they are ‘dual regulated’ by the PRA and the FCA).
3. Dual regulated firms seeking authorisation are required to make a single application to the PRA. The PRA and FCA work together to assess the firm’s application against their respective threshold conditions.⁴

¹ Some entities are exempt from the requirements to be authorised. These are appointed representatives, professional firms that run regulated activities alongside their main business, and local authorities or some housing groups. See [FCA firm authorisation](#).

² A firm authorised in an EEA state can offer certain products or services in the UK and other EEA states if it has the relevant passport. This is referred to as ‘inward passporting’. In most cases the firm will still be regulated by its home state regulator. See [FCA firm passporting](#).

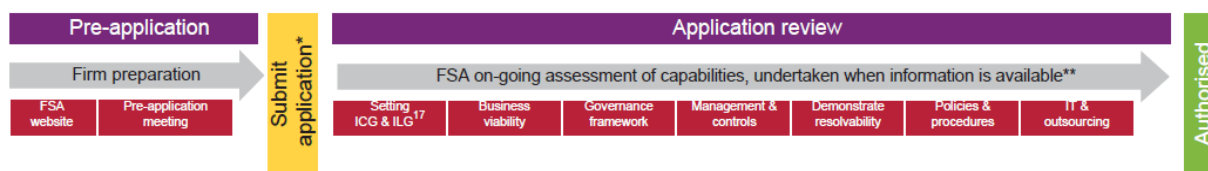
³ Other regulated UK financial activities include issuing e-money, carrying out or helping to administer insurance contracts, investment activities and arranging, advising on, entering into and administering home finance. For full list of regulated UK financial activities, see [FCA regulated activities](#).

⁴ See [FCA firm authorisation](#) and also Appendix 3.1 for details on the threshold conditions.

The authorisation process prior to 1 April 2013

4. The new authorisation process for banks was introduced in April 2013. Prior to this date, firms seeking authorisation to carry out regulated UK financial services submitted an application to the FSA.

Figure 1: Authorisation process under the FSA



Source: FSA and BoE (2013), [A review of requirements for firms entering into or expanding in the banking sector](#).

*Past experience is that applications are often not complete, leading to a longer application review period.

**These assessments are not sequential and timing is dictated by the firm's preparation.

5. Under the FSA, the authorisation process consisted of two phases: the pre-application phase and the application assessment phase (see Figure 1 above). During the pre-application phase firms would be given the opportunity to discuss their proposals with the FSA to identify any immediate issues and help them to understand what information they would be required to submit. Once the application was submitted, the FSA would use this information to assess a number of factors, including the viability of the business model, the capital and liquidity requirements necessary to support the level of business proposed and whether the firm could be resolved in an orderly way.⁵
6. The FSA required an applicant to be fully operational before granting authorisation. This meant the applicant needed to show that all the regulatory capital was in place, staff had been hired and trained, IT systems were fully tested and operations and business continuity arrangements were in place.⁶
7. In March 2013 the FSA and the BoE published a review of the requirements for firms entering into or expanding in the banking sector. This review set out some significant reforms to the authorisation process for banks, which are discussed in the following sections.

The authorisation process since 1 April 2013

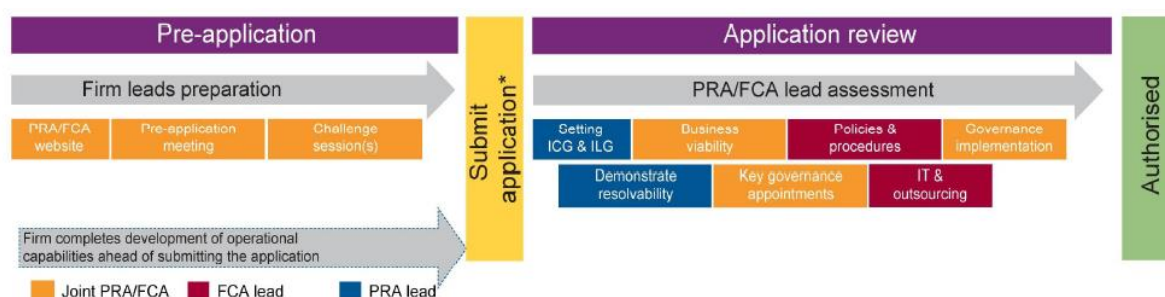
8. The reforms to the authorisation process introduced different options for firms to reflect the wide variation in applications received by the FSA and in the needs of firms.

⁵[A review of requirements for firms entering into or expanding in the banking sector](#), BoE and FCA, March 2013.

⁶ *ibid.*

9. Two options are now available for the authorisation of new banks:
- (a) Option A – for firms that have the development backing, capital and infrastructure to allow them to set up the bank relatively quickly (eg firms with IT and other infrastructure in place). From the start of the process to the end, a firm authorised through this option could start trading within six months (see Figure 2); and
 - (b) Option B – for firms that cannot immediately fund the upfront investment required to set up a bank or that have longer lead times for raising capital and setting up infrastructure. This option gives firms the certainty of authorisation before committing to all the necessary investment (see Figure 3).

Figure 2: Revised authorisation process – Option A



Source: FCA and BoE: *A review of requirements for firms entering into or expanding in the banking sector*, March 2013.
 *A firm targeting authorisation within six months (Option A) must submit in the application all the information required for the PRA and FCA to complete their assessments in the application review stage.

Figure 3: Revised authorisation process – Option B



Source: FCA and BoE: *A review of requirements for firms entering into or expanding in the banking sector*, March 2013.
 *The application for the Mobilisation option only needs to include the information required for the assessment and authorisation stage, which is less than required in the application for Option A.

10. Regardless of whether firms follow Option A or Option B, the FCA and PRA are committed to providing greater pre-application support than was available under the FSA arrangement. During the pre-application phase, the regulators provide (potential) applicants with detailed information about the application process, the information to be submitted by the firm and the level of detail that

this information must contain. This stage also currently involves an initial informal meeting, feedback meetings and a challenge session(s).⁷

11. In addition to receiving greater support from regulators throughout the pre-application stage, firms are also required to provide less information overall (regardless of which option is chosen) than under the previous authorisation regime. Firms applying through Option B need only provide the minimum amount of information that relates to activities that will be carried out later on (eg whether IT infrastructure will be built in-house or outsourced).
12. Once an application for authorisation has been submitted,⁸ the PRA and FCA have six months from the point at which the application is deemed complete to determine the outcome of that application.⁹

Mobilisation of firms under Option B

13. Providing a firm meets the threshold conditions,¹⁰ a firm applying under Option A will obtain authorisation and a firm applying under Option B will be authorised with a restriction. A restriction is a standard regulatory tool that, in this instance, allows the bank to accept deposits but will limit the scale of deposit-taking activities, and sometimes also the type of activity that the bank can engage in, acknowledging the lack of infrastructure and controls in place.
14. During this time the firm is said to be in 'mobilisation'. During the mobilisation phase the bank may raise capital, put in place and test an appropriate IT platform or outsourcing arrangements, hire the necessary staff, finalise policies and procedures that are appropriate to the activities it will carry out, and conduct any relevant training.¹¹
15. Firms are able to begin some or all of the activities related to mobilisation during the application assessment stage – it is up to the firm. However, these must be finalised during the mobilisation stage, which is capped at 12 months

⁷ The purpose of the challenge session is to increase the likelihood of the applicant submitting a fully-completed application. The challenge session usually takes place when a firm's business model and strategies for meeting capital and liquidity standards are nearly complete (see [A review of requirements for firms entering into or expanding in the banking sector](#), FCA, March 2013).

⁸ Details of the processes involved in submitting an application and reviewing it once submitted are provided in [A review of requirements for firms entering into or expanding in the banking sector](#), BoE and FCA, March 2013.

⁹ So long as this does not exceed 12 months from the submission date. The PRA and FCA have 12 months from the submission date to determine an incomplete application.

¹⁰ The threshold conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage, see Appendix 3.1 for more information.

¹¹ A list of activities that can be deferred to the mobilisation stage and those that must be completed prior to application are listed in, PRA/FCA (2014), [A review of requirements for firms entering into or expanding in the banking sector: one year on](#), paragraph 28.

to ensure the information on which the authorisation was granted does not become outdated.

16. Once the firm has completed all of these activities during mobilisation and is entirely operational, it must apply for a variation of permission in order to have the restriction on its authorisation lifted. Once the restriction is lifted (providing regulators are satisfied), the bank can increase the scale of the activities it has been authorised to undertake.¹²

Changes to capital and liquidity requirements for new entrants

17. As part of the reforms to the authorisations process that came into force on 1 April 2013, changes were made to the capital requirements imposed on entrant banks.¹³ These changes involve the following:
 - (a) The automatic additional requirements ('Pillar II scalars') that were previously applied to reflect the uncertainties inherent in start-ups will not be applied simply because the bank is new.
 - (b) Following full implementation of Basel III, start-ups are required initially only to meet a minimum common equity tier one capital of 4.5% of risk-weighted assets. Entrants will be given longer to build up the additional 2.5% of capital (the 'capital conservation buffer').¹⁴
18. Under authorisation Option B, only the minimum overall capital requirement as required by the CRD IV (£1 million) needs to be injected at authorisation.¹⁵ However, given that mobilisation is capital intensive, the PRA may require firms to hold additional capital during the mobilisation phase (such that a firm's capital holding does not fall below £1 million at any time).
19. In addition to the changes made to capital requirements, the liquidity requirements have been revised as well. The rules on liquidity requirements specify how much cash a bank has to hold in order to make sure that it can

¹² If the PRA/FCA ascertain that the firm does not meet the conditions for the restriction to be lifted, the PRA may take steps to remove the bank's authorisation once the 12-month period has passed.

¹³ See below for a further discussion of the capital requirements regime. These changes apply to entrant banks that the PRA judges can be resolved in an orderly fashion with no systemic impact. More detail on the changes made can be found in [A review of requirements for firms entering into or expanding in the banking sector](#), BoE and FCA, March 2013, section 6.

¹⁴ Banks (including entrants) can operate below the 2.5% capital conservation buffer but in doing so must accept automatic restrictions for example on distributions of dividends and variable remuneration, and agree a plan with the PRA to (re-)build the buffer. See [A review of requirements for firms entering into or expanding in the banking sector](#), BoE and FCA, March 2013, p11. More information on the CRD IV is contained in Appendix 3.1 on the regulatory framework.

¹⁵ The minimum of £1 million is for small specialist banks; most recent entrants and firms in the pipeline meet this requirement. This £1 million only covers the Individual Capital Guidance (which is Pillar I plus Pillar IIA).

meet its short-term obligations.¹⁶ All banks, including entrants, now face lower liquidity requirements and there is no longer a differential in liquidity requirements for entrant and incumbent banks.¹⁷

Observations since the implementation of reforms to the authorisation process

20. The PRA and FCA, in a review one year after implementation of the reforms, note a number of positive developments, including:
- (a) a substantial increase in the number of firms discussing with the PRA the possibility of becoming a bank; and
 - (b) an increase in the level of pre-application support offered to firms by the PRA and the FCA.
21. The PRA has authorised seven new retail banks between 1 April 2013 and 1 October 2015; all but one of these banks applied for authorisation via the new Option B and include Paragon Bank, Atom and OakNorth. Paragon Bank became fully operational in May 2014; OakNorth exited mobilisation and began offering savings products and SME lending in the autumn of 2015; and Atom launched its first (savings) products in April 2016. Since October 2015, the PRA has authorised a further two retail banks.

Table 1: Retail bank authorisations since 1 April 2013

<i>Bank</i>	<i>Date of authorisation</i>	<i>Products included</i>
Union Bank of India	September 2013	PCAs
Paragon Bank	February 2014	SME lending products
Charter Court*	December 2014	SME lending products
OakNorth	March 2015	SME lending products
Atom	June 2015	PCAs, BCAs, SME lending products
Habib AG Zurich UK Plc	July 2015	PCAs, BCAs, SME lending products
Tandem Bank	November 2015	PCAs and retail lending
Masthaven Bank	April 2016	SME lending products and retail savings accounts

Source: PRA.

*Charter Court varied its permissions to accept deposits. Formerly an FCA solo specialist mortgage lender, Charter Court is now a deposit taker offering residential mortgage lending and second charge lending.

Note: One additional retail bank has been authorised since 1 April 2013 but does not provide products within the scope of the CMA's market investigation and has therefore been excluded from this table.

¹⁶ See Appendix 3.1 and BCBS, January 2013, [Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools](#).

¹⁷ See [A review of requirements for firms entering into or expanding in the banking sector](#), BoE and FCA, March 2013, p47, box 5.

22. Six retail providers are currently in the application stage of the authorisation process and a further ten retail firms that are active in the pre-application stage.
23. In March 2015 the PRA recognised that while the number of banking licences granted in each of its first two years was close to the average number of licences granted per year by the FSA, over one-third of the licences granted by the PRA have been to new entrants (as opposed to variations to existing licences) compared to 10% of new banking licences under the FSA's regime.¹⁸

Experience of recent entrants

24. Recent entrants' (and those currently in the authorisation process) experience of the authorisation process is varied, as illustrated in our case studies of Metro, Virgin Money and prospective entrants.
25. Metro, which launched in 2010, found the authorisation process a slow and challenging one.¹⁹ However, its founder and former chairman Anthony Thomson, who went on to set up Atom (now the chairman of Atom), notes that the authorisation process has since improved significantly. In particular, Atom found that the clearer structure, which is organised into different stages, provides more clarity to the authorisation process. Mr Thomson also believes that there has been a big shift culturally in terms of the regulators' view of new entrants and a focus on promoting competition. Mr Thomson did, however, explain that the long lead times continue to present a problem for new banks and told us that it is not possible to wait until the firm is authorised (with restriction) to begin mobilising because this phase is limited to 12 months. For example, Atom told us that it was advised by FPS that it could anticipate a 12- to 18-month onboarding period after the granting of its licence for direct access, and that this period would vary on a case-by-case basis.²⁰
26. Paragon Bank and OakNorth told us that the authorisation process remained a substantial exercise. While Paragon Bank believed the authorisation process was no longer the barrier into entry to retail banking that it once was, OakNorth believed that it did continue to act as a barrier but recognised that the process was appropriate for institutions seeking to hold customer deposits.

¹⁸ BoE (2015), *Two years on from March 2013 publication of 'A review of requirements for firms entering into or expanding in the banking sector'* – Speech by Martin Stewart.

¹⁹ See [Metro Bank case study](#) in Appendix 9.2.

²⁰ Atom will access payment systems indirectly via an indirect access provider, at least initially.

27. Finally, Starling and CivilisedBank noted no concerns with respect to the authorisation process and commented that the reforms had improved the process.

Capital requirements

28. We set out below the additional evidence to support our analysis on capital regulation. We do not consider separately the rules on liquidity requirements, which specify how much cash a bank has to hold in order to make sure that it can meet its short-term obligations.²¹

The capital regime framework

29. Table 2 below summarises the components of capital of the risk-based framework and their values as well as the designated body responsible for setting these.

²¹ See Appendix 3.1 and BCBS, January 2013, [Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools](#).

Table 2: Summary of capital requirements

	<i>Total capital requirement</i>	<i>Of which common equity Tier 1</i>	<i>Set by</i>	<i>Applicable to</i>
Pillar I (minimum capital requirements)	8%	4.5%	EU	All banks
Pillar II				
Pillar IIA	Firm specific	Same composition as Pillar I requirements	PRA	All banks based on PRA assessment
Pillar IIB (PRA buffer)	Firm specific	Only CET1	PRA	All banks are subject to an assessment by the PRA, but the PRA only sets buffers if it judges that existing buffers under the CRD IV are inadequate
Capital buffers				
Capital conservation buffer	2.5%	Only CET1	EU	All banks
Countercyclical buffer	0–2.5% Currently 0	Only CET1	BoE (FPC) discretion	All banks
Systemic buffers				
Globally systemic banks	1–2.5%	Only CET1	Financial Stability Board	HSBC Barclays RBSG (list updated annually)
Domestically systemic banks: ring-fenced banks and large building societies with >£25bn core deposits	To be set in 2016 following a consultation by the BoE FPC: between 0% and 3%	Only CET1	BoE FPC	The following banks are likely to be subject to systemic risk buffers when it is implemented in 2019: HSBC Nationwide Building Society LBG Santander RBS Barclays

Source: PRA data and CMA analysis.

30. As a complement to the above components of the capital regime, the leverage ratio requires all banks to hold a minimum amount of capital to their total assets (regardless of the riskiness of those assets). The main intention of the leverage ratio is to act as a backstop to the main risk weighted framework by acting as a constraint on banks that hold too little capital because they have a large concentration of low risk assets on their balance sheet. The leverage ratio therefore is intended to mitigate against the possibility of banks' underestimating the likelihood of suffering credit losses on their assets and therefore posing a systemic risk to the economy. For example, banks' internal models may predict that residential mortgages are low risk (due to historical data or past performance on those assets) and therefore hold low levels of capital against these. In the event that an unforeseen external shock to the housing market caused large losses on residential mortgages, the bank (under the risk weighted asset framework) may have insufficient capital. The

leverage ratio aims to mitigate this risk by requiring the bank to hold a proportion of their assets in capital regardless of the riskiness of these assets.

31. Currently all UK banks are required to report and disclose their leverage ratios under CRD IV. In addition, there is a supervisory expectation that the eight largest domestic banks (HSBCG, LBG, RBSG, Barclays, Santander, Nationwide, Standard Chartered and Co-op Bank) have a minimum leverage ratio requirement of 3%. The FPC has directed the PRA to implement a UK leverage ratio framework which from 1 January 2016 imposes a 3% minimum, with a systemic leverage ratio buffer and a countercyclical leverage ratio buffer applied on top of this minimum. Initially this requirement will only apply to banks with greater than £50 billion in retail deposits, which is expected to capture HSBCG, LBG, RBSG, Barclays, Santander, Nationwide and Standard Chartered. The FPC will review its framework in 2017 with a view to extending it to all PRA-regulated banks, building societies and investment firms from 2018.
32. At the current rate, the leverage ratio imposes an effective average risk weight floor of 35% on banks. This is broadly equivalent to the risk weight for residential mortgages under the SA. This means that if an IRB bank sought to hold large concentrations of low risk assets to benefit from the lower capital requirements under the IRB approach for such assets, the leverage ratio would effectively eliminate the advantage. This in turn would provide incentives to an IRB bank to reduce the amount of low risk assets they hold to maintain their margins. In this respect the leverage ratio acts as a floor or a lower bound on the amount of capital banks that have a lower-than-average risk weight are required to hold. [✂] are constrained by the leverage ratio.
33. However, a well-diversified bank may still have an advantage in assets where it has a lower risk weight than under the SA. The leverage ratio only requires banks to have an average risk weight of 35% across all its assets. It therefore does not reduce the differential between the SA and the IRB approach; rather, it limits IRB banks' ability to take advantage of this differential.

Requirements for being IRB approved

34. There are significant requirements to becoming IRB approved. This is because regulators need to have sufficient confidence that banks have the capability to appropriately model their risk weights for determining capital ratios and that the models used are suitably robust.
35. Banks wishing to adopt and use the IRB approach have to make large upfront investments, such as developing an advanced risk model, investing in IT infrastructure to support data collection, and hiring more experienced staff

such as risk specialists and consultants to provide modelling expertise. There are also ongoing costs associated with maintaining risk models and complying with relevant regulations. LGB submitted that its annual running costs of being IRB approved were approximately £[25-50] million.²²

36. Participants that have recently undergone the IRB approval process or are in the process of becoming IRB approved, estimate the total cost of the IRB approval process between £[£]. For example, Principality Building Society commenced development of an IRB framework in 2006, submitting a formal IRB Waiver Application in July 2012 which was approved in August 2013. It estimated the total costs to be £[£]. However Principality Building Society also noted that it is extremely difficult to quantify direct costs, as these were included within a broader, budgeted, investment programme which reflected the firm's desire to ensure the continuous development and improvement of its risk management capabilities. Yorkshire Building Society, on the other hand, estimated the cost to be [£]. This includes the cost of hiring external contractors, IT, model development and testing. Both Principality Building Society and Yorkshire Building Society reported that it can take a significant amount of time to develop the required infrastructure and risk capabilities needed for IRB approval and subsequently apply to be authorised to use their own internal risk-based system.
37. However, a significant impediment to being able to adopt advanced modelling is data. Banks need to hold significant data on their lending in order to be able to internally model credit risk. Specifically, banks have to hold a minimum of between three to five years' worth of detailed lending data on the relevant asset class to be IRB approved. In practice, more data may be required to ensure that estimates are sufficiently robust and take account of different points of the economic cycle. For example, data from an economic downturn is required to estimate loss given default and exposure at default, and sufficient data is required to estimate a long-run average for probability of default. It is also expected that, following the implementation of technical standards set by the EBA,²³ this data requirement will increase to a minimum of five years. While there is an option to use pooled data from external sources, it would be necessary to demonstrate that such data is representative of the bank's asset portfolio and risk. The PRA and several banks have indicated that this is not a straightforward exercise. Santander

²² [LGB response to addendum to provisional findings](#), paragraph 24.

²³ The European Banking Authority (EBA) is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking. The EBA is consulting on the regulatory technical standards on assessment methodology for IRB approaches. For further information please refer to the EBA website: [Regulatory Technical Standards on assessment methodology for IRB approach](#).

has explained that having to acquire data to supplement its own data would mean that its risk weights would be higher than if it only used its own data.

38. In addition, banks have to demonstrate that they have been using their IRB models internally for at least three years before they apply for IRB approval.

IRB approved banks

39. Table 3 below lists all the banks that are currently IRB approved in the UK. As can be seen most large banks are IRB approved for all asset classes including mortgages and SME lending. The only exception is Santander, which is not IRB approved for SME lending as it does not have the requisite data. The table below also shows that there are a number of smaller banks that are IRB approved for mortgages, including Nationwide, TSB, Co-op Bank, Virgin Money and Principality Building Society.

Table 3: UK IRB approved banks

<i>UK mortgages</i>	<i>UK credit cards</i>	<i>UK retail SMEs</i>	<i>UK corporates</i>	<i>International retail SMEs</i>
Barclays	Barclays	Barclays	Barclays (advanced)	Barclays
Co-op Bank	Co-op Bank	HSBCG	Co-op Bank (foundation)	HSBC
Coventry BS	HSBCG	LBG	HSBCG (advanced)	RBSG
HSBCG	LBG	RBSG	LBG (foundation)	Standard Chartered
LBG	Nationwide		Nationwide (foundation)	
Nationwide	RBSG		RBSG (advanced)	
Principality BS	TSB		Santander (foundation)	
RBSG				
Santander				
TSB				
Virgin Money				

Source: PRA.

Notes:

1. SMEs are either classed as retail or corporate. In order to be classed as retail an exposure to an SME must not exceed €1 million, must be treated consistently in its risk management over time, must not be managed just as individually as those classed as corporates and must represent one of a significant number of similarly managed exposures.

2. Foundation IRB is a version of IRB that was introduced in 2007 for non-retail exposures. In the advanced IRB, the firm estimates probabilities of default, loss-given-default, exposure at default, and the maturity of the loan. In the foundation IRB approach the firm estimates only the probabilities of default.

3. Ulster Bank is IRB approved as part of RBSG. AIB, Bank of Ireland and Danske are on the SA for mortgages.

Comparison of risk weights under the SA and IRB approach

40. When calculating capital ratios, assets are weighted according to their associated risk to ensure banks with riskier assets hold more capital against these compared with banks that hold less risky assets. Table 4 below compares risk weights for credit risk under the two approaches. It is based on analysis conducted by the PRA. The average risk weights of banks on the IRB approach have been weighted by their exposure amount. As can be seen

from the table below, risk weights under the SA are higher for residential mortgages and SME lending. Conversely risk weights for higher risk assets, such as credit cards and commercial real estate are lower for banks on the SA.

Table 4: Comparison of risk weights under the SA and IRB approach

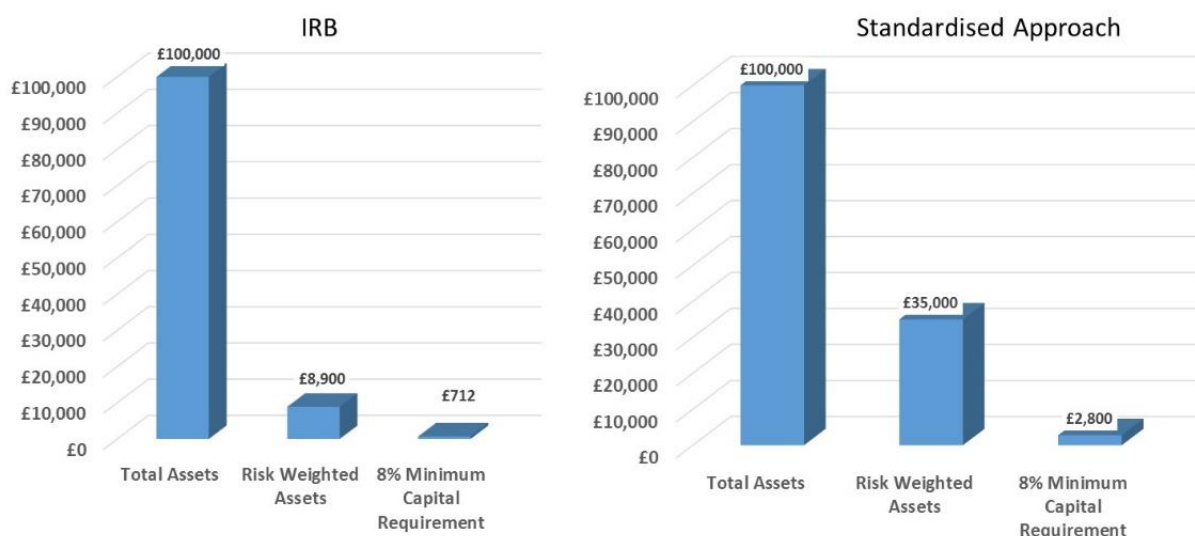
	SA SA risk weights	IRB Exposure weighted average risk weight	Low range risk weights	% Upper range risk weights
Mortgages (prime)				
0%<=LTV<50%	35	3.3	2.8	3.8
50%<=LTV<60%	35	6.0	5.1	7.0
60%<=LTV<70%	35	8.9	7.5	10.2
70%<=LTV<80%	35	12.7	10.8	14.6
80%<=LTV<90%	36	18.4	15.6	21.1
90%<=LTV<100%	43	31.4	29.9	36.1
>=100%		53.9	45.8	62.0
Mortgages (buy to let)				
0%<=LTV<50%	35	4.1	3.5	4.7
50%<=LTV<60%	35	9.7	8.2	11.1
60%<=LTV<70%	35	12.5	10.6	14.4
70%<=LTV<80%	35	17.5	14.9	20.2
80%<=LTV<90%	36	32.0	27.2	36.8
90%<=LTV<100%	43	43.1	36.7	49.6
>=100%				
Credit cards revolving retail expo				
UK credit cards	75	107	91	123
International credit cards	75	168	143	193
Corporate				
Large corporates		54.1	46	62
Mid corporates		79	67	91
SMEs	100	77.7	66.1	89.4
Commercial real estate	100	125	100	150

Source: PRA.

Note: LTV = loan-to-value ratio.

41. To illustrate the impact of the different risk weight on banks' capital holdings we can consider pillar 1 of the capital requirements regime, which sets a uniform minimum capital requirement of 8% of risk weighted assets. On that basis, a bank on the SA seeking to provide a retail customer with a £100,000 residential mortgage with a LTV of 60 to 70% would have to hold approximately £2,800 worth of capital compared with £712 for a bank on the IRB approach. This is illustrated in Figure 4 below.

Figure 4: Stylised example of pillar 1 capital requirements under the SA and IRB approach for £100,000 residential mortgage



Source: CMA calculation.

42. However, for some other types of assets the reverse is true. For example, risk weights for credit card lending are 107%, on average, for banks under the IRB approach and 75% for a bank on the SA.
43. The results above are broadly consistent with information we received from Principality Building Society, which was granted IRB approval in 2013. Principality Building Society, which had total assets of £7.3 billion in 2014, of which mortgage lending (including buy-to-let) made up around two-thirds (£4.8 billion), calculated that its minimum capital requirements in 2013 under the SA were just under one-third lower under the IRB approach than the SA, at £216.3 million compared with £154.1 million.²⁴
44. In Table 5 below, we calculate an illustrative cost of funds for a £100,000 residential mortgage using risk weights under the SA and the average IRB risk weights for different LTV bands (see Table 4 above), again taking into account only pillar 1 of the capital requirements regime. For this illustration, we assume that the required return on equity is 12%²⁵ and the average interest the bank pays on its debt is 2%. In this illustration, in order to demonstrate the impact of risk weights on the cost of funds, we allow only risk

²⁴ It should be noted that the figure on the benefits of moving to IRB only relates to Principality Building Society's retail mortgages (including buy-to-let) and commercial business. Principality Building Society's second charge portfolio had not yet migrated onto the IRB approach at the time of the calculations. This means the figure (£154.1 million) included some assets on the SA.

²⁵ Given the performance of banking shares in recent years – cf. for example [MSCI Europe Financials Index](#) – it is unclear what the best estimate of the required return on equity for banks is. However, based on the data provided by MSCI we consider that 12% is a reasonable estimate of the average total return on equity for banks in recent years. See Section 9 on parties views on the assumptions used in this analysis and Appendix 9.4 on the relationship between capital requirements and costs of funds.

weights to vary. However, other factors which affect mortgage prices also vary between IRB and SA banks (for example, the cost of equity and cost of debt).²⁶

45. As Table 5 shows, the applicable risk weight determines the share of the £100,000 loan that is financed through debt and the share that is financed through equity. Since debt is cheaper than equity – in this example we have assumed the difference to be 10% – using more debt to finance the loan results in a lower cost of funds. The larger the difference between the cost of equity and the cost of debt, the greater the impact of having a higher risk weight. While the calculation is only illustrative, it shows that a firm that switches from the SA to the IRB approach could reduce its cost of funds by around 10 to 20 basis points. However, we note that comparing the current gap in risk weights between SA and IRB banks may not provide an accurate estimate of the potential reduction in the cost of funds from adopting the IRB approach, as a bank’s credit risk for the same LTV level may lead it to having a lower or higher risk weight than the current average for IRB banks (which has been used in this example).

Table 5: Illustrative example of the calculation of the cost of funds associated with a £100,000 mortgage

	SA (LTV<80%)	IRB (LTV<50%)	IRB (60%≤LTV<70%)	IRB (75%≤LTV<80%)	Calculation
Amount loaned out (£)	100,000	100,000	100,000	100,000	(1)
Risk weight (%)	35	5	11	17	(2)
Risk-weighted assets (£)	35,000	5,000	11,000	17,000	(3) = (1) * (2)
Pillar I capital adequacy ratio (%)	8	8	8	8	(4)
Capital requirement (£)	2,800	400	880	1,360	(5) = (3) * (4)
Debt (£)	97,200	99,600	99,120	98,640	(6) = (1) – (5)
Required return on equity (%)	12	12	12	12	(7)
Interest on debt (%)	2	2	2	2	(8)
Cost of equity (£)	336	48	106	163	(9) = (5) * (7)
Cost of debt (£)	1,944	1,992	1,982	1,973	(10) = (6) * (8)
Cost of funds (£)	2,280	2,040	2,088	2,136	(11) = (9) + (10)
Cost of funds (%)	2.28	2.04	2.09	2.14	(12) = (11) / (1)

Source: CMA calculation.

Note: This calculation is entirely on a nominal, pre-tax basis, and disregards capital requirements other than those under Pillar I of the Basel framework.

Comparison of capital for banks on IRB and the SA

46. In order to help us assess the potential impacts of these differences, we prepared stylised examples showing the total capital banks would have to hold under the SA and the IRB approach when issuing a £100,000 SME loan or residential mortgage. This analysis included not only pillar 1 of the capital

²⁶ IRB banks tend to be larger and more diversified than banks using the SA, which could lead to lower costs of debt and equity.

requirements regime, as in the illustrative examples shown above, but also the rest of the regime.

47. After all, whilst we recognise the different objectives of particular aspects of the regime for example additional capital buffers for systemically important banks, we need to examine the differential cost created by the capital regime as a whole as this will determine the nature of the advantage/disadvantage that the regime confers on different banks regardless of the underlying rationales for each aspect of the regime. Moreover, none of the requirements work in isolation, complementing each other by addressing different limitations of the other and their impact on a bank's competitive position will be affected by its total capital requirements reflecting the portfolio of its assets and how it allocates capital and prices its products accordingly.
48. We included in our analysis the following components (see Table 5 above) of the capital framework:
 - (a) Pillar I requirements which currently require banks to maintain a minimum ratio of 8% capital to their total risk-weighted assets;
 - (b) Pillar II requirements which are firm specific and set by the PRA;²⁷
 - (c) Additional capital buffers including the capital conservation buffer ("CCB"), set at 2.5% for all banks and the countercyclical buffer ("CCyB"). While the countercyclical buffer was reduced from 0.5% to 0% on 5 July, our calculations assume a CCyB of 1.25%, representing an average value that the CCyB might take over the business cycle.
 - (d) Additional buffers for global systemically important banks ("GSIB"), set at [X] % for Barclays, [X] % for HSBCG and [X] % for RBSG.
49. We then calculated the bank's capital requirement as the sum of its capital requirements under pillar 1 and pillar 2A, plus the higher of its pillar 2B-requirement and the sum of the CCB, the CCyB and any GSIB buffer.
50. Note that we did not include in our analysis:
 - (a) Additional buffers for domestic systemically important banks. This is because the FPC has yet to designate which banks will be required to hold these buffers and their values. Additional buffers for domestic systemically important banks will be implemented in 2019. It is expected

²⁷ We have used in our analysis values for Pillar 2 for 2015 supplied by the PRA.

that Santander, LBG and Nationwide will all be subject to an additional buffer for domestically systemically important banks.

- (b) Capital conservation buffer for new banks. Currently the PRA allow newly authorised banks more time to build up their capital conservation buffer.²⁸ We have not included this in our example because none of the banks we considered in our example are using this provision.
- (c) The leverage ratio. For some banks with low risk weights or relatively low-risk loans portfolios, the determinant of their capital requirement may well be the leverage ratio rather than the components of the regime set out above.

51. These exclusions mean that the results may overestimate the difference between the IRB approach and the SA. Moreover, we note that the exact results are contingent on assumptions that could be varied. For those reasons, we consider that it would not be appropriate to place significant weight on the exact results using this particular set of assumptions. Rather, these stylised examples are intended to illustrate the broad trends that emerged from our analysis of the regime.
52. Table 6 below shows the results for a £100,000 SME loan. This indicates that, once the main components of the capital risk based framework and the particular circumstances of individual SA banks are taken into account,²⁹ the differential between the SA and IRB approach for SME lending is virtually eliminated. A large globally systemically important bank on IRB will be required to hold between £[X] and £[X] worth of capital, compared with between £[X] and £[X] for banks on the SA.

Table 6: Capital requirements under the SA and IRB approach for £100,000 SME loan – a stylised example

<i>Bank</i>	<i>SME loans</i>
Barclays	[X]
HSBC	[X]
LBG	[X]
RBS	[X]
Clydesdale	[X]
Metro	[X]
Santander	[X]
TSB	[X]

Source: CMA calculations based on PRA data.

53. For residential mortgages (see Table 7 below) an advantage still remains for banks on the IRB approach even after accounting for Pillar II and capital

²⁸ For further information please see [BoE website](#).

²⁹ For example, [X]

buffers for globally systemically important banks. This varies from approximately £4,500 for residential mortgages with a LTV less than 50% to about £2,000 for residential mortgages of between 80% and 90% LTV.

Table 7: Capital requirements under the SA and IRB approach for £100,000 residential mortgage – a stylised example

	£					
	0%<=LTV< 50%	50%<=LTV <60%	60%<=LTV <70%	70%<=LTV <80%	80%<=LTV <90%	90%<=LTV <100%
Barclays	[X]	[X]	[X]	[X]	[X]	[X]
HSBC	[X]	[X]	[X]	[X]	[X]	[X]
RBS	[X]	[X]	[X]	[X]	[X]	[X]
LBG	[X]	[X]	[X]	[X]	[X]	[X]
Nationwide	[X]	[X]	[X]	[X]	[X]	[X]
Santander	[X]	[X]	[X]	[X]	[X]	[X]
TSB	[X]	[X]	[X]	[X]	[X]	[X]
Virgin	[X]	[X]	[X]	[X]	[X]	[X]
Average IRB banks	576	1,047	1,554	2,217	3,212	5,481
Aldermore	[X]	[X]	[X]	[X]	[X]	[X]
Clydesdale	[X]	[X]	[X]	[X]	[X]	[X]
Metro	[X]	[X]	[X]	[X]	[X]	[X]
Paragon	[X]	[X]	[X]	[X]	[X]	[X]
Shawbrook	[X]	[X]	[X]	[X]	[X]	[X]
Tesco	[X]	[X]	[X]	[X]	[X]	[X]
Average Standardised Approach	5,203	5,203	5,203	5,203	5,352	6,393
Difference	4,627	4,156	3,650	2,986	2,140	911

Source: CMA calculations based on PRA data.

The impact of risk weights on outcomes in the mortgage markets

54. We examined three indicators of a potential disadvantage from higher capital requirements in the mortgage markets: mortgage prices; mortgage portfolios; and mortgage balances

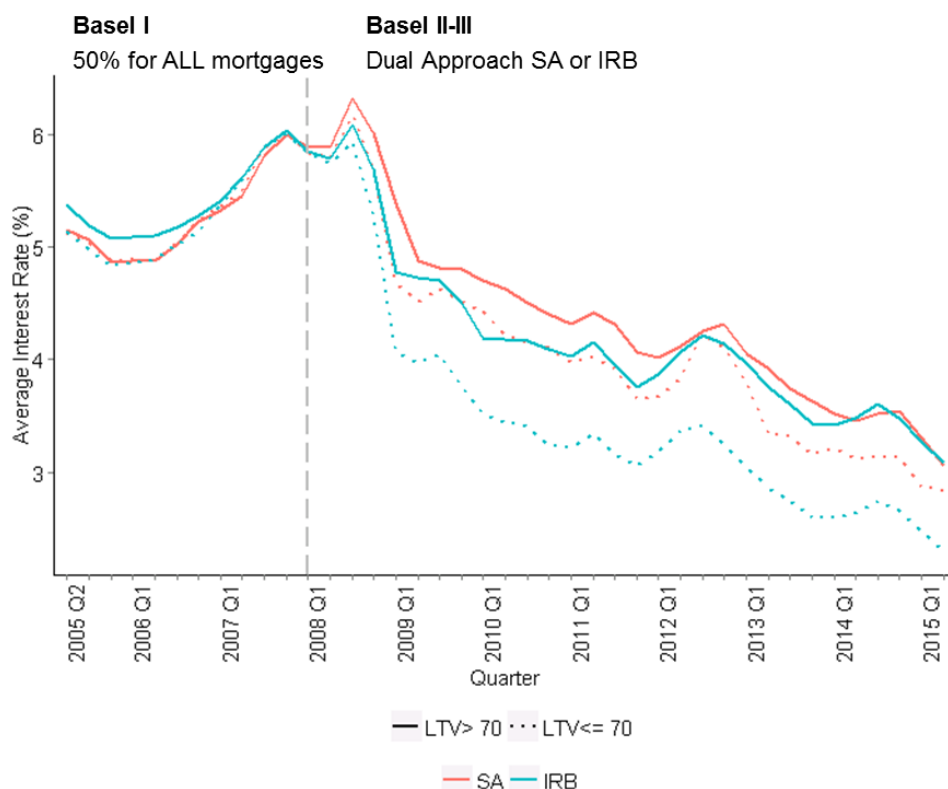
Mortgage prices

55. Average interest rates covering the 2005 to 2015 period for mortgages are shown in Figure 5 below for SA and IRB banks respectively. The dual SA-IRB approach to calculating credit risk weights came into effect in January 2008. Prior to this, the capital requirements regime applied risk weights of 50% to all mortgages issued by all banks.³⁰ Figure 5 below shows that average interest rates have declined for all banks across all mortgages since 2008, but declined most for IRB banks on lower risk mortgages (that is, LTV less than or equal to 70%). The effect of this is that the average price gap between IRB

³⁰ With the exception of four banks that moved to IRB during 2007.

and SA banks for lower LTV mortgages is now much larger than for higher LTV mortgages.

Figure 5: Average mortgage interest rates since 2005 for SA and IRB banks



Source: PRA.

Note: Pre-2008 SA and IRB definition based on subsequent use, since these were not in use prior to 2008.

56. While the change in the capital requirements regime from Basel I to II–III occurred at the start of 2008, it cannot be presumed that this explains the decline in average interest rates. Factors other than risk weights are likely to have had a substantial effect on firms’ pricing of mortgages in this period, and some such factors are likely to have been materially affected by the onset of the financial crisis in 2008, and will have affected banks very differently.³¹ For example, the financial crisis had a substantial impact on funding costs: funding costs will have been impacted by cuts to the BoE base rate and increased spreads on wholesale funding. Funding costs also vary across banks, and IRB banks tend to be larger and, therefore, as in many sectors, tend to have cheaper access to wholesale funding, reflecting relative differences in terms of perceived riskiness and reliance on this source of funding.

³¹ These factors are likely to include: required capital ratios; ‘normal’ return on unit capital; taxation; operational costs; business model/pricing strategy; LTV preferences; market power; interest rate risk; and credit risk.

57. The financial crisis also witnessed an industry-wide trend for increases in the relative price of higher LTV mortgages compared with lower LTV mortgages. Before the crisis, average interest rates on lower and higher LTV mortgages were similar, suggesting that risk did not strongly affect pricing. Increases in higher LTV prices will therefore to some extent reflect the more accurate pricing of risk after the financial crisis.
58. To precisely estimate the impact of risk weights on mortgage prices and to better control for other factors that could affect these prices, it is necessary to use econometric techniques.³²
59. The PRA has started a programme of econometric analysis. Below we discuss this analysis and provide a high-level overview of its provisional results. We summarise and comment below on the results of the PRA's preliminary analysis. Annex A contains details on the methodology adopted by the PRA in its econometric analysis together with the detailed results. In reporting the results of the PRA's analysis below we note that these findings are provisional, as this is work in progress which the PRA is seeking to refine to obtain more accurate and robust results.
60. The PRA's analysis is based on an extensive data set of 13 million owner-occupied residential mortgage loans that have been originated in the UK since Q2 2005.³³ From this data set the PRA dropped observations that could not be used for this study, such as: (a) loans provided by specialist lenders, which are not subject to the same system of prudential regulation; (b) loans where the data is incomplete; and (c) loans that are outliers (such as having an interest rate of more than 10%). As a result, its analyses were run on data sets containing 6.6 million and 7.4 million data points, depending on whether the analysis required data on historical risk weights, which were not available for some of the loans in the original data set.³⁴
61. For each loan, this data contains information on the mortgage interest rate at origination, the issuing bank and the risk weight on mortgages with the relevant LTV ratio that it held in the year in question.³⁵ It also contains data on a number of other factors that could affect mortgage prices, including the date the loan was issued, the LTV ratio, the loan-to-income ratio, the rate type (eg

³² For other factors that could affect prices, all of the models discussed below include controls for borrower type, interest rate type and loan-to-income ratio.

³³ Note that the data set excludes data relating to [X], which was not available.

³⁴ One large lender ([X]) in the pre-2008 period was excluded from the sample due to concerns related to the reported data.

³⁵ That is, the PRA assumed that, for a particular LTV band, the new loans the bank originated in a given year were sufficiently similar to the loans it already held – in terms of the other factors that determine an IRB risk weight – that the risk weight on all outstanding balances could be used as a proxy for the risk weight on newly originated loans.

tracker, capped) and the borrower type (eg first-time buyer, re-mortgager). However, the dataset does not include data on fees, which may be an important element of pricing, and it does not capture changes in interest rates after origination (eg at the end of a fixed-rate period).

62. Using this data the PRA has explored three different econometric approaches:

- (a) The **regime change model** uses the change in the regulatory regime in 2008 as a natural experiment to test how the change in risk weights affected banks' mortgage pricing. It considers the difference in prices between IRB and SA banks, comparing pre- and post-2008, and between high and low LTVs (a 'triple difference' approach).
- (b) The **IRB switch model** uses a more sophisticated statistical approach to control for other factors that may affect prices (a 'fixed effects' approach). It also reflects the specific date on which relevant individual banks adopted the IRB approach (as this does not necessarily coincide with the regime change at the start of 2008).
- (c) The **historical risk weights model** also applies a fixed effects approach but rather than simply considering whether each bank used the SA or the IRB approach, instead exploits more granular data on their specific risk weights as the main explanatory variable of interest.

63. We discuss the preliminary results from each model in turn below.

Regime change model

64. The regime change model is a 'triple difference' model, as it proceeds in three steps:

- (a) It examines the current differences in mortgage prices between IRB and SA banks. However, in isolation this analysis would suffer from the limitation that prices are likely to vary across these two types of bank because of factors other than risk weights.³⁶
- (b) To try to control for these other factors the model compares the price difference between IRB and SA banks to that which existed before the change in regime in 2008. Any pre-2008 difference (when there was no variation in risk weights) would tend to capture the other factors that vary

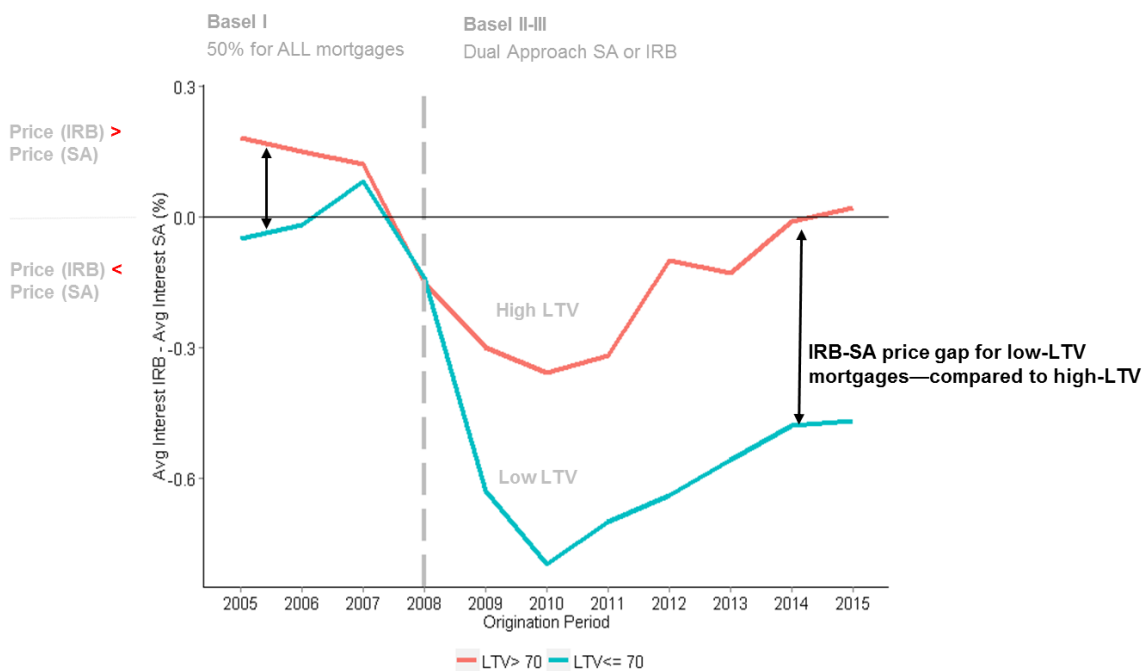
³⁶ For example, banks using the IRB approach tend to be larger and therefore have cheaper access to wholesale funding, which may result in them offering lower prices unrelated to their approach to calculating risk weights.

between banks, so that any additional difference in current prices may reflect the impact of the banks varying risk weights post January 2008.

- (c) It examines how this price difference has evolved over time for high and low LTV mortgages separately. If risk weights do substantially affect pricing, we would not only expect to observe a general increase in the price difference between IRB and SA banks, but would in particular expect this difference to also become larger in the case of low LTV loans, where the reduction in risk weights for IRB banks was greatest.

65. Figure 6 below presents this graphically. The vertical axis is the mortgage pricing gap between IRB and SA banks, and this is shown through time for low and high LTV mortgages. If risk weights do impact mortgage pricing then we would expect the gap between low and high LTV to increase after 2008 (to reflect that the difference in risk weights between IRB and SA banks is largest for low LTV loans).

Figure 6: Mortgage price gap between IRB and standard approach banks by LTV band



Source: PRA.

66. The results show that differences in the approach to calculating risk weights (IRB vs SA) have an economically and statistically significant effect on mortgage pricing, with an impact on low LTV loans relative to high LTV loans (ie increase in the gap between the red and blue lines) of the order of around 28 to 46 basis points (the 'relative effect' on different types of loan). The PRA

performed a number of sensitivity checks on the model.³⁷ It found a generally consistent picture across most (though not all) of its various sensitivities.

67. While controlling for additional factors that affect banks' mortgage prices, this model does not control for all factors in particular for credit risk. The model cannot completely separate the effect of risk weights and credit risk, and to this extent will overestimate the effect of risk weights on prices. On the other hand, the use of securitisation by banks might mean that the risk weights for residential mortgages are less relevant to pricing decisions for mortgages that are expected to be securitised, because the mortgage is held on the bank's balance sheet for a limited period of time.
68. While the intuitive nature of this model is appealing, a weakness of the model is that this 'triple difference' approach only controls quite crudely for other explanatory factors that could be driving differences in mortgage prices. We cannot rule out other possible explanations besides differences in risk weights for these observed pricing patterns.

IRB switch model

69. The IRB switch model is a refinement of the above model. It uses a 'fixed effects' approach to more effectively control for the unrelated variation in prices across banks, time, and LTV band of the loan.³⁸ One advantage that the IRB switch model offers over the regime change model is that it uses the specific date at which each individual bank adopted the IRB approach.³⁹
70. The 'fixed effects' approach serves to control for other factors that can affect pricing, although this has the potential to absorb some of the variation in prices accounted for by the differences in risk weights. As with the model above, however, this model does not fully control for credit risk and does not take into account securitisation.⁴⁰
71. The results of this analysis are broadly consistent across many sensitivity tests, and suggest an economically and statistically significant effect of risk

³⁷ These include what LTV threshold is used to define 'low' and 'high' LTV loans, and the data set that was used. Using the smaller data set described as 'Sample B' in Appendix 2, the estimate of the relative effect is 42 to 60 basis points.

³⁸ Specifically, these include fixed effects by bank (to control for individual banks' pricing), time (to control for general price changes over time), LTV band (to control for variation in prices by LTV band), bank time (to control for changes in relative pricing of different banks over time), LTV-time (to control for changes in relative pricing of different LTV bands over time) and bank LTV (to control for variation in banks' relative prices by LTV band). This model can be seen as a more general version of the regime change model, in that a triple difference model can be obtained by running a restricted version of the fixed-effects model.

³⁹ However, in practice we understand that most banks that adopted the IRB approach did so fairly quickly after the change in regulation.

⁴⁰ By banks other than [X], which for the IRB switch model is eliminated from the data set.

weights on mortgage pricing. These estimates are, however, of substantially smaller magnitude than those found under the regime change model. Specifically, where the regime change model found an impact on low LTV loans relative to high LTV loans (ie increase in the gap between the red and blue lines in Figure 2) of around 28 to 46 basis points, the IRB switch model estimates a relative effect of around 11 to 17 basis points.⁴¹ Moreover, there are some sensitivities of this analysis that suggest little or no substantial relationship between the approach used to calculating risk weight (IRB vs SA) and mortgage prices.

Historical risk weights model

72. The PRA's third model goes beyond a focus on whether a bank used the SA or IRB approach to risk weights, and examines the relationship between mortgage prices and the actual risk weights that the issuing bank had at the point in time that the loan was issued.⁴² In other respects this model is similar to the IRB switch model, since it also uses a fixed-effects approach to control for other potential explanations for variations in prices. In common with the previous models, however, the model does not fully control for credit risk and does not take into account securitisation.
73. The advantages of this model are that by exploiting the granular data on the actual risk weights of banks it can potentially obtain more refined estimates of their effect. This model does, however, suffer from the limitation that the data on historical risk weights does not appear to be entirely reliable, in contrast to the IRB switch model which uses more robust data on the date of adoption of the IRB approach.⁴³
74. The model provides a direct estimate of the impact of the use of risk weights (and therefore the SA) on mortgage prices (the 'absolute effect'). This is in contrast to the previous models, which only provide an estimate of the relative effect of the SA on low LTV mortgages versus high LTV mortgages. The output of this model is a direct estimate of the effect of a one percentage point increase in risk weights on mortgage prices. To illustrate the implied increase in mortgage prices for low LTVs caused by the use of the SA, we therefore multiply this figure by 30 to reflect the fact that there is approximately a 30 percentage point difference in risk weights between the SA and IRB

⁴¹ Using the smaller 'Sample B' data set, the estimated relative effect is 8 to 19 basis points.

⁴² Note that the risk weight data is not available on an individual loan level, rather this is available for each LTV band of 5 or 10 percentage points for each bank in each period.

⁴³ The information obtained by the CMA and PRA for this exercise differs from that obtained by the PRA in the past. This model also has other potential limitations, including relating to changes in firms' business models over time in particular since the financial crisis, the impact of differential interest rate risk on banks, the treatment of [X], self-selection of firms adopting the IRB approach, and the impact of other aspects of prudential regulation.

approach for mortgages with LTV below 50% (see Table 7 above. Note that this assumes that the bank switching to IRB has a similar credit risk in this LTV band to the average bank already on IRB). For mortgages with a LTV above 50% the difference in risk weights is (sometimes substantially) smaller, so the implied increase in mortgage prices would be lower.

75. Using data for 2009 to 2015, the model finds that use of the SA results in a bank charging mortgage prices that are 42 basis points higher for low LTV loans than if it used the IRB approach – a difference that is statistically significant and that accounts for approximately one-quarter of the variation in prices in the market.⁴⁴ We consider that this estimate of the absolute effect is the most relevant output of the historical risk weights model to focus on, as it represents the full impact on the price of low LTV loans of using the SA rather than the IRB approach. However, we also note that if this is converted into a relative effect, so that it is comparable with the output of the previous two models, it implies an impact of 15 to 16 basis points on low LTV loans relative to high LTV loans – ie broadly equivalent to the findings of the IRB switch model.⁴⁵
76. If the model is run on the longer period of data from 2005 to 2015 then the estimate of the absolute effect shrinks substantially from 42 basis points to only 3 basis points, equivalent to an impact of only 1 basis point on low LTV loans relative to high LTV loans, ie much smaller than the other models.⁴⁶ We consider that there are good reasons for focusing on the results using the data from 2009 to 2015, as there may have been a structural break in how the industry operated around 2008 to 2009 following the financial crisis and the introduction of the new regulatory regime, for example in terms of how credit risk is priced and the importance of risk weights. This means that data from 2005 to 2008 would not be informative of the current relationship between risk weights and pricing.⁴⁷

⁴⁴ The direct output of the model is that a one percentage point increase in risk weights results in an increase in mortgage prices of 1.386 basis points. As set out above, we estimate the impact of the use of the SA as $30 \times 1.386 = 42$ basis points.

⁴⁵ Note that this is based on running the IRB switch model for the full period of 2005 to 2015 and running the historical risk weights model for 2009 to 2015 only. This is because the IRB switch model – like the regime change model – cannot be run in a meaningful way unless there are enough observations that predate the switch to IRB. Note also that, because of their varying data requirements, the different models use slightly different samples.

⁴⁶ Note, however, that it is not statistically significant using clustered standard errors. The direct output of the model is that a one percentage point increase in risk weights results in an increase in mortgage prices of 0.116 basis points. As set out above, we estimate the impact of the use of the standard approach as $30 \times 0.116 = 3$ basis points.

⁴⁷ The new regulatory regime could have affected the importance of risk weights for pricing, and in practice the 50% risk weight may not have applied in full to many loans pre-2008 because of securitisation.

Mortgage balances

77. The proportion of assets invested in mortgages is informative of the importance of mortgages as an investment option to a bank's business.
78. We based our assessment on data we received from banks on their mortgage portfolios and total UK retail banking assets for each year between 2011 and 2014. Where possible this was requested on an average and period-end basis.⁴⁸ The submissions included nine IRB banks and six SA banks, with a further four banks⁴⁹ reporting no mortgage balances being held. While the approach used to allocate assets to retail banking will differ between banks and is a snapshot of a limited number of banks, we nevertheless consider that this assessment allows for a broad indication of the importance of mortgages to a bank's business.
79. In 2014 total mortgage balances for the nine IRB banks exceeded £800 billion, compared with £[X] billion for the six SA banks, almost £[X] billion of which relates to one SA bank. As noted above, several SA banks reported no mortgage balances.
80. For eight IRB banks, the mortgage share of total retail assets in 2014 was between approximately [60 and 100]%. The other IRB bank did not report retail assets to us.
81. Among the six SA mortgage banks, two banks had approximately [40–60]% of their UK retail banking assets held as mortgage assets; the other four SA banks had between [10 and 40]%.
82. Four further banks reported holding no mortgage balances. In addition, one additional bank told us that it intended to enter the retail banking market without investing in mortgages (Starling), and another bank intended to enter the retail banking market offering just current accounts and overdrafts (Mondo).⁵⁰

⁴⁸ We requested data for period end and average assets and average risk-weighted assets. Where average assets were not available, we have used period-end assets as an estimate.

⁴⁹ Atom Bank, Paragon, Secure Trust and Shawbrook.

⁵⁰ See [Mondo website](#) and article in *The Telegraph* (26 March 2016): 'Banking industry primed for a pocket-sized revolution'.

Table 8: Residential mortgages as a proportion of UK retail assets 2014

	<i>Mortgages as % UK retail assets</i>
<i>IRB banks</i>	
Barclays	[X]
Co-op Bank	[X]
HSBC	[X]
LBG	[X]
Nationwide	[X]
RBS	[X]
Santander	[X]
TSB	[X]
Virgin	[X]
<i>SA banks</i>	
Aldermore	[X]
Clydesdale	[X]
Danske	[X]
First Trust	[X]
Handelsbanken	[X]
Tesco	[X]

Source: CMA based on banks' data.

Definitions:

1. Residential mortgages: Comprising UK owner-occupied mortgages, ie residential mortgages secured on owner-occupied properties in the UK. This includes mortgages to first-time buyers, home movers and remortgages but excludes buy-to-let, second-charge and business mortgages and mortgages secured on properties outside the UK.

2. Retail banking includes personal lending and SME lending (turnover below £25 million) including mortgages and overdrafts, credit and debit cards and other payment facilities.

Mortgage portfolios

83. The data received from banks suggests that the mix of mortgage assets between LTV bands varied substantially between IRB banks, between SA banks and across the two types. Table 9 below sets out the results of our analysis. For example, in 2014, for the 80% and above LTV bands, IRB banks have shares of mortgage assets between [0 and 30]%, compared with SA banks with a range of [0–60]%.

Table 9: Mortgage asset mix across LTV bands – 2014

	LTV range			Balances* £bn
	0–50%	50–80%	80% +	
<i>IRB banks</i>				
Barclays	[X]	[X]	[X]	[X]
Co-op Bank†	[X]	[X]	[X]	[X]
HSBC†	[X]	[X]	[X]	[X]
LBG‡	[X]	[X]	[X]	[X]
Nationwide	[X]	[X]	[X]	[X]
RBS	[X]	[X]	[X]	[X]
Santander	[X]	[X]	[X]	[X]
TSB	[X]	[X]	[X]	[X]
Virgin	[X]	[X]	[X]	[X]
<i>SA banks</i>				
Aldermore	[X]	[X]	[X]	[X]
Clydesdale	[X]	[X]	[X]	[X]
Danske†	[X]	[X]	[X]	[X]
First Trust	[X]	[X]	[X]	[X]
Handelsbanken	[X]	[X]	[X]	[X]
Tesco	[X]	[X]	[X]	[X]

Source: CMA calculations.

* We requested data for period-end and average assets. Where average assets were not available, we have used period-end assets as an estimate.

† [X]

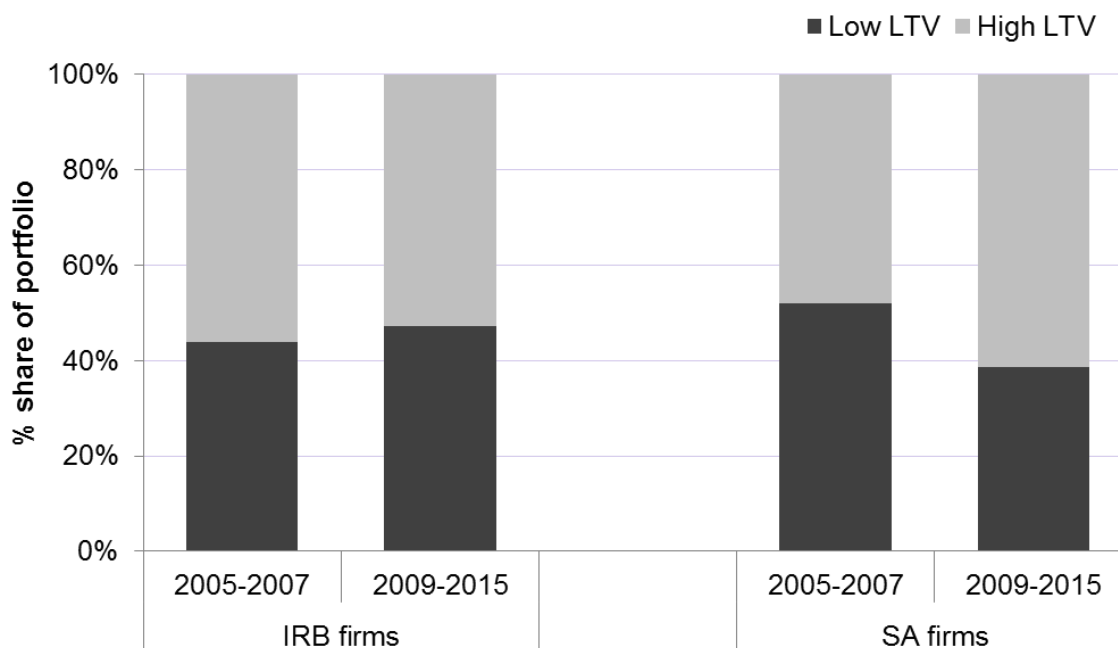
‡ [X]

84. We have also considered whether there has been a change in banks' mortgage portfolios stock since the introduction of the new capital requirements regime in 2008. The data we have suggests that over 2011 to 2014 IRB banks⁵¹ increased the percentage of their mortgage assets within the 0–50% LTV band by between 1% and 20%. Among SA banks that operated in 2011, [X] showed an increased proportion of assets within 0–50% LTV over the period 2011 to 2014, [X].

85. Analysis undertaken by the PRA on mortgage origination (rather than mortgage stock as above) set out in Figure 7 below, shows that SA banks have increased the proportion of high LTV loans (defined as loans with LTV above 70%) in their portfolio since 2007 by around 10%.

⁵¹ Considering those IRB banks which were operating since 2011.

Figure 7: Comparison of mortgage origination for IRB and SA firms for low (below 70%) and high (above 70%) LTVs since 2005



Source: PRA calculations using loan-level data from the FCA Product Sales Database.

Notes:

1. Analysis contains IRB and SA firms only, which account for around 94% of new origination value in the market currently. Buyer types include first-time buyers, home movers, and re-mortgagors, which together make up 96% of originations over the whole period.
2. The qualitative results are robust to thresholds between 50% and 90%.
3. This chart aggregates 'split loans', that is, multiple loans against the same property on the same date, into a single combined loan. 1.4% of the loans (after combination) had been split.

Future reforms

86. There are currently a number of developments being considered by the BCBS that may change the future approach to calculating risk weights:

- (a) **Revisions to the SA for credit risk⁵²** – In December 2014 and March 2015, the BCBS published consultations on proposed revisions to calculating risk weights for credit risk. The revisions are intended to address existing 'weaknesses' in the SA to credit risk, including lack of granularity and risk sensitivity, over-reliance on the information provided by credit rating agencies, out-of-date estimates of risk weights, and lack of comparability and misalignment with the risk weights under the IRB approach. The new proposals will seek to move from the current flat risk weights for mortgages to a more granular approach assigned by reference to the exposure's LTV ratio and debt service coverage.

⁵² BCBS (March 2015), *Revisions to the Standardised Approach for credit risk*, consultative document.

(b) **Review of capital risk floors**⁵³ – The Basel Committee is also consulting on the design of a standardised floor to be applied to all IRB-approved banks. This consultation forms part of broader work to reduce variation in capital ratios across banks.⁵⁴ The objective in introducing capital floors is to ensure that the level of capital across banks does not fall below a certain level. This should further reduce the difference between the SA and the IRB approach. However, the British Bankers' Association, for example, has indicated that this reform could negate the benefits from investing in IRB models sufficiently that some IRB-approved banks revert to the SA.⁵⁵

(c) **Review of the structure of the regulatory capital framework** – This is a strategic review considering the costs and benefits of determining regulatory capital that reduces or removes reliance on internal models, while still being adequately risk sensitive.

87. Although many of these are unlikely to be implemented in the near-term, they demonstrate that there is a recognition by the BCBS that there are imbalances in the existing framework. However, Secure Trust said that the proposed changes in particular to the standardised capital model published by the BCBS would dramatically worsen the competitiveness of banks on the SA.

88. In addition, the European Commission is currently consulting on the proportionality of the CRR and CRDIV.⁵⁶ In its consultation it states 'the requirements of the CRR and CRDIV, particularly those relating to credit and other prudential risks, are of general application to all financial institutions, without any distinction being made on the basis of size, business model or business line and are designed to ensure a level playing field.' However, it notes that smaller banks may be less able to spread the fixed overheads of these regulations over their activities. Further it notes that the standards set by the BCBS, on which the CRR was to a large extent based, were originally designed to apply to internationally active institutions only. A conscious decision was made to make the requirements of the CRR and CRDIV apply more widely. It is now consulting on whether the CRR should allow for more differentiation on how the requirements are applied to banks of different sizes. The PRA is supportive of this development and agree that a more

⁵³ BCBS (December 2014), [Capital floors: the design of a framework based on standardised approaches](#), consultative document.

⁵⁴ For further information, please see BCBS (November 2014), [Reducing excessive variability in banks regulatory capital ratios: A report to the G20](#).

⁵⁵ See the [British Bankers' Association](#) website.

⁵⁶ [DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy](#).

proportionate approach could be adopted on many aspects of banking regulation.⁵⁷

The bank levy and corporation tax surcharge

Introduction of the bank levy

89. The UK government introduced a bank levy in January 2011, which applied to banks (including building societies) operating in the UK. The introduction and design of the levy was motivated by the following published policy objectives:⁵⁸
- (a) To ensure that the banking sector makes a fair contribution, reflective of its risks to the financial system and wider UK economy.
 - (b) To provide an incentive for banks to move away from riskier funding profiles, with the aim of increasing their resilience to liquidity shocks.⁵⁹
90. The levy takes the form of an annual charge on the value of all of the liabilities of the UK banks (including money deposited with the banks) on a global basis, with the following exemptions:
- (a) Ordinary deposits covered by the UK's deposit insurance scheme.
 - (b) Borrowing backed by UK government debts.
 - (c) The first £20 billion of any bank's taxable debts.
 - (d) Long-term debts which are subject to the levy at half the standard rate.
91. Table 10 below sets out a simulation of the bank levy liability paid by each bank in 2016 before the changes announced to the tax regime for banks in the summer 2015 budget. The simulation is carried out by applying a bank levy rate of 0.21% (ie the prevailing rate of the bank levy before the summer 2015 budget changes) to banks' forecasts of their relevant balance sheet liabilities in 2016. Banks' levy liability as a proportion of forecast 2016 profit is also shown to provide an indication of the materiality of the levy for each bank.

⁵⁷ For further information on the BoE's response to the consultation, please refer to <https://ec.europa.eu/eusurvey/publication/long-term-finance-2015?language=en>.

⁵⁸ HMT (2014), *A Bank Levy Banding Approach: Consultation*.

⁵⁹ Liquidity shocks are circumstances in which the funding for banks is restricted or withdrawn such that it must use assets that are readily convertible into cash (ie liquid assets) in order to repay its depositors and other creditors. Banks can increase their resilience to such shocks either by adopting a more stable funding profile or by holding a larger buffer of liquid assets.

Table 10: Simulation of bank levy liabilities in 2016, before changes announced in the summer 2015 budget

	£m	%
<i>Banks</i>	<i>Bank levy</i>	<i>Bank levy liability as percentage of profit</i>
<i>Six largest banks</i>		
Barclays	[x]	[x]
HSBCG*	[x]	[x]
LBG	[x]	[x]
RBSG†	[x]	[x]
Nationwide	[x]	[x]
Santander	[x]	[x]
Total of six largest banks	[x]	[15-20]

Source: CMA calculations using data provided by banks.

* [x]

† [x]

92. When considering the bank levy liability as a proportion of UK profit, there is substantial variation between banks in the ratio of the bank levy to profits. We estimate that the bank levy costs the six largest banks on average [15–20]% of their taxable profits. This variation is driven by the exemptions to the levy, reflecting differences in the composition of banks’ balance sheets, and is consistent with the policy objective of the bank levy.

Summer 2015 Budget

93. In the summer budget in July 2015, it was announced that there would be a stepped reduction in the bank levy rate from 0.21% to 0.10% over the next six years, and that from 2021 the levy would only be charged on UK balance sheet liabilities. As the bank levy is charged at the balance sheet date, the new rates affect periods ending after 31 December 2015.
94. The Chancellor also announced a new ‘bank corporation tax surcharge’ (CTS) – a supplementary tax on banking sector profit of 8% to be levied on the profits of all banks and building societies arising after 1 January 2016. The new tax surcharge will be collected alongside corporation tax, similar to the collection of the bank levy.
95. The CTS will apply to ‘total taxable profits’ computed for corporation tax purposes, excluding group relief from non-banking companies. Losses arising prior to 2016 are also excluded, which effectively excludes any legacy losses incurred during the financial crisis and start-up losses of new entrant banks. There is a £25 million annual allowance, so participants with profits below that level will not pay the surcharge. HM Treasury estimated that between 60 to 100 banks are potentially within scope of the CTS and above the annual allowance. There is no carry-forward of unused allowances.

96. The summer 2015 budget statement stated that the aim of these changes was to move towards a more internationally competitive and sustainable model for raising revenue from the banking sector, given the very significant improvements in banking sector regulation and underlying profitability since the bank levy was first introduced.⁶⁰ It stated that the changes will result in increasing alignment of banks' tax contributions with profitability and capital accumulation, reducing the risk that the tax regime will constrain lending or influence banks' decisions on the location of internationally mobile activities.⁶¹
97. The summer 2015 budget statement stated that by allowing tax receipts to respond naturally to changes in banks' balance sheets and profitability, greater stability will be introduced in the banking taxation regime, allowing banks to incorporate tax into their business plans with greater certainty.⁶²
98. In its submission to the CMA, HMT said that it was important to look at the overall bank tax regime and in its view the changes introduced by the summer 2015 budget will ensure a fair, internationally competitive and sustainable mechanism for taxing UK banks in the long term, which is consistent with the UK government's objective to see greater competition within the UK banking sector.⁶³
99. In particular, HMT noted that larger banks will remain subject to the bank levy from which smaller banks are exempt due to the £20 billion threshold. HMT submitted that the six largest banks will have an effective additional rate of 10% or more as a percentage of profits (taking the bank levy and the CTS together) compared to a rate of less than 8% for smaller banks and that the effective additional rate for the smallest banks is 0% because of the £25 million CTS annual allowance. HMT also noted other features of the tax regime that benefit smaller banks such as an exemption to the 50% limit on historical losses for losses incurred during a bank's start-up period (ie prior to April 2015) that banks may carry forward to offset their general corporation tax liability.⁶⁴
100. HMT submitted the following:
- (a) The £25 million annual tax free-allowance significantly reduces the number of banks and building societies subject to the CTS, with around 90% of building societies removed from scope.

⁶⁰ HMT, [Summer Budget 2015](#), paragraphs 1.201–1.202, p46.

⁶¹ HMT, [Summer Budget 2015](#), paragraph 1.203, p47.

⁶² HMT, [Summer Budget 2015](#), paragraph 1.204, p47.

⁶³ [HMT submission on the taxation of banks](#).

⁶⁴ See [HMT submission on the taxation of banks](#).

- (b) For banks and building societies with profit above the £25 million allowance, the effective tax rate increases gradually.
- (c) The combined effective tax rate under the bank levy and the CTS is considerably higher for the larger banks. Five of the largest banks are subject to an effective rate (ie bank levy and bank surcharge payments as a proportion of profit) of more than 10% or greater as a percentage of profits, compared to a rate of significantly less than 8% for many of the smaller banks and building societies).⁶⁵
101. Separately, HMT also provided us with information from banking groups' 2014 annual reports in order to analyse the impact of the changes on individual banking groups. This data can be used to estimate individual banks' tax liabilities before and after the changes to the bank levy rates and introduction of the CTS. Such an approach has the benefit of holding all other factors (such as balance sheet size and profitability) constant in the assessment. This allows any changes in banks' tax liabilities to be directly attributable to the changes to the tax regime. A drawback to this approach, however, is that it will not necessarily capture the potential impact of the changes on banks, such as new entrants, that are likely to expand and increase their profitability over the short to medium term.
102. Being based on 2014 data, such an approach is also likely to overstate the impact of the changes to the tax liability of the six largest banks because it does not take account of the change in the base of the bank levy from global to UK balance sheet liabilities in 2021. This change will benefit banks with significant international exposure. Furthermore, the offsetting impact arising from the phased reduction of the bank levy from 0.21% to 0.10% is not captured in this analysis which is based on the 2016 levy rate.
103. A number of assumptions were also required to remove the profit of any non-regulated entities (which are not subject to the CTS) where it was reported together with banking entity profit within banks' group accounts. Nevertheless, we consider that the data provides a useful cross-check of our own assessment.
104. Our interpretation of this data is that it broadly shows that the six largest banks (ie those that incur the bank levy) experience an increase in their effective tax rate of between 4 and 6 percentage points. Of the other banks analysed, those with profit below the £25 million tax-free threshold do not

⁶⁵ [HMT submission on the taxation of banks.](#)

experience any increase and those with profit above the threshold experience an increase of up to 7 percentage points.

Quantification of the financial impact of the bank tax changes

105. We asked the banks to provide internal documents (including management reports, executive/Board papers or strategic plans) which cover the impact of the changes to the tax regime and its potential impact on their business. Where this was not covered by the above material, we also asked each bank to provide its own quantification of the impact of the bank levy and CTS. We have reviewed this evidence to assess:

- (a) the financial impact of the tax changes (and how this varies between banks); and
- (b) whether and to what extent the tax changes may affect the ability and/or incentives of banks to enter, expand or exit.

106. Table 11 provides an overview of each bank's estimation of the impact of the changes in the tax regime on their tax liability, where a positive number denotes an increase in the tax liability and a negative number a reduction relative to the expected tax liability before the changes. More detailed information on the evidence provided to us by each bank can be found in Annex B to the Appendix.

107. It is important to note the following caveats in interpreting these estimates:

- (a) The definition of UK versus global balance sheet liabilities to be used for the bank levy base in 2021 is not yet known and banks consequently may have used different assumptions for this in their modelling of the impacts.
- (b) Banks' estimates will include assumptions about growth in profits and/or changes to the size and composition of balance sheets which will affect the tax base. In the data we have collected from the banks, it is not possible to distinguish between changes to a bank's tax liability arising from forecast changes to the tax base and changes arising from the changes to the tax regime.
- (c) Not all banks have estimated the impact of the changes over a consistent time period. This is particularly problematic for those banks that are subject to the bank levy because the reduction in the rate of the levy is stepped over time and the switch from a global to UK liability base, which occurs in 2021.

108. While these caveats limit the comparability of the estimates between banks, we consider that the estimates provide useful information on the size and overall direction of the tax changes.
109. In interpreting the last two columns of Table 11 (ie the combined levy and CTS liability as a percentage of profit for CTS purposes) it is important to note that any reductions in the combined levy and CTS liabilities as a proportion of profit between 2016 and 2021 may be due to an increase in forecast profitability between 2016 and 2021, as well as a reduction in the combined tax liability.

Table 11: Summary of banks' estimates of tax liability changes for 2016 and 2021, relative to the expected tax liability before the changes

Banks	Change in levy liability (£m)		Change in CTS (£m)		Combined change (£m)		Combined change, % of profit for CTS purposes		Combined levy and CTS liability, % of profit for CTS purposes	
	2016	2021	2016	2021	2016	2021	2016	2021	2016	2021
<i>Six largest banking groups</i>										
Barclays	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
HSBCG	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
LBG †	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
RBSG ‡	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Santander	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Nationwide	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total of six largest banking groups	-393	-1693	1245	1894	852	201	[0-5%]	[0-5%]	[20-25%]	[10-15%]
<i>Other established retail banks</i>										
AIBΔ	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Bank of Ireland	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Clydesdale **	**	**	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Co-op Bank ##	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Danske †	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
TSB ◇	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total of other established retail banks	0	0	18-27	38-47	18-27	38-47	6-7%	7%	6-7%	7%
<i>New or recent entrants</i>										
Aldermore□	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Atom	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Coventry Building Society ∂	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Handelsbanken Å	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Metro Bank x	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
One Savings Bank γ	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Paragon ρ	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Secure Trust Bank	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Shawbrook Bank φ	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Tesco	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Yorkshire Building Society ς	0	0	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Total of smaller banks and recent entrants	0	0	59-69	111-123	59-69	111-123	6%	7%	6%	7%

Source: CMA calculations using data provided by banks.

[X]

110. Because the changes in the bank levy impact banks' tax liabilities in a different direction to the introduction of the CTS, it is useful in considering the estimates to distinguish between banks which incur the levy and banks which are exempt from the levy.

Banks that incur the levy and corporation tax surcharge

111. Six retail banks incur the levy. The estimates in Table 11 suggest that initially in 2016 all banks that incur the levy experience a net increase in their tax liability. This is because the introduction of the CTS is not fully offset by the reduction in the rate of the levy. For Barclays and RBSG the additional cost is around £[x] million, though [x] around £[x] million for HSBCG. This contrasts with a [x] tax liability for LBG of around £[x] million.
112. The other two banks which incur the levy, Santander and Nationwide, both experience a net increase in their tax liability: Santander expects to pay around £[x] million more in 2016, with Nationwide paying around £[x] million more tax. Therefore, in aggregate, we estimate that the six levy paying banks will pay around £850 million more in 2016, with [x] relating to LBG.
113. By 2021, when the levy only applies to UK liabilities and the full reduction in the rate of the levy has occurred, the direction of the net impact varies between the banks depending on the scope of their international activities. [x]
114. In aggregate, the tax liability of the six banks which incur the levy will increase by approximately £200 million (relative to the expected tax liability in 2021 before the introduction of the changes).

Banks that are exempt from the levy but are liable for corporation tax surcharge

115. Banks that do not and will not pay the levy will experience no offsetting benefit from the reduction in the levy rate. Where estimates of the CTS were provided by banks, the time horizon was generally three to four years, rather than extending to 2021. In such cases we have produced illustrative estimates of the CTS liability by assuming 10% yearly growth in profit before tax. Furthermore, some banks did not provide accurate forecasts for individual years, rather providing a range of possible outcomes over a period of several years.
116. Overall we estimate that the group of 17 retail banks included in our analysis which are exempt from the levy but liable for the CTS will experience a net increase in tax liability of around £75–£95 million in 2016, potentially

increasing to £150–£170 million in 2021. We note that this group of banks includes both recent entrants as well as established banks with large market shares in the relevant geographic market in which they operate (for example AIB, Bank of Ireland and Danske).

117. In response to our [working paper](#), a multiparty submission⁶⁶ from a group of ‘challenger’ banks⁶⁷ cited research by the Sheffield Political Economy Research Institute (SPERI) which stated that the cost of the surcharge for smaller banks will be greater than that of bigger banks as a proportion of total liabilities, raising questions about whether the new surcharge will undermine competition in banking.
118. The analysis undertaken by SPERI was based on applying the CTS surcharge rate to 2014 profitability data collected from banks’ published accounts of 12 banks.⁶⁸ There are a number of limitations to this approach. Firstly, it does not cover the full range of PCA and BCA providers that come under the scope of the CTS.⁶⁹ Secondly, the published profitability data used to calculate tax liabilities will not necessarily correspond to the definition of profit to which the CTS applies. In particular it may include the profit of any non-regulated entities where these are reported together with banking entity profit within a bank’s group accounts. Thirdly the analysis is based on banks’ 2014 levels of profitability. This means it will not capture the potential impact of the tax changes on banks, such as new entrants, that are likely to expand and increase their profitability over the short to medium term. Finally the SPERI analysis produces estimates of banks’ CTS liabilities as a proportion of their balance sheets, whereas the CTS is a profit-based tax. While a bank’s balance sheet can act as an indicator of scale, it does not necessarily correlate with banks’ profitability and rate of capital accumulation. As such it does not tell us anything meaningful about the impact of the CTS on banks’ incentives to expand and invest or their ability to compete.
119. In contrast, the analysis undertaken in this report presents tax liabilities as a proportion of profit for 23 parties to the investigation (including the six largest banking groups, smaller established banks and building societies, new and recent entrants and banks in NI). It is calculated using banks’ internal information on forecast CTS and banking levy liabilities and is therefore aligned with definition of profit to which the CTS applies. The analysis is also

⁶⁶ [Multiparty submission from a group of ‘challenger’ banks in response to the CTS and Bank Levy working paper](#).

⁶⁷ Aldermore, Charter Savings Bank, Close Brothers, Hampden & Co Bankers, Metro, Secure Trust, One Savings Bank, Shawbrook, Tesco Bank and Paragon.

⁶⁸ LBG, HSBCG, RBSG, Barclays, Nationwide, Aldermore, One Savings, Shawbrook, Secure Trust, Yorkshire Building Society, Coventry Building Society, Skipton Building Society.

⁶⁹ Established providers such as Santander, TSB, Clydesdale, Co-op Bank and the NI banks are omitted from the analysis. Recent entrants such as Metro and Handelsbanken are also not included.

forward looking, capturing the forecast impact of the CTS on recent entrants and expanding banks, as well as banks which are yet to launch their PCA proposition (eg Atom and Paragon).

Annex A: Summary of Bank of England research on the impact of risk weights on pricing in the UK owner-occupied residential mortgage market

Summary

Background—The BoE/PRA is conducting research on the impact of risk weights on mortgage pricing. The research is still in progress, but the BoE has agreed to share with the CMA some of the preliminary results. The BoE expects to further refine the model and further check data quality—both could affect the results.

The research focuses on evidence that firms who calculate mortgage risk weights using the IRB approach tend to have lower risk weights than firms who use the SA, and more so for lower-LTV mortgages. This gap between risk weights for firms using IRB models and those using the SA was highlighted in the CMA’s preliminary findings report.⁷⁰ (In the following, the labels ‘IRB firms’ and ‘SA firms’ are used to identify the two groups of firms).

Data—The research is based on a dataset derived from the FCA’s Product Sales Database,⁷¹ that contains all mortgages originated by banks and building societies,⁷² and secured on UK owner-occupied residential property, between 2005Q2 and 2015Q2. The loan data is matched with two other datasets. First, data on whether the originating firm was on IRB or not on the date that the loan was originated. This gives a sample with approximately 7.4 million loans (sample A). Second, information on the historical risk weights used by IRB firms over the period 2008-15, which was collected with the help of the CMA. This gives a smaller sample with approximately 6.6 million loans (sample B) because historical weight data is available for only a subset of firm-years.

Methodology—To test the impact of risk weights on pricing, the research uses three different model specifications. These can be ordered in terms of increasing tightness of identification, or extent of controls for factors other than risk weights that might be driving variation in prices (initial interest rates at the point of origination):⁷³

⁷⁰ CMA (2015), ‘Retail banking market investigation: Provisional findings report’.

⁷¹ The FCA Product Sales Data include regulated mortgage contracts only, and therefore exclude other regulated home finance products such as home purchase plans and home reversions, and unregulated products such as second charge lending and buy-to-let mortgages.

⁷² Non-deposit taking (“specialist”) lenders are not included, except in a small number of cases where the lender is a subsidiary of a deposit taker and is not just a specialist lender. We also excluded one large lender [X] in the pre-2008 period due to concerns related to the reported data.

⁷³ The FCA’s Product Sales Database does not include information on fees and changes in interest rates after origination (eg at the end of a fixed-rate period).

- 1) The *regime change model* is perhaps the most intuitive. However, it implicitly assumes that all firms switch to IRB at the same time, and the controls are relatively coarse.
- 2) The *IRB switch model* uses information on individual firms' switch dates, and adds more granular controls.⁷⁴
- 3) The *historical risk weights model* has the same controls as the IRB switch model, but captures the risk weight variation directly. However, we only have the risk weight data for a subset of firms and years, as mentioned above.

Preliminary results—The preliminary results so far all point to a positive sign (lower risk weights lead to lower prices). The effects appear to be material for low-LTV mortgages, in particular in the regime change and IRB switch models. However, the results of the historical risk weights model, which allows for the tightest identification, are not robust to changes in the sample period: they are economically significant for 2009Q1-2015Q2, but not for the full 2005Q2-2015Q2 sample. Further work is required to understand how material the effects are.

Limitations—The research approach captures only imperfectly credit risk, which is correlated with risk weights, and is likely to bias (upwards) the estimated impact of risk weights on prices. Moreover, comparisons of average risk weights between IRB and SA firms could be biased by self-selection if the firms that have stayed on SA are those with riskier portfolios and hence with less to gain from IRB models in terms of risk weights. At the moment, the research does not take into account the effect of securitisations and other aspects of the regulatory framework for capital (e.g. capital ratio, leverage ratio), and it does not include specialised lenders (non-deposit takers). The quality of the information provided by firms on historical risk weights has not been audited.⁷⁵ Finally, the magnitudes of the results are sensitive to which firms and years are included in the sample.

The regime change model

The regime change model simply tests whether any gap in average prices – that emerged between IRB and SA firms after the regulatory regime for risk weights changed in 2008 – was larger at lower LTV.⁷⁶ Under Basel, the risk weight was 50% for all mortgages. From 2008, banks and building societies have had to choose between the IRB and standardised approach. Under both approaches, average risk

⁷⁴ Both the regime change and the IRB switch model capture the variation in risk weights indirectly, using a dummy variable for the switch to IRB as a proxy for the decline in risk weights that we know is typically associated with such a switch. We observe this proxy for all firms and time periods in our samples (see below).

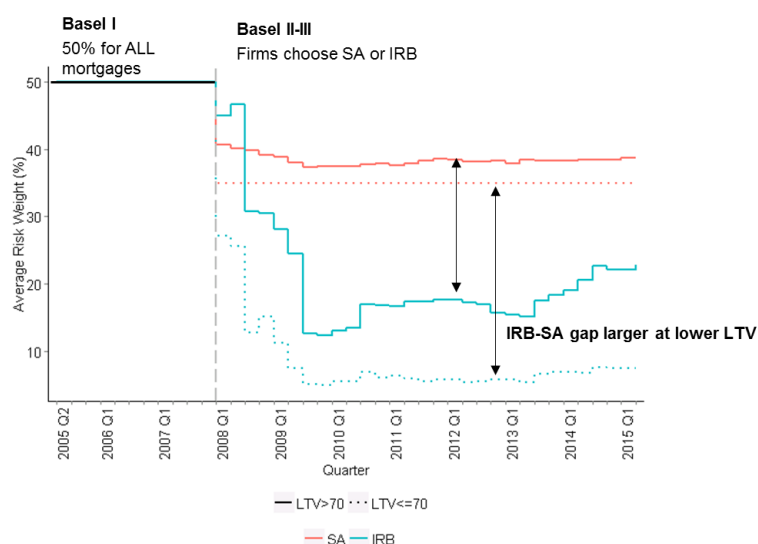
⁷⁵ The information obtained by the CMA and PRA for this exercise differs from other risk-weight data obtained by the PRA in the past.

⁷⁶ Some firms switching to foundation (as opposed to advanced) IRB were allowed to do so in 2007. All the IRB firms in our sample use advanced IRB.

weights fell—but they fell more for IRB firms, in particular at low LTVs (*Figure 1*). After 2008, mortgage prices also fell, mainly driven by macroeconomic factors. But the fall was larger for IRB firms, and more so at low LTVs (*Figure 2*). This can be seen more clearly by comparing the IRB-SA price difference at low vs high LTVs. The change in the IRB-SA price difference is larger for low LTV mortgages—consistent with the hypothesis that it was caused by the introduction of the new regime for risk weights (*Figure 3*). For example, if we put the threshold between high- and low-LTV at 70% LTV, then the relative price difference is approximately 60bp on the same sample used in the historical risk weights model below (results are qualitatively similar for other choices of sample and threshold, see *Table 1*).

The triple difference (IRB vs SA, before vs after the switch to IRB/SA, and high- vs low-LTV) helps capture the effect of risk weights on prices while controlling for drivers of prices other than risk weights. For example, changes in funding costs will have the same effect on high- and low-LTVs for the same lender, and as a result the impact of funding costs will cancel out in the triple difference.⁷⁷

Figure 1: Average risk weights for IRB and SA firms on low- and high-LTV mortgages (2005Q2-2015Q2)



⁷⁷ Assuming that the lender does not account differently for funding costs for low- and high-LTV mortgages, eg through its transfer pricing.

Figure 2: Average prices for IRB and SA firms for low- and high-LTV mortgages (2005Q2-2015Q2)

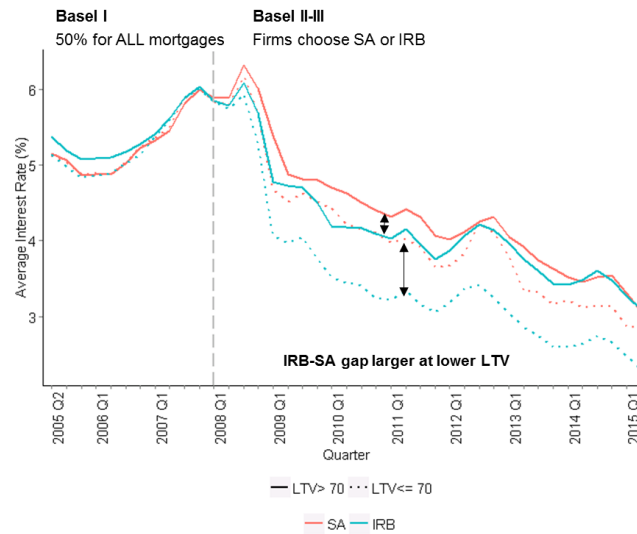
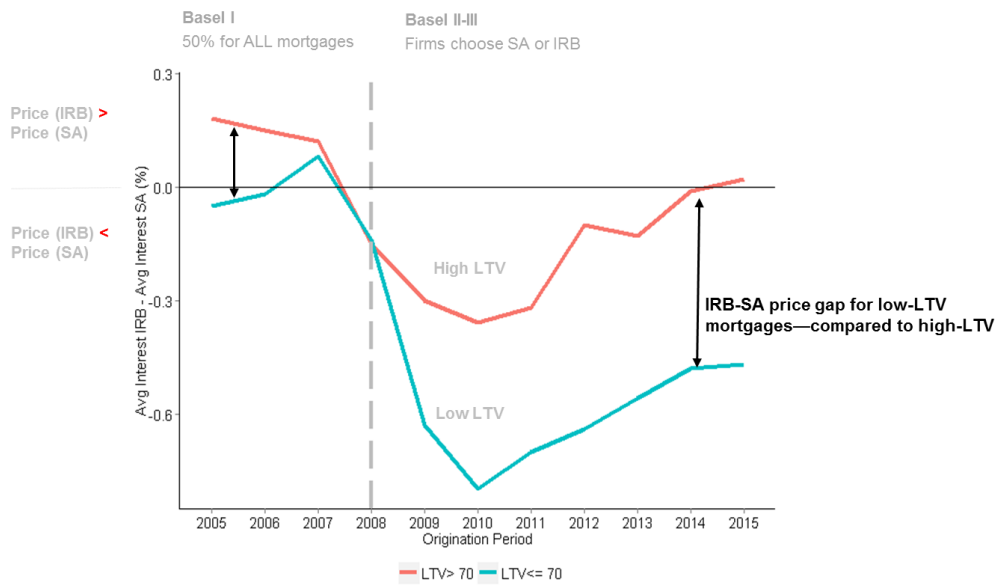


Figure 3: Price gap between IRB and SA firms for low- and high-LTV mortgages (2005Q2-2015Q2)



Box 1: Specification of the regime change model

The regime change model is specified as a difference-in-difference-in-difference model. The impact of IRB models after 2008 on low-LTV loans is captured by a triple interaction factor.

$$Rate_{ibst} = \beta_0 + \beta_1 IRB_b + \beta_2 LowLTV_s + \beta_3 Post2008_t + \beta_{12} IRB_b \times LowLTV_s + \beta_{13} IRB_b \times Post2008_t + \beta_{23} LowLTV_s \times Post2008_t + \beta_{123} IRB_b \times LowLTV_s \times Post2008_t + \theta X_{ibst} + \varepsilon_{ibst}$$

Where i indicates the individual loan, b the lender (bank), s the LTV band, t time, and:

$Rate_{ibst}$ is the initial interest rate on the mortgage loan

IRB_b is a dummy equal to 1 if the bank b is on IRB at any point in time

$LowLTV_s$ is a dummy equal to 1 if the loan-to-value is below a certain threshold (e.g. $LTV \leq 70\%$)

$Post2008_t$ is a dummy equal to 1 after January 2008

X_{ibst} are additional individual controls (borrower type, interest rate type, LTI)

$\beta_{123} IRB_b \times LowLTV_s \times Post2008_t$ is the triple interaction factor that we expect to capture the impact of IRB models from 2008 (cf. before) on low-LTV (cf. high-LTV) loans.

Table 2: Regime change model, 2005Q2-2015Q2: price advantage (in bps) for IRB firms at low LTVs (compared to high LTVs)

Sample	Definition of 'low' LTV		
	LTV ≤ 70	LTV ≤ 75	LTV ≤ 80
Sample A	-46.3*** (0.005)	-34.7*** (0.005)	-28.4*** (0.005)
Sample B	Classical errors -60.0*** (0.005)	-48.4*** (0.005)	-41.8*** (0.005)
	Clustered errors -60.0*** (19.258)	-48.4*** (16.578)	-41.8*** (12.491)

Notes: Standard errors in parentheses. ***, **, * denote significance at the 99%, 95%, and 90% levels respectively. Clustered errors use two-way clustering by bank and time.

The individual IRB switch model

The IRB switch model is very similar to the regime change model, but uses i) the specific quarter in which firms switched to IRB, and ii) more detailed fixed effects to control for other factors. Fixed effects control for all variation along particular dimensions or combinations thereof—rather than explicitly for specific explanatory factors. Our models include fixed effects for pairwise interactions between time, bank and LTV, capturing the variation along these dimensions—which encompass many factors that may drive price variation.

For example, volatility in funding costs is captured by interacting bank and time fixed effects. Changes in central bank rates would be captured by simple time fixed-effects. However, the impact on pricing of spreads on wholesale funding diverged across banks during the crisis, reflecting relative differences in terms of riskiness and reliance on wholesale funding. This latter variation is captured by interacted bank-time fixed effects.

Table 2 below summarises the main results. The size of the relative price advantage for IRB firms at low LTVs (compared to the price advantage at high LTVs) is estimated around 19bp, using 70% as a threshold for high vs low LTV, and considering the same sample we used to estimate the historical risk weights model below (sample B). The results remain statistically significant (at the 90% level), for results with 70% and 75% LTV thresholds, when we allow for correlation of the error term (ε_{ibst}) within clusters of loans made by the same bank and/or in the same period, which could cause classical errors to exaggerate the statistical significance of the coefficients. The results are qualitatively similar for other choices of sample and threshold.

Box 2: Specification of the individual IRB switch model

The ‘individual IRB switch’ model uses the date at which firms switched to IRB; pairwise interacted fixed effects that capture bank-time, bank-LTV and time-LTV variation; and loan-level controls for borrower and rate type and loan-to-income (LTI) ratio.

$$Rate_{ibst} = \gamma_{bs} + \gamma_{st} + \gamma_{bt} + \delta IRB_{bt} \times LowLTV_s + \theta X_{ibst} + \varepsilon_{ibst}$$

Where i indicates the individual loan, b the lender (bank), s the LTV band, t time, and:

$Rate_{ibst}$ is the initial interest rate on the mortgage loan

$\gamma_{bs}, \gamma_{bt}, \gamma_{st}$ are bank-LTV, bank-time and LTV-time dummies (fixed effects)

IRB_{bt} is a dummy equal to 1 in the period t when the bank b is on IRB (note that this is different from the definition of the IRB dummy in the regime-change model)

$LowLTV_s$ is a dummy equal to 1 if the loan-to-value is below a certain threshold (e.g. $LTV \leq 70\%$)

X_{ibst} are additional individual controls (borrower type, interest rate type, LTI)

The effect of IRB models is captured by the coefficient δ that reflects the price gap between firms on IRB vs SA, on high- vs low-LTV mortgages, after vs before the adoption of IRB.

Table 3: Individual IRB switch model, 2005Q2-2015Q2: price advantage (in bps) for IRB firms at low LTVs (compared to high LTVs)

Sample	Definition of ‘low’ LTV		
	LTV ≤ 70	LTV ≤ 75	LTV ≤ 80
Sample A	-17.0*** (0.003)	-15.5*** (0.003)	-10.7*** (0.003)
Sample B	Classical errors -18.8*** (0.003)	-15.0*** (0.003)	-7.6*** (0.004)
	Clustered errors -18.8* (9.939)	-15.0* (8.496)	-7.6 (7.643)

Notes: Standard errors in parentheses. ***, **, * denote significance at the 99%, 95%, and 90% levels respectively. Clustered errors, in *italics*, use two-way clustering by bank and time.

The historical risk weights model

The last model is a fixed effects model that uses information about historical risk weights (by LTV band). Otherwise, the model is similar to the individual IRB switch model.

The size of effect depends on the sample period. We focus on two subsamples of sample B (we do not have the data to estimate this model on sample A):

- 2009Q1-2015Q2: the period during which the IRB-SA regime is in place (excluding 2008 because of limited data, transitional effects of the new regime, and the impact of the financial crisis).
- 2005Q2-2015Q2: this is the full period for which we have data available. Within the period 2005-2007 however there is no variability in risk weights (50% for all firms/mortgages).

The results for 2009Q1-2015Q2 indicate a 1.4bp reduction in price per 1pp reduction in risk weights (here the relevant change in risk weights can be both within the same LTV and between LTVs). The impact in terms of price difference between IRB and SA firms can be calculated by multiplying this coefficient by the risk weight gap between IRB and SA firms. As a result the impact is larger for low LTV mortgages, where the IRB-SA risk weight gap is largest. This results in a 42bp reduction in price for a 30pp difference between SA and IRB that is typical for $LTV \leq 50\%$.

The results for 2005Q2-2015Q2 indicate a much weaker effect (about 1/10th the size of the estimate for 2009Q1-2015Q2) and the effect on pricing for the same 30pp difference in risk weights is around only 3bp.

Box 3: Specification of the historical risk weights model

The historical risk weights model captures variation over time in bank- and LTV-specific risk weights. The specification is otherwise identical to the individual IRB switch model, with pairwise interacted fixed effects that capture, bank-LTV, LTV-time, and bank-time variation, and loan-level controls for borrower and rate type and LTI.

$$Rate_{ibst} = \gamma_{bs} + \gamma_{st} + \gamma_{bt} + \beta RW_{bst} + \theta X_{ibst} + \varepsilon_{ibst}$$

Where i indicates the individual loan, b the lender (bank), s the LTV band, t time, and:

$Rate_{ibst}$ is the initial interest rate on the mortgage loan

$\gamma_{bs}, \gamma_{bt}, \gamma_{st}$ are bank-LTV, bank-time and LTV-time dummies

X_{ibst} are additional individual controls (borrower type, interest rate type, LTI)

RW_{bst} captures the variation over time in bank- and LTV-band-specific risk weights.

Table 4: Historical risk weights model (2009Q1-2015Q2 and 2005Q2-2015Q2)

Period	Effect of a 1pp change in RW on price (bp)	
	Classical errors	Clustered errors
Full period (2005Q2-2015Q2)	0.116*** (0.011)	0.116 (0.271)
Only 2009Q1-2015Q2	1.386*** (0.029)	1.386* (0.678)

Notes: Standard errors in parentheses. ***, **, * denote significance at the 99%, 95%, and 90% levels respectively. Clustered errors use two-way clustering by bank and time.

Annex B: Summary of evidence provided by banks in response to the information request

Barclays

1. The combined effect of the bank levy and tax surcharge is expected to [REDACTED].

<i>£m</i>	<i>2016</i>	<i>Change</i>	<i>2021</i>	<i>Change</i>
Levy	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Surcharge	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Net cost	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

HSBCG

2. [REDACTED]

<i>\$m</i>	<i>2016</i>	<i>Change</i>	<i>2021</i>	<i>Change</i>
Levy	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Surcharge	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Net cost	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

LBG

3. LBG has projected the effect of the levy and surcharge up to 2018, comparing with the position before the summer 2015 budget changes. The overall effect of the budget changes is a significantly increased tax liability for LBG (with the surcharge increasing by significantly more than the reduction in the levy payable). LBG also commented that recent broker reports have highlighted the adverse effect of the budget changes on UK domestic banks, such as LBG, while also noting that the surcharge applies to all banks (whereas smaller banks are not subject to the levy).

<i>£m</i>	<i>2016</i>	<i>Change</i>	<i>2018</i>	<i>Change</i>
Levy	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Surcharge	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Net cost	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

4. LBG has not estimated the effect of the bank levy and CTS for 2021, as it does not forecast tax liabilities beyond its five year Group performance planning horizon. LBG anticipates, in the circumstances, that the effect in 2021 would be similar to that in 2018. The change in levy coverage to UK liabilities only in 2021 is not expected to have a material impact on LBG, given the UK focus of the Group's business, following the reduction in its non-UK activities over the past few years.

RBSG

5. RBSG's projection is based on [REDACTED].

<i>£m</i>	2017*	Change	2019	Change
Levy	[X]	[X]	[X]	[X]
Surcharge	[X]	[X]	[X]	[X]
Net cost	[X]	[X]	[X]	[X]

[X]

Santander

6. Santander estimated that in 2017, a surcharge of £[X] million would be payable, partly offset by a reduction in bank levy of £[X] million, leaving the net impact being a cost of £[X] million. An earlier presentation suggested that in 2016 and 2018 the net cost [X]

<i>£m</i>	2017	Change
Levy	[X]	[X]
Surcharge	[X]	[X]
Net cost	[X]	[X]

Nationwide

7. Nationwide provided an estimate of the banking levy, with the cost of the levy increasing from £[X] million in 2016 to £[X] million in 2020 [X]. The increase in the tax surcharge in 2019/20 reflects growth in bank profits. Nationwide projected that it would pay approximately £300 million additional tax up to March 2020.

<i>£m</i>	2016/17	Change	2019-20	Change
Levy	[X]	[X]	[X]	[X]
Surcharge	[X]	[X]	[X]	[X]

AIB

8. AIB UK estimated the 2016 effect of the CTS to be £[X] million, [X].

Bank of Ireland

9. BoI said that changes to allowances for tax losses will lead to cash payment of tax when unutilised tax losses remain. Cost of the tax surcharge over five years is expected to be around £[X] million with return on equity (RoE) being reduced by [X]% by 2020. Ensuring hurdle rates are achieved may impact on product prices.

<i>£m</i>	2016	2021
Surcharge	[X]	[X]

Clydesdale

10. Clydesdale was not able to provide an estimate of the effect of the surcharge. It stated 'Given, amongst other matters, the proposed demerger from National Australia Bank, we do not believe it is appropriate to provide any information on forecast profitability on a tax basis of a single entity within this retail group.'

Danske

11. Danske stated that [X]

<i>£m</i>	2016	2021
Surcharge	[X]	[X]
	[X]	

Aldermore

12. [X]

<i>£m</i>	2016	2021
Surcharge*	[X]	[X]
	[X]	

Co-op Bank

13. The Co-op Bank is currently loss-making [X].

Handelsbanken

14. Handelsbanken did not provide projections for the impact of the tax surcharge, but its estimate for 2016 was £[X] million.

Paragon Bank

15. Paragon Bank said it does not expect to exceed the £25 million profit threshold in 2016 and did not provide forward projection to 2021. However, it highlighted that the tax surcharge will have a disproportionate effect on its business through the impact on profitability and capital. Paragon Bank is part of Paragon Group and as capital allocations between Group entities are based on relative post-tax returns, the banking business could have less

capital allocated unless it is able to pass on the cost of the surcharge through higher margins.

Secure Trust Bank

16. Secure Trust Bank estimated that an additional £[X] million tax will be payable over 2016-21. The impact is expected to create a competitive disadvantage with non-banking companies and reduce lending to SMEs by £[X] billion over the period.

<i>£m</i>	<i>2016</i>	<i>2021</i>
Surcharge	[X]	[X]

Shawbrook Bank

17. Shawbrook provided a forecast for 2016 based on a consensus from publicly available analysts.

<i>£m</i>	<i>2016</i>	<i>2021</i>
Surcharge	[X]	[X]

Virgin Money

18. Virgin Money submitted that the CTS may delay, but not prevent, achieving its IPO targets by about a year and that between 2016-2021 it anticipated an additional £[X] million in tax to be payable under the CTS.

Appendix 9.4: Natural or intrinsic barriers to entry and expansion

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Cost of funding

1. In this appendix, we discuss recent trends in the mix of wholesale and retail funding used by different banks, as well as evidence on the cost of each type of funding. As part of our analysis of the cost of wholesale funding, we also discuss the too-big-to-fail subsidy, and consider the impact of the Funding for Lending scheme (FLS) on funding costs. We also consider the relationship between the capital requirements regime and funding costs.

Introduction

2. Banks obtain funding from three sources: equity capital, retail funding (retail customer deposits) and wholesale funding (deposits from wholesale investors and wholesale debt). In some circumstances banks may also be able to draw on government schemes as alternative means of funding. Such schemes include, for example: Help to Buy which launched in 2013 and is targeted at first-time residential mortgages; the BoE's Sterling Monetary Framework, ie its operations in sterling money markets seeking to support its monetary and financial stability goals; and the Funding for Lending Scheme (FLS), a joint initiative between the BoE and HMT that has been operational since 2012. FLS is particularly relevant to this investigation as, since April 2013, it has been targeted towards providing support for SME lending.^{1,2}
3. The mixture of capital, retail funding and wholesale funding relied on by each bank is a strategic decision for each bank, taking into account the cost of each

¹ The FLS was launched by the BoE and HMT in July 2012, at a time of significant contraction in lending activity as a result of the financial crisis, and was thereafter extended in modified form with incentives skewed towards lending to SMEs. It is designed to incentivise banks to boost their lending to UK households and private non-financial corporations (PNFCs). It does this by providing funding to banks for an extended period, at below market rates, with both the price and quantity of funding provided linked to their performance in the above forms of lending. See BoE quarterly bulletin Q4 2012 and, for the extension to SME lending, [the BoE Market Notice dated 24 April 2013](#). See also paragraphs 44 to 46 describing recent changes to the FLS including its extension to the end of January 2018.

² On 4 August 2016, the [BoE announced](#) the Term Funding Scheme. While we have not considered this in our report given the timing, it may potentially be relevant to this area/issue. For more information on this scheme, please consult the BoE website.

type of funding and the capital requirements regime discussed in appendix 9.3. In the remainder of this section we will mostly focus on the cost of retail and wholesale funding, leaving equity capital to one side. While new entrants will generally face a higher cost of equity due to the risks associated with entry, we have not received evidence to suggest that the cost of equity creates a barrier to entry or expansion.

4. Moreover, we will generally focus only on the direct costs of funding, ie the interest rate paid to the banks' depositors and the interest rate paid to the wholesale investors who lend to the bank. We do not consider in detail other costs, such as:
 - (a) the costs of operating different types of deposit accounts (which may be lower for banks that do not operate PCAs or BCAs) or
 - (b) the 'all-in' cost of wholesale funding including the cost of issuing wholesale debt and managing its risks.³
5. We note that the cost of funding to a bank is, from a retail customer's or wholesale investor's perspective, equivalent to the return they earn from their retail deposits or from lending money to the bank. The cost of retail funding (retail deposits) or wholesale funding (wholesale deposits and debt) can be considered as a combination of three elements: the risk-free rate; a credit risk premium (the risk of default within a bank's portfolio); and a liquidity risk premium (the risk that banks are unable to fund withdrawals at short notice or that wholesale debt cannot readily be redeemed by investors (or can only be redeemed at short notice subject to a substantial reduction in its price). Each of these premia has a macro-economic element and a firm-specific element that reflects individual firm risk.
6. Banks' funding costs will vary according to the mix of funding they use. The cost of each individual type of funding depends on the demand for, and hence availability of, that funding from the banks' retail customers and wholesale lenders. In turn, this demand is driven by the trade-off individual customers or lenders seek between risk and return, and for depositors their value for the depository service they also receive in return. All else equal, higher demand leads to lower costs: if demand is low, the bank has to stimulate demand by raising the return it offers in exchange for funds, which will raise its costs.

³ For example, fees paid to the banks that arrange and underwrite the issuance; fees paid to register the bonds with the listing authority; and fees paid to ratings agencies to rate the debt. Examples of risk management costs include the costs of hedging interest rate and currency risks. See BoE paper on bank funding costs, p10.

7. Regulatory requirements, such as the rules on capital requirements and liquidity requirements,⁴ as well as the bank's commercial strategy and asset mix, also affect its funding mix and risk/return profile, and hence its total funding costs. It should be noted that the rules on capital requirements and on liquidity requirements interact, since a change in capital ratios can change liquidity ratios and vice versa. For example, an increase in the capital requirement can mean a reduced reliance on debt, including a reduced reliance on less stable debt. The result of that would be that the bank has to keep less cash on hand to be able to service that debt. Similarly, an increase in the liquidity requirement can mean a reduction in lending, which would imply a reduced capital requirement.⁵
8. The availability of retail funding is integral to a bank's retail strategy, as banks compete for customers' retail deposits in order to have funds available for lending. As current accounts represent a significant proportion of retail deposits and provide linkages to savings accounts, this creates wider incentives to compete for current accounts beyond considerations of their profitability on a stand-alone basis. Hence banks' funding needs are an important factor in competition for PCAs and BCAs.

Recent trends in the mix of wholesale and retail funding

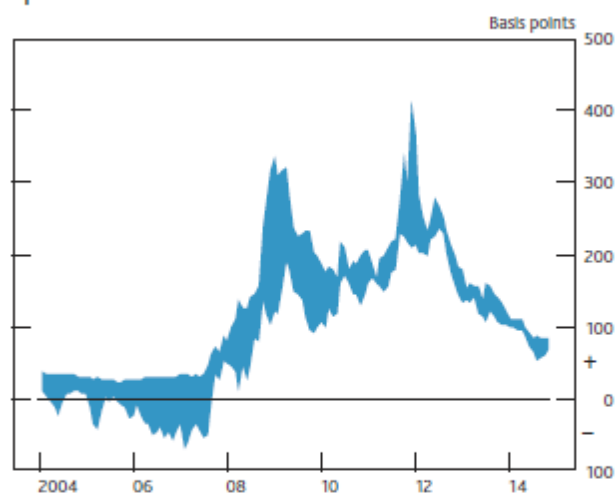
9. The mix of funding used by banks and hence their average cost of funding is influenced by macro as well as micro-economic conditions. For example, Figure 1 shows that during the financial crisis, levels of unsecured wholesale funding fell significantly as sector risk rose and demand for bank debt fell hence forcing its costs up. With the funding cost of retail bonds also rising, retail deposits such as current accounts and savings accounts (which were seen as a less risky 'safe haven' by investors) became more important to banks.

⁴ The rules on liquidity requirements, which are also set by the Basel Committee on Banking Supervision, specify how much cash a bank has to hold in order to make sure that it can meet its short-term obligations. See Appendix 3.1. Liquidity requirements aim to ensure banks have sufficiently stable sources of funding and an adequate buffer of liquid assets to meet their obligations under stressed market conditions. Retail deposits are generally considered a stable source of funding in normal circumstances, particularly where subject to deposit protection. See BoE paper, [Bank capital and liquidity](#).

⁵ See BoE, 2013, [Bank capital and liquidity](#): published in BoE Quarterly Bulletin 2013 Q3.

Figure 1: Range of indicative measures of bank funding spreads (the difference between funding costs and the risk-free rate)

Chart 1 Range of indicative measures of bank funding spreads^(a)



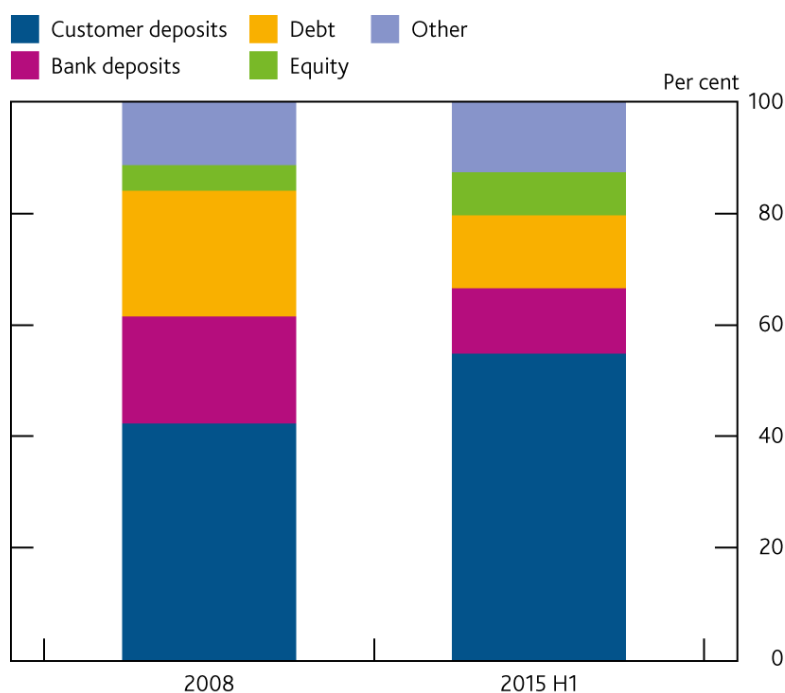
Sources: Bank of England, Barclays Live, Markit Group Limited and Bank calculations.

(a) The swathe includes three measures of long-term wholesale funding spreads for UK banks: the average of major UK banks' five-year euro-denominated senior CDS; quoted rates on one-year fixed-rate bonds over one-year swap rates for UK banks; and the Barclays Live 'Pan-Euro Corporate Banking: Senior - Spread' series.

10. While funding spreads have reduced since the end of 2012, banks have continued to shift towards retail deposit funding and the overall demand for unsecured wholesale bank funding remains low.⁶ A number of smaller banks reported they did not use, or relied to a minimal extent on, wholesale funding.
11. The overall shift towards retail funding over time is illustrated by Figure 2 on the sources of funding of major UK banks.

⁶ See also BoE [Bank Liabilities Survey, Q1 2016](#) and BoE [Bank Liabilities Survey, Q2 2016](#), which show demand for wholesale debt overall, falling significantly for the first time since the survey began in 2012 Q4.

Figure 2: Major UK banks' liabilities



Source: [Bank of England Financial Stability Report, December 2015](#), page 47.

Major UK banks are Banco Santander, BoI, Barclays, Co-op Bank, HSBC, Lloyds Banking Group, National Australia Bank, Nationwide, RBS and Virgin Money.

12. The increased reliance on deposits has resulted in a decline in banks' loan-to-deposit ratios. Table 1 provides more detail on banks' loan-to-deposit ratios based on published information.⁷ These loan-to-deposit ratios are calculated at group level, which is most relevant to our analysis as banks have told us that they do not tend to segregate their funding by business line (the ratios will therefore include products that are not within the scope of our market investigation reference).

⁷ We have not included Handelsbanken in this table as its position does not appear fully comparable; its UK business draws on wholesale funding through its parent bank in Sweden to a significant degree.

Table 1: Reported loan-to-deposit ratios at Group level (for 31 December 2014 unless otherwise stated)

<i>Bank</i>	<i>Loan-to-deposit ratio</i>	<i>%</i>
Barclays	88*	
HSBC Bank plc‡	74	
LBG	107	
RBSG	94§	
Santander	124	
Nationwide	117*	
Clydesdale	115†	
Aldermore	109*	
OneSavings Bank	99*	
Secure Trust	102*	
Shawbrook	102*	
Tesco Bank	112¶	
TSB	77	
Virgin Money	107*	

Source: CMA estimates from published data. AIB, Bol and Danske were omitted as their published results are not UK specific.
*30 June 2015.

†30 September 2014.

‡Note that this figure is not UK-specific as HSBC Bank plc also reports Europe.

§Based on net loans and advances to customers.

¶28 February 2015.

13. It is difficult to draw any firm inferences from comparisons of loan-to-deposit ratios as these will reflect differences due to various factors such as business strategy, the business mix, as well as different approaches to risk management; and there is no very clear trend to be seen. However, we observe from the above data that that many smaller banks and new entrants are lending at close to their current retail funding capacity, which may indicate that they are constrained by the level of their retail deposits. Larger banks, on the other hand, tend to have lower loan-to-deposit ratios, potentially reflecting a greater flexibility to source and use funds. This is also consistent with other information provided by banks to the CMA, which suggests that larger incumbent banks tend to use a more diversified mix of funds.

14. Specifically, a number of smaller banks reported they did not use, or relied to a minimal extent on, wholesale funding.
 - (a) For example, [redacted]; Shawbrook commented that it does 'not have a current need for such funding'; and Metro indicated that 'it is not the bank's business model to use wholesale funding'.

 - (b) The main type of non-retail funding, where used, was FLS, which a number of smaller banks considered to be an important source of funds. At the larger end of the smaller banks (firms such as Aldermore, Coventry Building Society, Tesco Bank, Virgin Money and Yorkshire Building

Society), secured wholesale funding (for example via the asset backed securitisation markets) is also used.⁸

15. Having considered the mix of wholesale and retail funding the banks rely on, we will now discuss the cost of each type of funding and the use of the FLS scheme, before considering the total cost of funding and its interaction with capital requirements.

Evidence on the cost of retail funding

16. For the purpose of analysing the cost of retail funding, we have focused on the interest rate that is paid to depositors. However, as noted in paragraph 4, this will be a lower bound given that there are also shared operating costs associated with providing, for example, the payments system, branch and/or ATM infrastructure to support such deposit taking which are difficult to measure.
17. It is also important to note that the average cost of retail funding is an average across a wide range of products and customer types.
 - (a) Most importantly, products vary depending on whether the customer can instantly access their funds or whether, as in the case of term deposits, short term access is impossible or very costly for the customer. Customers are typically prepared to receive less interest for products allowing greater ease of access (ie liquidity). Additionally, the indirect (operating) costs of different products will vary according to the nature of the services and functionality provided.
 - (b) Customers, in turn, vary from households to smaller and larger SMEs to large non-financial institutions. Each type of customer typically has their own preferences in terms of price and quality.
18. In practice, the cost of retail funding tends to be lower than the cost of wholesale funding given that retail customers are (unlike wholesale customers) not using deposits solely as an investment vehicle but have wider considerations of security, transactional capability and ease of access in mind.
19. Deposit protection schemes, which provide compensation to depositors in the event of bank failure, are important in providing customers with the security they seek. Deposit guarantees will therefore tend to equalise the cost of retail funding across banks, as they reduce the risk-sensitivity of depositors. This

⁸ Company annual reports, available on the companies' websites.

benefits smaller banks and new entrants in particular, who might otherwise be seen as riskier. Since the financial crisis, these protections have been strengthened with regulators raising the compensation threshold for depositors to £75,000 via the FSCS.⁹ Under these protections the credit risk for retail deposits is low and this also contributes to the lower interest rates on these funds.

20. For consumer (household) deposits, a 2014 report by Deutsche Bank estimated the weighted average cost of retail funding across the industry as 108 basis points at July 2014 (as Table 2 shows). This is down from 180 basis points in 2012, driven both by a fall in savings account rates, and a rise in the proportion of non-interest bearing balances over time as lower interest rates have reduced customer incentives to move money into savings or keep it locked up for a period of time.

Table 2: Cost of household deposit by type (stock)

	<i>Balance at July 2014</i>	<i>Rate (%)</i>
Notes and coin	56,756	0
Non-interest bearing	141,432	0
Sight deposits	546,616	0.77
Time deposits	221,026	2.06
Cash ISA	235,415	1.81
Total	1,201,245	1.08

Source: Deutsche Bank, BoE. Figure 99 from Deutsche Bank Equity Research (September 2014), *UK Retail Banking 2014: Bank to the Future*.

21. The report by Deutsche Bank also estimated the average costs of UK customer deposit funding for some of the UK banks. This shows a mixed picture, with the figure for some banks (eg HSBC, RBSG and Metro) lower than the industry average and others (eg LBG, Santander and BoI) higher than the average, with TSB close to the average. This is partly driven by a differing deposit mix between banks (some include SMEs, some are predominantly household deposits).¹⁰
22. BoE data from April 2016 (Table 3) shows that the effective interest rate for the largest six banks in the UK is around [✂] lower than that of a selection of smaller banks, and this gap widens if focusing only on the largest four banks. This data represents the total retail funding gap averaged across deposits (both current and savings accounts) from households and private non-

⁹ See Appendix 3.1 on the regulatory framework. The limit is set by EU legislation at €100,000. The equivalent UK amount was originally set at £85,000 and changed to £75,000 from 1 January 2016 due to foreign exchange rate changes. Under Directive 94/19, the amount was €20,000, which was increased to €50,000 in 2008 and to its present amount as of the end of 2010.

¹⁰ Deutsche Bank Equity Research (September 2014), *UK Retail Banking 2014: Bank to the Future*.

financial corporations.¹¹ However, disaggregated data shows that the differentials observed arise predominantly from household deposits.

Table 3: Effective interest rate data (%), April 2016

	<i>Largest 6 banks</i>	<i>Largest 4 banks</i>	<i>Smaller banks</i>
For deposits from private non-financial corporations (PNFCs)	[ⓧ]	[ⓧ]	[ⓧ]
For household (HH) deposits	[ⓧ]	[ⓧ]	[ⓧ]
<i>Total deposits (PNFCs+HH)</i>	[ⓧ]	[ⓧ]	[ⓧ]

Source: BoE analysis, based on the data it compiles on [effective interest rates](#).

Notes:

The largest 6 banks are Barclays, HSBCG, LBG, Nationwide, RBSG and Santander.

The largest 4 banks are Barclays, HSBCG, LBG and RBSG.

Smaller banks are Clydesdale, Co-op Bank, M&S, Tesco, TSB, Virgin Money, Yorkshire Building Society.

23. We have also considered the extent to which current accounts (as opposed to savings accounts) contribute to any retail funding advantages. Such advantages may arise from the lower average interest rate paid on current accounts and the linkages between savings and current accounts.
24. While they represent a minority of household retail deposits¹² (and a slight majority for SME deposits)¹³ current accounts are generally cheaper sources of funds for the bank than savings accounts or wholesale funding, as customers are willing to pay a premium for transactional capability and liquidity.¹⁴ This is why banks offer current account products in the first place. For example, in response to our [addendum to provisional findings](#), a group of ‘challenger’ banks told us: “A key motivation for offering BCAs and PCAs is as a source of low cost funding, in particular so as to fund low risk lending.”¹⁵ All else equal, a bank with a large current account book can therefore be expected to have a lower average cost of funds than a bank that is relying on either wholesale market funding or competing solely for savings accounts.

¹¹ While we look at the aggregate data for household and non-financial private corporations combined, as a proxy to estimate retail funding differences, this estimate is likely to include some overlap between retail and wholesale deposits as the category of ‘private non-financial corporations’ includes larger firms, a proportion of which can be expected to behave more as wholesale investors.

¹² The FCA’s cash savings market study estimated that approximately £700 billion was held in savings accounts in 2013, and cites data from Mintel (see Mintel Deposit and Savings Accounts – UK, April 2014, page 12) estimating that the total value of household retail deposits (including funds placed in current accounts) was £1,225 billion in 2013. [FCA cash savings market study report](#), January 2015.

¹³ For SME banking, BCAs contribute a higher proportion (57% in June 2015) of SME retail deposits than PCAs for household (consumer) deposits. BCA estimates are based on data from the British Bankers’ Association. See [Bank support for SMEs – monthly release aggregates Q2-2015](#). Bank support for SMEs – monthly release aggregates Q2-2015. CMA analysis, calculated as current account credit balance/current account credit balance + deposit account balances. This figure is 64% for small SMEs, 50% for medium SMEs, and 57% on aggregate.

¹⁴ See paragraph 18.

¹⁵ [Letter from a group of ‘challenger’ banks to Alasdair Smith, in response to addendum to provisional findings](#).

25. Furthermore, there is a link between current account holdings and other deposit holdings. For SME banking, we have found a high level of linkage between SMEs' choice of a BCA and of business deposit accounts, with around 95% of SMEs that have an instant access savings account and 82% of SMEs with a term deposit account holding it with their main BCA bank.¹⁶
26. For personal banking, the FCA's cash savings market study found that:¹⁷
- (a) Large PCA providers hold significant savings balances from their PCA customers. They are able to offer the convenience of access to a multitude of accounts in one place. The FCA noted that in 2013, banks and building societies with a smaller PCA customer base in its sample sold on average over 50% of their savings products to non-PCA customers, compared with an average of 15% for the largest PCA providers.
 - (b) Interest rates on easy access accounts held by consumers with the large PCA providers are lower on average than those with other providers. The average interest rate offered by the top five PCA providers on easy access saving accounts opened in the last two years was 0.47%, while the equivalent rate offered by other providers was 1.65%. However, this pattern was not the case for all products.
 - (c) Consumers that hold savings accounts with the large PCA providers tend to be less responsive to reductions in the interest rate compared with consumers holding savings accounts with small and medium sized banks.
 - (d) The FCA also found that, on average, easy access savings interest rates decrease with the length of time an account is held,¹⁸ with a steeper decline in interest rates for providers other than the top five over time.
27. The FCA concluded that all else equal, it is harder for small and medium providers, compared with larger providers, to attract and retain retail deposits unless they offer and maintain higher interest rates than the larger providers. This is particularly the case for instant access accounts.
28. The findings of a 2016 report by KPMG appear consistent with the FCA's findings. KPMG found that:¹⁹

¹⁶ Source: Charterhouse BBS.

¹⁷ [FCA cash savings market study report](#), January 2015.

¹⁸ See Figures 21 and 25 of the FCA's cash savings market study report.

¹⁹ [KPMG, May 2016, A new landscape: Challenger banking annual results](#).

- (a) “Deposits remain the most significant element of Challenger bank funding. They provide c. 80 percent of total funding required, with retail customers the largest single source.”
- (b) “Larger Challengers”²⁰ had a funding advantage over “Smaller Challengers”,²¹ which KPMG attributed to the former’s “seasoned, stable deposit back books” and the fact that “a number of the ‘Larger Challengers’ also provide current accounts, which are not a significant feature of the ‘Smaller Challengers’, with the exception of Metro”.²²
- (c) The “Challenger banks” offer consistently higher savings rates, with “early stage Challengers” relying on best buy tables for deposit growth. KPMG estimated that, as at January 2016:
 - (i) For live easy access accounts, the average rate for the “Big Five” was 36 basis points (bps) compared with 73 bps for Larger “Challengers” and 108 bps for “Smaller Challengers”.
 - (ii) For three year fixed rate bonds, the price differential between the best “Big Five” rate and “Larger Challengers” was 55 bps, and 85 bps against “Smaller Challengers”.
 - (iii) Over the last three years, these differentials have widened – for example by 20bps between the “Big Five” and “Larger Challengers” for easy access accounts.

Evidence on the cost of wholesale funding

- 29. A bank receives wholesale funding through deposits and lending from wholesale investors.
- 30. Wholesale funding can be obtained on an unsecured or secured basis. Unsecured funding includes unsecured deposits from other firms, or the issuance of debt of varying maturities such as short-term commercial paper and certificates of deposits or medium term notes and bonds. Secured funding can be obtained via sale and repurchase or ‘repo’ transactions or the securitisation of illiquid assets. For example, mortgages can be securitised to

²⁰ In the KPMG report, this group includes banks such as Clydesdale, Bol, first direct, Handelsbanken, Nationwide, Paragon, TSB, Virgin Money, and Williams & Glyn.

²¹ In the KPMG report, this group includes banks such as AIB UK, Aldermore, Charter Savings, Close Brothers, Metro Bank, OneSavings, Secure Trust, and Shawbrook, as well as digitally focused challengers such as Atom, Fidor, Mondo, Starling, and Tandem.

²² KPMG, May 2016, [A new landscape: Challenger banking annual results](#).

create residential mortgage-backed securities which are tradable in the highly liquid secondary mortgage market.²³

31. To assess differences between banks in the cost of wholesale deposits, we examined BoE data from April 2016 on effective interest rates for non-retail deposits as a proxy for this purpose (Table 4).²⁴ We found that the estimated effective interest rate for the largest six banks in the UK is [redacted] lower than that of a selection of smaller banks. While the wholesale market is outside the scope of our investigation, we consider there likely to be a range of reasons why wholesale depositors may accept lower returns from incumbent banks. For example, they may have more complex banking needs that are more readily satisfied by larger, more diversified banks. More complex banking needs may also lead to some inertia of the type observed in retail banking. Additionally, the reasons why differentials may arise in wholesale lending, as discussed in the next paragraphs, may also apply to some extent to wholesale deposits.

Table 4: Effective interest rate data (%), April 2016

	<i>Largest 6 banks</i>	<i>Largest 4 banks</i>	<i>Smaller banks</i>
Non-retail deposits*	[redacted]	[redacted]	[redacted]

Source: BoE analysis, based on the data it compiles on [effective interest rates](#).

Notes:

The largest 6 banks are Barclays, HSBCG, LBG, Nationwide, RBSG and Santander.

The largest 4 banks are Barclays, HSBCG, LBG and RBSG.

Smaller banks are Clydesdale, Co-op Bank, M&S, Tesco, TSB, Virgin Money, Yorkshire Building Society.

* Deposits from central and local government, public corporations, UK MFIs (banks and BSOCS), financial corporations and non-profit institutions serving households.

32. We also considered differences between banks in the cost of wholesale lending. As previously discussed, it is less common for a smaller bank to access substantial amounts of wholesale lending. As a result, it has not been possible to gather detailed quantitative information about differences in wholesale lending costs between large banks and small banks. However, we consider that differences are likely to be material, even apart from the TBTF subsidy, which we discuss in paragraphs 35 to 38.
33. The credit risk and liquidity risk of debt issued by different firms will differ. For unsecured debt, the key driver of funding costs is the bank's perceived creditworthiness, as captured in its credit rating.²⁵ For secured debt, the cost depends on the quality of the collateral offered. While wholesale lending costs

²³ See *Bank funding costs: what are they, what determines them and why do they matter?*, published in BoE Quarterly Bulletin 2014 Q4 (BoE paper on bank funding costs).

²⁴ See also footnote to paragraph 22.

²⁵ See, for example, Moody's, June 2015, [Rating Action: Moody's concludes review on 14 UK banks' ratings; assigns CR Assessments to 17 UK banks](#).

will vary between individual firms on such grounds, larger incumbent banks are likely to have some advantages in having a longer track record and more extensive coverage by ratings agencies, and may benefit from expectations of government support, as well as being able to draw on a wider range of collateral.²⁶ Other factors exist that can also contribute to differences in wholesale funding costs between smaller and larger banks. For example, it is well known from the literature that smaller issuers of debt incur relatively higher transaction costs, such as issuance fees and carry costs;²⁷ and that their debt tends to be more thinly traded, hence carrying higher liquidity risks.²⁸ Many of these factors are a function of wholesale markets and risk preferences and are not unique to retail banking.

34. While a number of parties have made submissions on differences in wholesale funding costs,²⁹ we consider that the evidence is generally insufficient to allow us to isolate and quantify the impact of different drivers of wholesale funding costs and in particular whether any differential in costs reflect rational behaviour that would be likely to persist in a well-functioning market. Given the complexity of the issue and the interrelationships between the drivers of funding costs, it would be inappropriate for us to attempt to attribute incremental funding costs to specific causes. Nevertheless, we will briefly set out the evidence on one well-known potential driver of incremental funding costs which has been a particular focus of submissions from smaller banks: the ‘too-big-to-fail’ subsidy.

The ‘too-big-to-fail’ subsidy

35. Because of the perceived externalities involved in the failure of a large bank, in recent history public authorities have been reluctant to allow certain institutions to fail. To the extent that such a ‘bail-out’ is anticipated by a bank’s stakeholders, it has two distinct impacts on its business:
- (a) There is a moral hazard effect, whereby the bank’s management can choose to search for higher returns by taking on more risky investments without having to fully bear the consequences of this decision; and

²⁶ See also Appendix 9.3, which outlines the effect capital requirements may have on the mortgage assets of banks and hence the collateral available to them.

²⁷ The cost of carry is the opportunity cost incurred by a borrower as a result of the fact that it will only be able to issue debt infrequently. As a result, it will have to hold some of the money it has borrowed for a while before it can be used as intended. During this period, the borrower will incur a cost, equal to the difference between the interest due on the loan and the return it is able to achieve on the balance. Clearly, the smaller the borrower, the less frequently it will be able to issue debt, the higher the average balance of unused borrowed money it has to hold, and the higher the cost of carry.

²⁸ See [BoE paper on bank funding costs](#).

²⁹ See for example [response from Secure Trust to addendum to provisional findings](#) on capital requirements.

(b) There is an impact on the cost of funding, whereby the bank's cost of wholesale funding is reduced because lenders are willing to accept a lower risk premium.³⁰ It is unclear whether this impact also extends to retail funding. Particularly that part of retail funding that is covered by deposit insurance – which is the majority of retail funding – might already be considered risk-free by depositors, in which case there is no TBTF-related impact. However, the FCA's cash savings report³¹ found a low willingness by consumers, when choosing easy access savings accounts, to consider providers they did not know. Given that depending on the type of account opened, 73% to 86% said that they would be willing to consider a provider covered by the FSCS, this suggests that respondents may be unsure about whether these types of providers were likely to be covered by FSCS hence reducing its benefits for smaller, newer providers. As part of the FCA's cash savings study, the FCA also collected evidence on balances held by banks which indicates that, among the savings products in scope for the study, 14% of the balances of large banks exceeded the then applicable FSCS limit of £85k, compared to 7% for smaller banks.³² However, this analysis is not definitive in that it does not take into account the extent to which customers may have spread their savings across different accounts in order to remain within the FSCS threshold, nor the extent to which different customer targeting strategies may affect this.

36. The former is a potential concern from a prudential point of view. The latter, on the other hand, may well amount to a subsidy to the larger incumbent banks, reducing their funding costs relative to their smaller competitors. Because of the importance of TBTF for prudential and competition regulation, considerable effort has been made – and continues to be made – to estimate the size of the impacts on investment decisions and funding costs, as well as trends over time and effects of policy interventions.³³ This literature is surveyed in a BoE working paper by Siegert & Willison.³⁴

³⁰ A common assumption is that equity holders might not benefit from a bailout directly because their claims could be fully wiped out when a bank is bailed out. See C. Siegert & M. Willison, February 2015, [Estimating the extent of the 'too big to fail' problem – a review of existing approaches](#), Financial Stability Paper No. 32.

³¹ [FCA cash savings market study report](#), January 2015.

³² FCA analysis, based on the balances held in December 2013 by the firms in the sample used for its cash savings market study report. These balances accounted for the majority of cash savings accounts in the UK.

³³ Concerning US banks, researchers from the Federal Deposit Insurance Corporation found an advantage of “around 40bps”, cf. [S. Jacewitz & J. Pogach \(2014\), 'Deposit Rate Advantages at the Largest Banks'](#). A research paper by the Federal Reserve Bank of New York distinguished between AA and A rated issuers, and found an advantage of 121bps among the former, and 31bps among the latter, cf. [J.A.C. Santos \(2014\), 'Evidence from the Bond Market on Banks' "Too-Big-to-Fail" Subsidy'](#).

³⁴ C. Siegert & M. Willison, February 2015, [Estimating the extent of the 'too big to fail' problem – a review of existing approaches](#), Financial Stability Paper No. 32.

37. As they report, estimates of the size of the TBTF subsidy have been considerable. Particularly at the height of the financial crisis, there are studies that found a subsidy of more than 100bps. However, the exact magnitude of the impact varies significantly between different sources of funding and between different methodologies that might be used.³⁵
38. However, there is evidence that the measures taken and ongoing to address this³⁶ have reduced the magnitude of the TBTF subsidy:
- (a) An IMF study in 2014 used a range of approaches to estimate the TBTF subsidy on bond spreads in the UK as between 20 and 60 basis points (by one estimate, equivalent to \$20–\$110 billion in subsidies to G-SIBs alone in the UK in 2011/12). The study also indicated that these subsidies have been declining from their post-crisis peak in recent years (by one estimate, having reverted to close to the pre-crisis level in the UK).³⁷
 - (b) There are also clear signs of the market reacting to TBTF reforms. Ratings agencies have started to reduce their ‘government support’ uplifts for big banks.³⁸ For example, in May 2015 Fitch announced a three-notch downgrade for RBSG and LBG on its senior unsecured debt ratings at both holding company and operating company levels on this basis,³⁹ while Moody’s took a similar action for systemically important UK banks in June 2015.⁴⁰ Spreads between senior and structurally subordinated debt of UK Global Systemically Important Banks (G-SIBs) also suggest that resolution regimes are gaining credibility.⁴¹
 - (c) A report by PwC on the impact of structural reform in the EU banking sector which analyses the existence and magnitude of any implicit subsidy on bond spreads for EU banks concludes that ‘we do not find any evidence of cost of funding advantages for banks that are designated as G-SIBs’, size is statistically insignificant in explaining spreads but credit

³⁵ C. Siebert & M. Willison, February 2015, [Estimating the extent of the ‘too big to fail’ problem – a review of existing approaches](#), Financial Stability Paper No. 32. See for example tables A and B, which show estimates of long-run average funding cost advantages ranging from -6 to 100 bps dependent on the type of liability examined and the methodology applied.

³⁶ For example, see Appendix 3.1 on measures to strengthen bank resilience and resolution, including the introduction of ring-fencing.

³⁷ IMF (April 2014), *Global Financial Stability Report*, Chapter 3.

³⁸ See BoE press release: [A 21st century approach to dealing with failed banks – speech by Sir Jon Cunliffe at the 1st Single Resolution Board Annual Conference](#).

³⁹ Published announcements from ratings firms.

⁴⁰ Moody’s, June 2015, [Rating Action: Moody's concludes review on 14 UK banks' ratings; assigns CR Assessments to 17 UK banks](#).

⁴¹ See BoE press release: [A 21st century approach to dealing with failed banks – speech by Sir Jon Cunliffe at the 1st Single Resolution Board Annual Conference](#). Sir Jon notes in his [speech](#) an apparent jump in awareness at the beginning of 2016, with the average spread for senior debt issued by European G-SIBs increasing by over 25% within little more than a week.

risk is a material factor, and ‘on average, funding cost differences exist between large and small firms in other sectors similar to financial institutions’.⁴² However, this analysis applies at an EU rather than UK level.

Funding for lending

39. FLS was introduced in 2012 to incentivise banks to boost their lending to the UK real economy. It was extended and amended in 2013, with further changes in 2014 to focus on supporting SME lending. A BoE report in May 2014 observed that banks’ marginal retail and wholesale funding costs fell around 150 to 200 basis points between the launch of the FLS and the end of 2013. While noting the difficulty of assessing the FLS’ contribution to these developments, the BoE concluded that, overall, ‘it is probable that the FLS helped to reduce bank funding costs and, more generally, boosted lending to the real economy over the period of its operation’.⁴³
40. A 2015 KPMG report noted that the ‘Smaller Challengers’ achieved an 80bps increase in their average net interest margin between 2012 and 2014, largely as a result of FLS having lowered their costs of funding. The report states that FLS has reduced competition for savings and allowed the ‘Challengers’ to re-price their deposits and diversify their deposit products. The ‘Larger Challengers’ have also benefited from the introduction of the FLS. However, this has been offset by an average reduction in asset yield of 60bps between 2012 and 2014, primarily reflecting increased competition in prime residential mortgages lending’.⁴⁴
41. The FCA found in respect of cash savings accounts that FLS ‘has reduced banks’ reliance on retail deposits, and average interest rates on retail deposit accounts have declined across the board as a result’.⁴⁵
42. Atom said that FLS has played a role in underwriting the assets of new banks and allowing them to expand by giving them access to a cheap source of funding to build their business and brand. This is important because new

⁴² PwC report for the Association for Financial Markets in Europe (November 2014), [Bank structural reform study: Supplementary report 1: Is there an implicit subsidy for EU banks?](#)

⁴³ BoE Inflation Report, May 2014.

⁴⁴ KPMG (May 2015), [The game changers: Challenger Banking Results](#). Smaller challengers are defined in the report as Aldermore, Handelsbanken, Metro, OneSavings Bank, Shawbrook and Secure Trust. Larger challengers are defined in the report as first direct, National Australia Bank, Nationwide, Post Office, TSB, Virgin Money and Williams & Glyn.

⁴⁵ FCA (January 2015), [Cash savings market study report: Part I: Final findings Part II: Proposed remedies](#), paragraph 3.57.

banks are not rated by the agencies and so see a lower demand for their debt and have to price it more attractively.

43. However, some smaller banks criticise the FLS, arguing that they are disadvantaged relative to the larger banks as they are not able to provide the collateral required to access FLS to the extent desired,⁴⁶ and noting that LBG draws down on the scheme more than any other firm.
44. A further extension to the FLS, until 31 January 2018, was announced in late 2015.⁴⁷
45. Under this two-year extension, funding will remain available to support further SME lending, with drawdowns available for the same term (four years) and fees (25 basis points). However, the borrowing allowances available under the scheme will reduce over the extension period, ensuring that the scheme is gradually phased out in order to minimise risks to the economic recovery from the withdrawal of funding support. The extension will be open to both current and new participants.
 - (a) Current participants in the FLS extension will remain part of the scheme and will continue to be able to draw against existing unused borrowing allowances beyond 31 January 2016, but will not generate additional allowances from lending beyond the end of 2015. From 1 February 2016, participants will initially retain full access to draw against their borrowing allowance. Allowances will reduce by 25% after six months, and by the same amount every six months thereafter until the end of January 2018 when the scheme will close. The tapering of allowances will enable a smooth withdrawal of this funding support and bring the drawdown window to a natural close after two years.
 - (b) Provision has also been made within the scheme extension to ensure that new banks are not put at a disadvantage relative to other banks that have access to the scheme due to their lack of a prior lending history (ie because they may not have had the opportunity to generate any prior allowances to draw against during the extension period). New banks that have been authorised or had a significant change in control since 1 April 2013 and with a lending stock smaller than £50m at end-2015 will be

⁴⁶ For example, [Secure Trust's response to our updated issues statement](#). Secure Trust also stated that disparities between the SA and IRB approach to capital requirements for low loan-to-value mortgage asset classes (see the discussion of capital requirements earlier in this section) contribute to this as banks using the SA are less able to compete for prime mortgage assets. This is considered in detail in Section 9 on capital requirements.

⁴⁷ BoE news release, 30 November 2015: [Bank of England and HM Treasury announce extension to the Funding for Lending Scheme](#).

allowed to generate and draw against new allowances over the two-year extension.

46. Under this approach, the FLS extension should continue to provide some support for SME lending to established and new banks alike, while facilitating a smooth transition to other funding sources and allowing a reasonable lead time to manage this process.

Evidence on the total cost of funds and its relationship with capital requirements

47. In response to our [addendum to provisional findings](#) on the capital requirements regime, a number of parties made submissions about the relationship between their capital requirements and their funding costs.
48. LBG told us that our analysis of the impact of higher capital requirements on the total cost of funds (including the cost of equity) was likely to overstate any increase, because in our illustrative example we held the cost of equity constant, regardless of the bank's gearing.⁴⁸ LBG considers that the impact of a higher capital requirement is likely to be offset partially by a decrease in the bank's cost of equity.
49. This view is consistent with the relevant literature. In a 1958 paper, Franco Modigliani and Merton Miller showed that, under certain conditions, the average cost of capital of the firm was independent from its gearing.⁴⁹ In subsequent work, they showed that this result did not hold in the presence of taxes, bankruptcy costs, agency costs, asymmetric information, or other market inefficiencies, but their analysis still predicted a partial offset: while equity is more costly than debt, financing a company with more debt tends to increase the rate of return shareholders require,⁵⁰ meaning that an increase in gearing will not necessarily reduce the cost of capital.
50. This proposition has generally been confirmed by empirical studies. However, estimates of the size of the Modigliani-Miller offset have varied considerably. In recent years, there has been considerable effort to estimate this offset for banks specifically, as there are reasons to believe that the relationship between gearing and the cost of capital is different for banks than for other companies. Differences cited include the ability of banks to borrow money –

⁴⁸ See Appendix 9.3 and [LBG response to addendum to provisional findings](#).

⁴⁹ Modigliani, F.; Miller, M. (1958). "The Cost of Capital, Corporation Finance and the Theory of Investment". *American Economic Review*, Vol. 48, No. 3, p. 261–297.

⁵⁰ As this would increase the variability of returns to equity holders over the economic cycle.

through current accounts – without paying interest because consumers value current account balances as a form of money.

51. Recently, the literature in this area has been surveyed by a number of policy makers in the area of prudential regulation looking to estimate the macroeconomic costs and benefits of higher capital requirements. For example, in December 2015 the BoE published a policy paper that assumed, based on a survey of the literature, that a 50% Modigliani-Miller offset was the most appropriate assumption.⁵¹
52. Applying a similar offset to our illustrative example of the impact of the differences in capital requirements on the cost of funding, which is replicated in Table 5 of Appendix 9.3, would reduce the impact by half. However, because this table is intended to illustrate the concept rather than provide an estimate of the magnitude of the impact, we continue to hold the cost of equity constant there.
53. Secure Trust told us that the funding costs of the IRB and SA banks were not the same at 2% as assumed by the CMA in Table 5 of Appendix 9.3. It stated that based on its analysis,⁵² larger banks funded their deposits at less than half of the cost of smaller banks, and that they dominated the lending market because of their funding cost and capital requirement advantages.
54. According to Secure Trust's calculations, a large IRB bank will generate a >200% RoE (ignoring operational costs and impairments) on a 50% LTV mortgage using a fixed 2 year 1.7% fixed rate, whereas a smaller SA bank will lose money. Secure Trust made the point that this differential in profitability was why the larger banks were writing proportionately more low LTV mortgages – which were also the safest form of lending.
55. This assessment was based on estimates of funding cost (%) calculated by dividing interest expense by average customer deposits.⁵³ While this may be one measure of estimating funding costs, it may not be comparable across banks because of various factors including the following:
 - (a) accounting policies;
 - (b) business mix;
 - (c) scope of operations ie international versus domestic;

⁵¹ [Bank of England Financial Stability Paper No. 35 – December 2015](#): Measuring the macroeconomic costs and benefits of higher UK bank capital requirements.

⁵² [Secure Trust Bank response to provisional findings](#).

⁵³ Based on figures reported in published accounts of RBSG and Secure Trust Bank.

- (d) proportion of wholesale and retail funding used; and
- (e) hedging policy and use of derivatives.
56. The RoE differential between a small SA bank and an IRB bank according to the profitability model provided by Secure Trust are highly sensitive to the funding costs attributed. Secure Trust has assumed cost of funds for a small SA bank to be 2.6% compared to 0.9% for an IRB bank, a differential of 170 bps. This is calculated by dividing interest expense by average customer deposits from banks⁵⁴ published accounts. In respect of sensitivity analysis, if the funding costs of the IRB bank were to be 1.8% instead of 0.9% (a difference of ~80 bps compared to the SA bank), the RoE advantage for the IRB bank would be eroded.
57. Using a similar methodology to Secure Trust, KPMG reported⁵⁵ the overall cost of funds as 1.1% in 2015 for “Larger Challengers”,⁵⁶ and 2.0% for “Smaller Challengers” (a difference of 90 bps).⁵⁷
58. Due to inherent difficulties of comparing funding costs on a like for like basis, and variances in capital requirements across different assets, it is not readily possible to quantify the advantage incumbent banks receive from the combined effects of capital requirements and funding sources. Given the sensitivity analysis above, and the variation in funding outcomes for different banks as illustrated by KPMG, while we expect some advantage for certain asset classes due to these factors, this may not be consistently as large as suggested by Secure Trust. For the reasons set out in Section 9 we have not undertaken any further analysis to determine the scale of the impact on competition that is attributable to the capital requirements in our reference markets.

Branches

The decline of bank branches

59. Branches have traditionally been the principal distribution channel for banks, used by customers for checking account balances, handling cash payments/withdrawals and obtaining advice. The advent of telephone banking

⁵⁴ STB and RBS.

⁵⁵ *A new landscape: Challenger banking annual results*. KPMG, May 2016.

⁵⁶ In the KPMG report, this group includes banks such as Clydesdale, BoI, first direct, Handelsbanken, Nationwide, Paragon, TSB, Virgin Money, and Williams & Glyn.

⁵⁷ In the KPMG report, this group includes banks such as AIB UK, Aldermore, Charter Savings, Close Brothers, Metro Bank, OneSavings, Secure Trust, and Shawbrook, as well as digitally focused challengers such as Atom, Fidor, Mondo, Starling, and Tandem.

in the 1990s, and online and mobile banking more recently⁵⁸ (collectively, ‘direct channels’), has changed how customers (personal and SME alike) interact with their bank(s), and multi-channel banking has become the new norm.

60. Some banks have stand-alone branches or business centres for SME customers that provide services such as a dedicated business banking counter service and relationship/business banking advisers. The total number of business centres in the UK has been more stable than retail branch numbers since 2013 (see Table 5 below).⁵⁹

Table 5: Total number of business centres in the UK*

	2013	2014	% YoY change†
England	395	394	-0.3
Scotland	63	63	0.0
Wales	22	19	-13.6
NI	20	19	-5.0
Total	500	495	-1.0

Source: CMA analysis.

*Based on data from ALB, BoS, Clydesdale, Danske, HSBC, Lloyds, RBSG, Santander and Yorkshire Building Society. Data provided as at 1 January 2014 (approximated stock 2013) and at 1 January 2015 (approximated stock 2014). Branches (business centres) that service SME customers only.

†Year-on-year change in stock of business centres between 2013 and 2014.

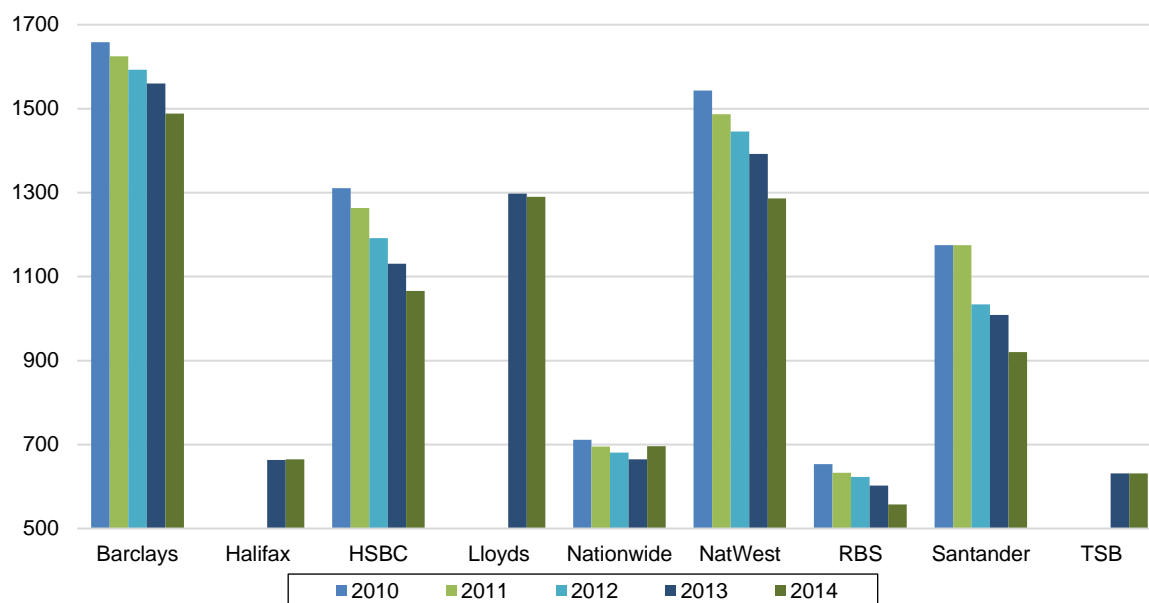
61. Figure 3 and Figure 4 below plot the decline in the number of (retail) branches between 2010 and 2014 for banks with greater than 500 and fewer than 500 branches respectively. With the exception of Halifax, Nationwide and TSB, bank brands with relatively large branch networks (more than 500 branches) have been closing branches in every year since 2010. Nationwide also had a smaller branch network in 2014 compared to 2010. A similar trend of branch closures can be seen for those banks with relatively smaller branch networks. Metro, which entered the market in 2010 with a strategy focused on branch and customer service, is the exception; it has been steadily growing its branch network and plans to continue to do so at least until 2020⁶⁰.

⁵⁸ This includes ‘digital wallets’ that facilitate the storage of payment (and possibly other) credentials and enable users to make payments, either online or via a mobile device. For more details see section 4 and appendices 4.2, 5.6 and 7.6.

⁵⁹ In our information request to banks, we asked parties to exclude retail branches which provide basic services such as deposit facilities to SME customers. Some banks have co-located branches and business centres that they cannot separate for data collection purposes. These figures may overestimate the number of business centres.

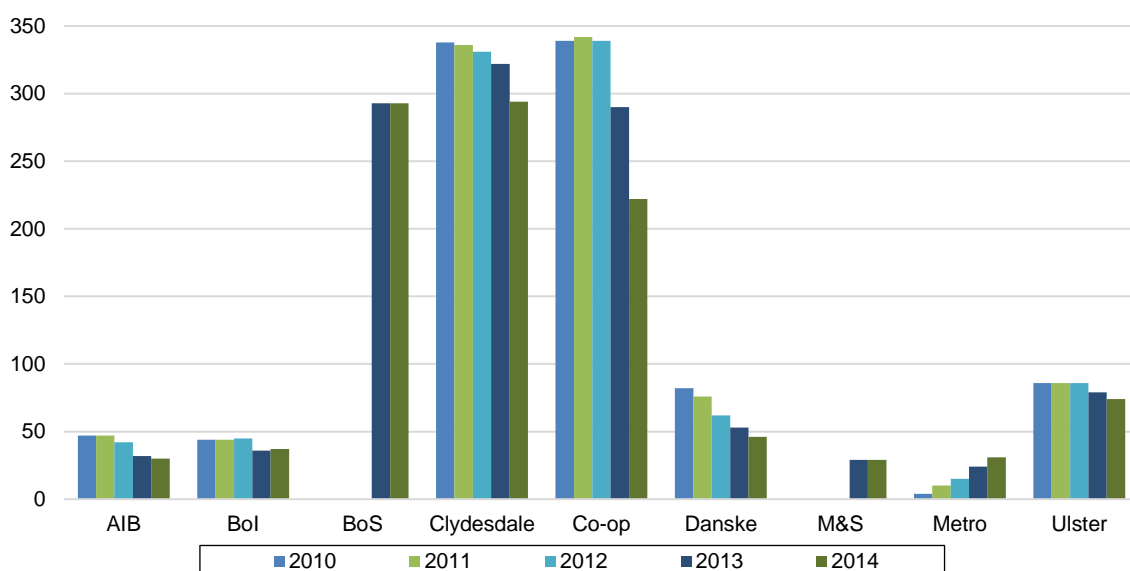
⁶⁰ See further Appendix 9.1 Metro case study on its branch strategy.

Figure 3: Number of branches by brand, 2010 to 2014 (banks with more than 500 branches)



Source: CMA analysis.

Figure 4: Number of branches by brand, 2010 to 2014 (banks with fewer than 500 branches)*



Source: CMA analysis.

*Clydesdale refers to Clydesdale Bank Plc, which includes trading names Clydesdale Bank and Yorkshire Bank.

62. For the nine banks included in Figure 4, the average branch network size in 2014 remained significant at 961. A report by Deutsche Bank⁶¹ quotes research by CACI,⁶² which found that 80% of the UK market today can be covered by a bank through around 800 branches. CACI forecasts that 600

⁶¹ UK Retail Banking 2014: Bank to the Future, Deutsche Bank Equity Research, September 2014.

⁶² CACI is a location planning consultancy that has worked with a number of banks to assess their optimal branch network size.

branches will 'deliver effective nationwide customer coverage' in five years' time.

Reforms to existing branches

63. In addition to an overall branch network consolidation by existing banks, remaining branches are being replaced with smaller, more digitally-focused outlets. A number of aspects of banks' branch optimisation strategies are common across firms and include the following:
- (a) **Assisted digital** – a migration to self-service technology (including 'smart ATMs' with enhanced functionality such as cash and cheque paying-in facilities, and mobile technology) and reformed staff interactions with customers. HSBCG, for example, is introducing tablets in its branches during 2015 to enable improved services to customers. TSB's analysis suggests that increasing self-service facilities in branches can deliver a cost reduction of around [X]% 'without impacting customer service'. Barclays told us that one of the ways of ensuring the accessibility of digital banking for all its customers is the introduction of more than [X] (specially trained staff) in all of its branches to provide technology advice to customers and the general public.
 - (b) **Reduced counter services and teller staff** – according to Barclays, [X]% of bill payments by its customers are made through online and mobile banking, with less than [X]% of bill payments made in branch. Barclays also noted the importance of alternative physical channels like the Post Office for cash handling. Meanwhile, HSBCG noted that while most visits to its branches remained for cash and cheque deposits, it expected this to decline as cheque usage was decreasing and the use of mobile payments and peer-to-peer payments increasing.
 - (c) **Remote/virtual advice** – replacing static branch-based advisers with a central pool of advisers that engage with customers via video-conferencing. Barclays and Nationwide are examples of banks using this technology to link customers with advisers or relationship managers.
 - (d) **Alternative branch formats** – temporary pop-up branches and smaller branches are being used to fulfil demand where banks may be under-represented (or not present at all). Halifax, for example, has trialled pop-up branch operations in Scotland, where branch staff provide customer advice and assistance in shopping centres, supported by access to online banking facilities provided in the pop-ups. Barclays has introduced a new distribution format with Asda, called 'Barclays Essentials'. Barclays currently has eight Barclays Essentials branches, which it says offer its

customers convenience and extended opening hours. RBSG has extended counter services to mobile banking vans. It told us that this service was used by [redacted] SME customers in the [redacted].

64. Smaller branch networks and reforms to remaining branches are enabling banks to focus investment more narrowly, increase efficiency and cut costs.⁶³

Importance of branches to customers

65. Customer preferences may be driving a response by banks (existing banks and new entrants) as well as responding to a reduction in the supply of bank branch services. Banking is increasingly becoming a self-serve activity for consumers. Consumers are, according to a report by Deloitte, demanding greater convenience and expect a seamless integration of remote and in-person channels wherever they may be.⁶⁴

Importance of branches to PCA customers

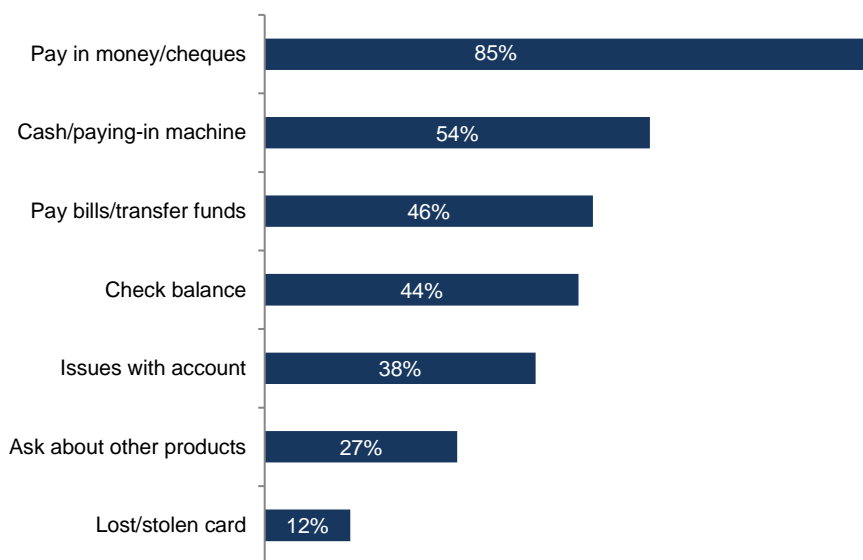
66. TSB carried out its own customer research and found that for 69% of customers, having a branch close to where they lived was important.
67. Despite the reported importance of bank branches, according to GfK PCA consumer research, less than two-fifths (39%) of PCA customers visit their branch at least once a month (see Figure 5). This falls to 31% for PCA customers aged between 18 and 44 years. 42% of respondents use a branch less than twice a year (this includes those who said they 'never' use a branch). Consumers may, therefore, place some intrinsic value on a branch presence even where they are not frequent users. In contrast, 66% and 74% of respondents' use internet banking and mobile banking respectively and most are frequent users (logging on to their account at least once a week).
68. RBSG told us that currently, and increasingly, customers made use of multiple channels combining frequent digital access with less frequent in-branch or telephone interactions. It told us that despite reducing its branch network, the number of customer interactions with RBSG had increased in recent years (from [redacted] customer interactions with the bank in [redacted] to [redacted] in [redacted]). RBS predicted this would rise to [redacted] in [redacted] as more people used digital technology to interact with the bank.

⁶³ Although branch reforms are not without cost: RBS noted in its [response to our issues statement](#) that the refurbishment and updating of its branch network carried a 'significant' cost. [redacted]

⁶⁴ Deloitte (2014), [Bricks and clicks – Mapping the future of branches](#).

69. The most common reasons for visiting a branch cited by respondents to GfK PCA consumer survey were to pay in money or cheques (either over the counter or by machine) (85%) and to use cash machines or paying-in machines (54%), as depicted in Figure 5. Accenture’s report, *Winning the race for relevance with banking customers*, found that more than twice as many PCA customers making deposits prefer to do so through an adviser at a counter rather than using a self-service ATM.⁶⁵
70. Further, nearly half (46%) of respondents to GfK PCA consumer survey that use branches visited their branch to pay bills or transfer funds between accounts. This was more common among those aged 45 years or over (50% versus 41% of 18 to 44 year-olds) and those who did not use internet banking (58% versus 40% of those who did).

Figure 5: Reasons provided for visiting a bank branch*



Source: GfK PCA consumer survey.

*Respondents were asked: 'Have you used any of the following in the last year when going inside a branch?'

Base: All those who have visited a branch in the last year (3,764).

71. LBG told us that a significant proportion of current branch activity occurred because customers were not yet aware of, or comfortable with, using digital channels. It noted that branches were key enablers of the multi-channel experience as they were used as a point of contact for branch staff to educate customers about digital channels and sign them up to digital banking. While not accounting for a significant proportion of branch visits at present, LBG noted that an increasing proportion of branch visits were for complex

⁶⁵ Accenture report (2014), [Winning the race for relevance with banking customers](#). Accenture’s research consisted of online interviews with 3,604 UK current account customers, conducted in March 2014.

conversations across a range of products and its branch strategy reflected this.

72. There is evidence that branch usage differs between PCA customer segments. First, age appears to be a factor in determining branch usage. GfK PCA consumer research found that, as shown in Figure 5 above, those aged 18 to 44 tend to be less frequent visitors to a bank branch than the average population. However, having a national network of branches was more important to younger respondents (68% of 18 to 44 year-olds versus 51% of those over 65) who may be more likely to relocate (eg moving away for university or moving jobs).

73. [✂]

Figure 6: [✂]

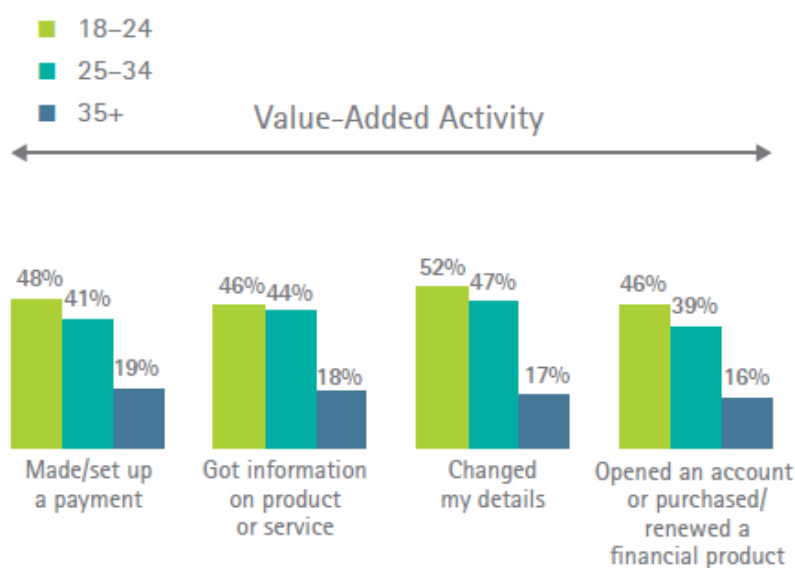
[✂]

Source: [✂]
[✂]

74. A report by Accenture found that in addition to those around retirement age, 18 to 24 year-olds were most likely to visit branches, reflecting 'changing needs over life stages'. According to Accenture's research, younger customers have a greater bias for physical interaction pointing to their need for face-to-face contact, advice and reassurance as they begin their financial journey.⁶⁶ As Figure 7 depicts, 18 to 34 year-olds are more likely than over 35s to engage in 'value-added activity' in branches (defined as non-transactional activity).

⁶⁶ Accenture (2014), *Winning the race for relevance with banking customers*.

Figure 7: 'Value added' activity in branches by age group*

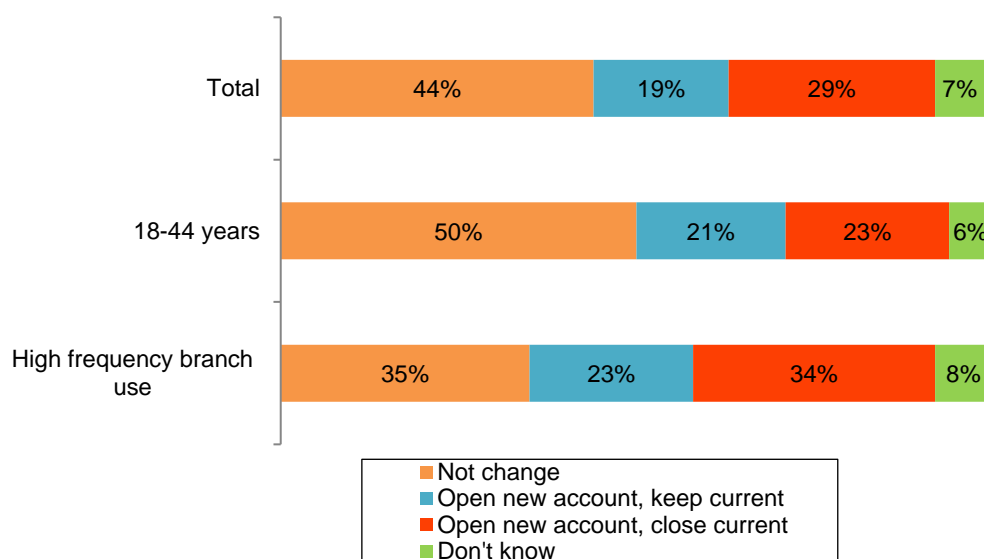


Source: Accenture UK Financial Services Customer Survey 2014. Accenture (2014), *Winning the race for relevance with banking customers*.

*Responses to the survey question: 'Which of the following activities did you do during your last visit to your bank's branch?' The research consisted of online interviews with 3,604 UK current account customers conducted in March 2014.

75. Second, branch usage is correlated with usage of other channels. Frequent users of telephone banking are, according to GfK PCA consumer survey, also more frequent branch users. Further, over half (55%) of high frequency branch users (once a week or more) have never used internet banking. 74% of consumers that do not use internet banking consider having a convenient local branch to be either essential or very important compared with 56% of consumers that do use internet banking.
76. Third, GfK PCA consumer research found that PCA holders who are on a low income (defined as less than £12,000) tend to visit their bank branch (of their main current account) more frequently. 47% of customers on low incomes visited their bank branch at least once a month compared to 39% on average.
77. The difference in channel preferences by consumer type are reflected in Figure 8, which shows reported customer behaviour in response to the (hypothetical) closure of their main bank branch. On average, 44% of customers would stay with their existing 'main' bank if their most-used branch closed but 29% of customers would open a new account and close their current account. Half of 18 to 44 year-olds would not take any action if their main bank branch closed versus 35% of frequent branch users (those that use a branch at least once a week). This analysis does not take into account the proximity of a customer's alternative branch either with their existing bank or a different bank.

Figure 8: Reported behaviour if most-used branch closed*†



Source: GfK PCA consumer research.

*Responses to the survey question 'Thinking about the branch of bank that you use most often, if that branch was closed permanently, would you open an account with a bank with a more convenient branch? If yes would you keep your account [with the bank that closed its branch] open or would you close it?'

†High frequency branch use defined as those customers that visit a branch at least once a week.

Note: Base = all those who have visited own bank branch in the last year (3,764).

78. GfK's qualitative consumer research found that individuals' responses to a branch closure are likely to be determined by the availability of alternative branches in their area and the extent to which they use digital resources. The closure of a branch network (ie branches across the country), however, is considered by most to be a severely detrimental development. Younger consumers saw this as a significant challenge to their relationship with the bank, while older consumers saw it as the termination of the relationship.⁶⁷

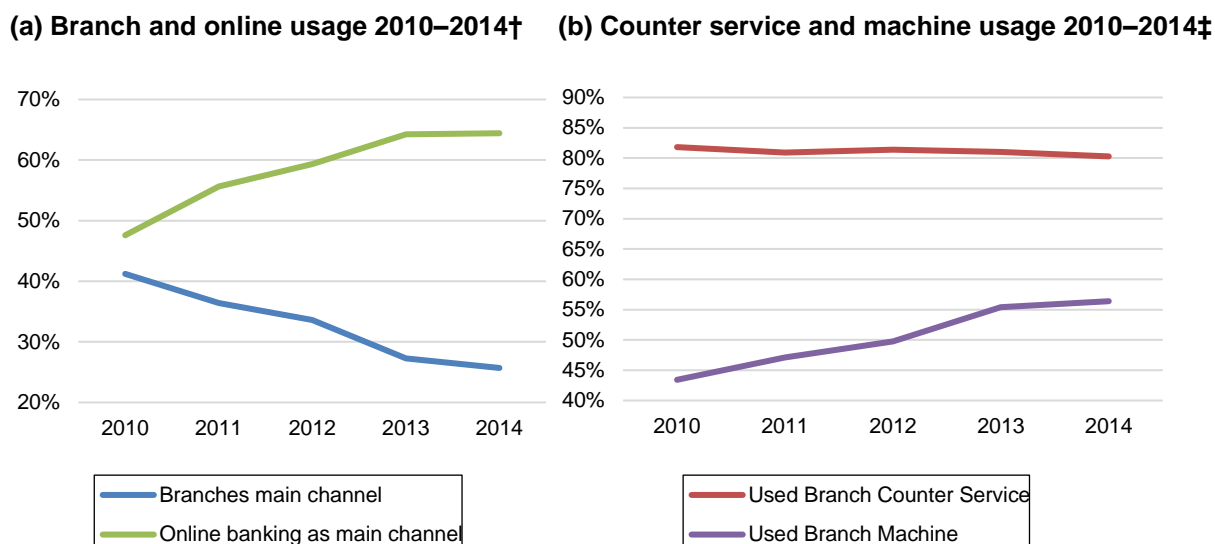
Importance of branches to SME customers

79. According to survey data from Charterhouse, the proportion of SMEs reporting they use branches as their main banking channel has fallen in every year of the past four years, decreasing from 41% of SMEs in 2010 to 26% in 2014.⁶⁸ However, over the same period the number of SMEs using branch counter services in the 12 months prior has remained level at around 80%. Meanwhile, the proportion of SME customers using online banking as their main channel rose to 64% in 2014 from 48% in 2010. This is shown in Figure 9 below.

⁶⁷ GfK PCA consumer survey.

⁶⁸ In its [response to our provisional findings](#), HSBC references a [research report](#) from McKinsey which found that SMEs in Europe are 4.5 more times likely to choose a bank with a good digital banking platform than one with branches nearby.

Figure 9: SME channel usage*



Source: Charterhouse BBS 2010–2014.

*Data from the Charterhouse BBS. This is a quarterly survey, collecting approximately 14,000 to 16,000 interviews with SMEs annually.

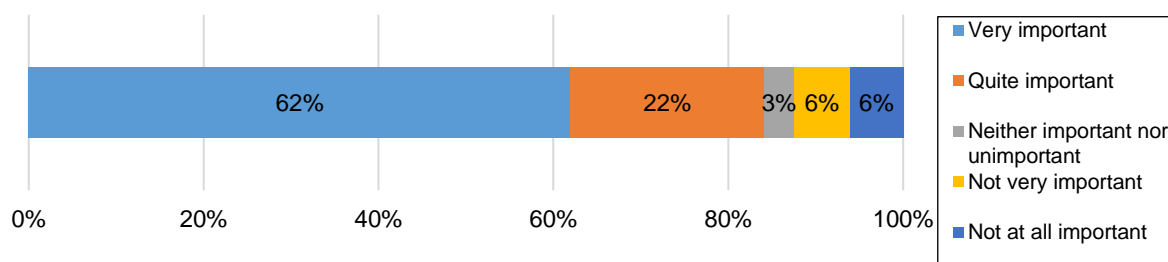
†In response to the survey question 'What is your most used banking channel?'

‡In response to the survey question 'Have you or anyone else in your business used Branches/Branch Machine in the past year?'

80. A Charterhouse survey of SME start-ups found that 82% use their local branch to open their BCA.⁶⁹ After banks' websites (29%), branch visits or leaflets from branches were the most popular source for start-ups to obtain information on BCAs (22%).

81. According to Charterhouse's survey of start-ups, having a branch in a convenient location or close to their business was the second most important reason for choosing a bank (17%) after access to free banking (19%). Further, 84% of start-ups reported that having a branch was either very important or quite important to their decision of who to bank with (see Figure 10 below).

Figure 10: Importance of branches to start-up SMEs*



Source: Charterhouse survey of start-up SMEs.

*In response to survey question: 'How important to you choice of bank was having a convenient branch location /or a branch that is close to your business?'

⁶⁹ Start-ups defined as businesses which have been operating for two years or less. [Survey undertaken by Charterhouse for the CMA.](#)

82. Paying in cash or cheques and taking out cash were the main reasons start-ups provided for requiring access to branches. 84% of respondents to Charterhouse's survey of start-ups quoted this as being the most important reason for having access to a physical branch. The next most important reason was for meeting a relationship manager/bank staff, but this was only true for 19% of respondents. Access to a network of branches across the country was viewed as 'not very important' or 'not at all important' for the majority of start-ups (62%). 29% considered a branch network as very/quite important.
83. Consumer research undertaken by Research Works found that SMEs consider it important to know branch staff, particularly counter staff and the relationship manager.⁷⁰ Being known personally implied to the customer that the bank knew their business well and this was given as a reason for staying with their bank.
84. [✂]⁷¹
85. The services demanded of, and available to, customers in branch is also often dependent on the size of business and the complexity of their needs. For example, RBSG told us that the extent to which a business customer made use of branch counter services depended primarily on how cash/cheque heavy the business' operations were. In addition to branch services that served RBSG's business customers' simplest needs (day-to-day transmission requirements such as cash/cheque deposits and withdrawals), relationship managers⁷² were assigned according to complexity of the relationship, sophistication of customer, size of customer, growth expectations, financial requirements and business needs. Customers with annual turnover of £250,000 to £2 million, or that had debt greater than £25,000 were managed by relationship managers (who were typically based in retail branches) on a face-to-face basis. These relationship managers, RBSG told us, interacted with their customers to satisfy 'more complex needs' including borrowing requirements and introductions of experts in asset and invoice finance. RBSG's larger SME customers with annual turnover between £2 million and £25 million were managed by relationship managers operating out of separate 'commercial banking centres'. These did not have counter facilities, and engagement was by appointment only.
86. Similar to the trends observed in personal retail banking, digital channels are playing an increasingly important role in SME banking. RBSG told us that

⁷⁰ [Research Works SME qualitative research report.](#)

⁷¹ [✂]

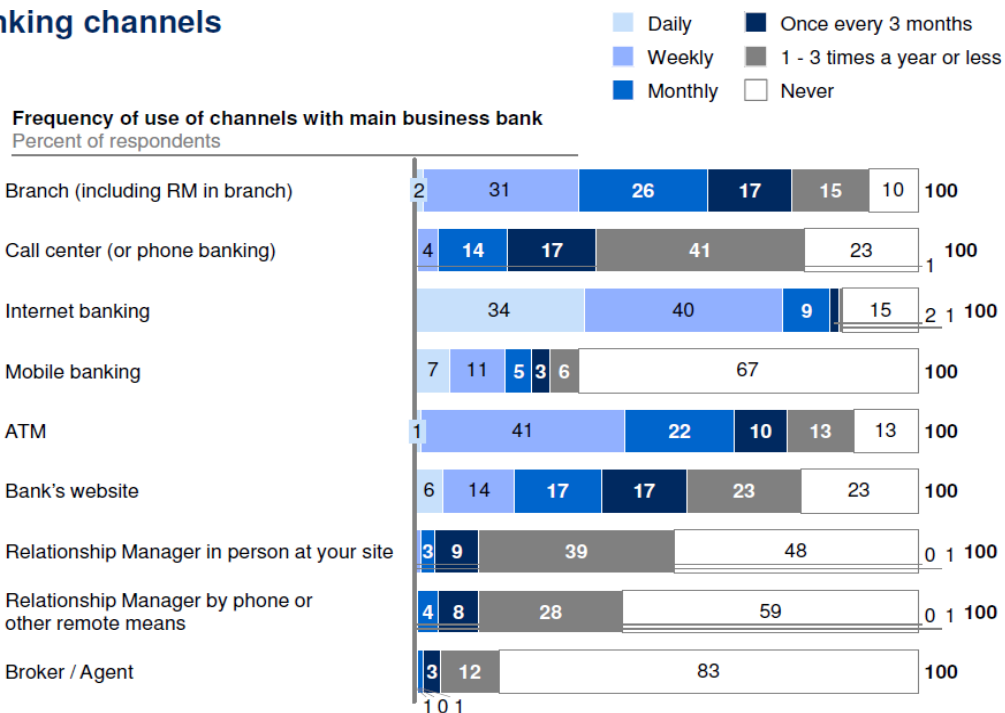
⁷² Which would also include business managers, business specialists and the RBS Connect team.

digital channels accounted for [X%] of SME servicing activity and this was expected to grow to [X%] by [X]. Further, [X%] of RBSG's SME sales are delivered through online or telephone banking services. A separate Charterhouse customer survey undertaken for RBSG shows that [X%] of its SME customers would value banking services through mobile.

87. A McKinsey survey of SMEs with less than £0.5 million turnover found that one-third of customers use a branch at least once a week whilst 74% use internet banking with the same frequency (see Figure 11).

Figure 11: Banking channel usage by SMEs (less than £0.5 million turnover)

Banking channels



DC1: How often do you use the following banking channels to interact with your main Bank?

Source: McKinsey small business banking survey: UK.

88. Handelsbanken told us that while demand for mobile technology from SMEs had increased, it had done so from a lower base and to a lesser extent than for personal customers. Handelsbanken noted that the demands it was seeing for application ('app') functionality was at present limited to basic balance and transaction information (without the need for payments functionality). It considered that there was continued and growing demand from SMEs for branch-based, local relationship banking across the UK and it would continue to open branches alongside investing in its internet and telephone banking offering for SMEs and developing mobile banking for SMEs.

Importance of branches to banks

89. Branches continue to fulfil a number of valuable functions for banks. Namely, branches enable banks to acquire new customers and (to a lesser extent) to retain existing customers. In addition, a high street presence helps build brand recognition and thus loyalty among customers.

Branches and market positioning

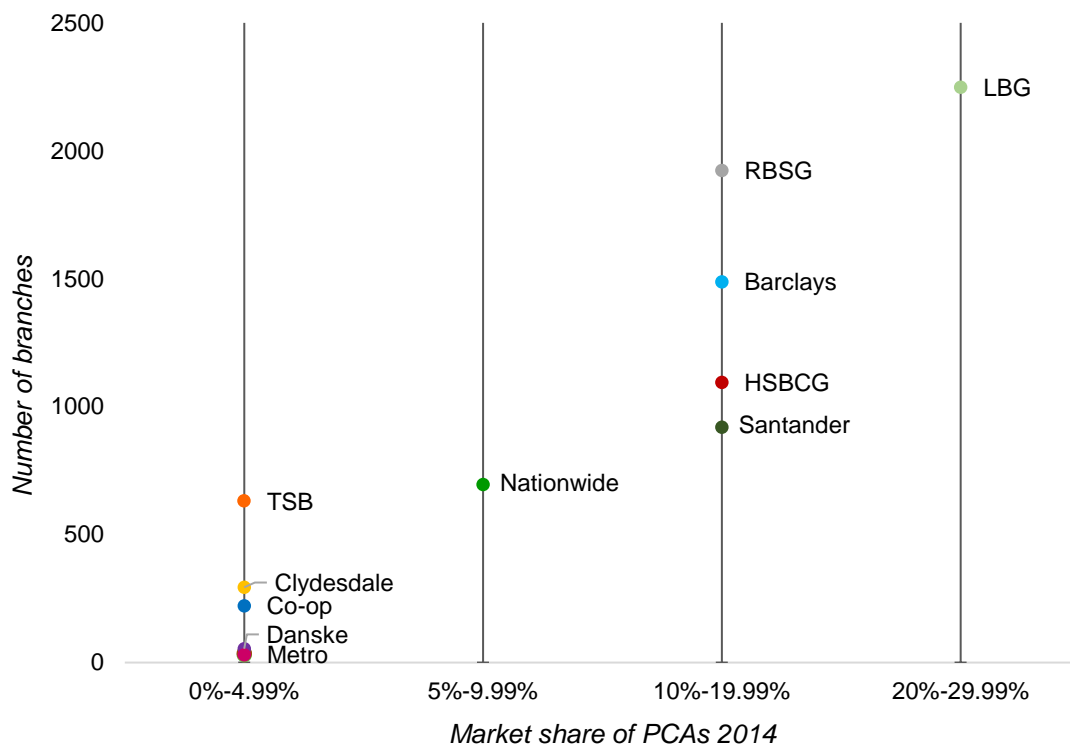
90. Figure 12 and Figure 14 depict a strong positive correlation between banks' market shares of PCAs and BCAs and the number of branches.⁷³ Banks that have a large branch network also tend to have a larger share of the PCA and BCA market. Barclays, RBSG, LBG and HSBC are the four largest banking groups by number of branches and by PCA and BCA market share. Barclays is the exception in that all of its retail branches service its SME customers as well as personal customers, which might explain Barclays' position in Figure 14 and Figure 15.
91. While there is a strong correlation between market shares and branch numbers at the national level (this is more marked for PCAs), local effects also exist; analysis undertaken by Deloitte for TSB shows that TSB outperforms in areas where it has a strong branch presence due to a 'network effect'.
92. However, as Figure 13 and Figure 15 illustrate, the relationship between net account openings of PCAs and BCAs and branch numbers is less clear. Santander is a clear outlier in the PCA market (and to a lesser extent in the BCA market)⁷⁴ and Metro outperformed several banks with substantial branch networks on net PCA openings despite having only 36⁷⁵ branches (all of which are located in London and the south-east).
93. While we observe these relationships, it is not possible to draw from them any conclusions with regard to causality. It is not necessarily a direct result of having a large branch network that some banks have a high market share. Those banks with the largest market shares also tend to be those that have been present in the market longest and have therefore been able to build up larger customer bases. Importantly, the lack of relationship between net account openings and branches suggests that having a small branch network

⁷⁴ This may be due to the success of its 123 current account that launched in 2012 and its high spend on advertising relative to other banks.

⁷⁵ As at September 2015.

does not necessarily create an insurmountable barrier to customer acquisition (as Metro's experience illustrates).

Figure 12: Market share of PCAs and branch numbers by banking group 2014*



Source: CMA analysis.

*Number of branches excludes dedicated business centres.

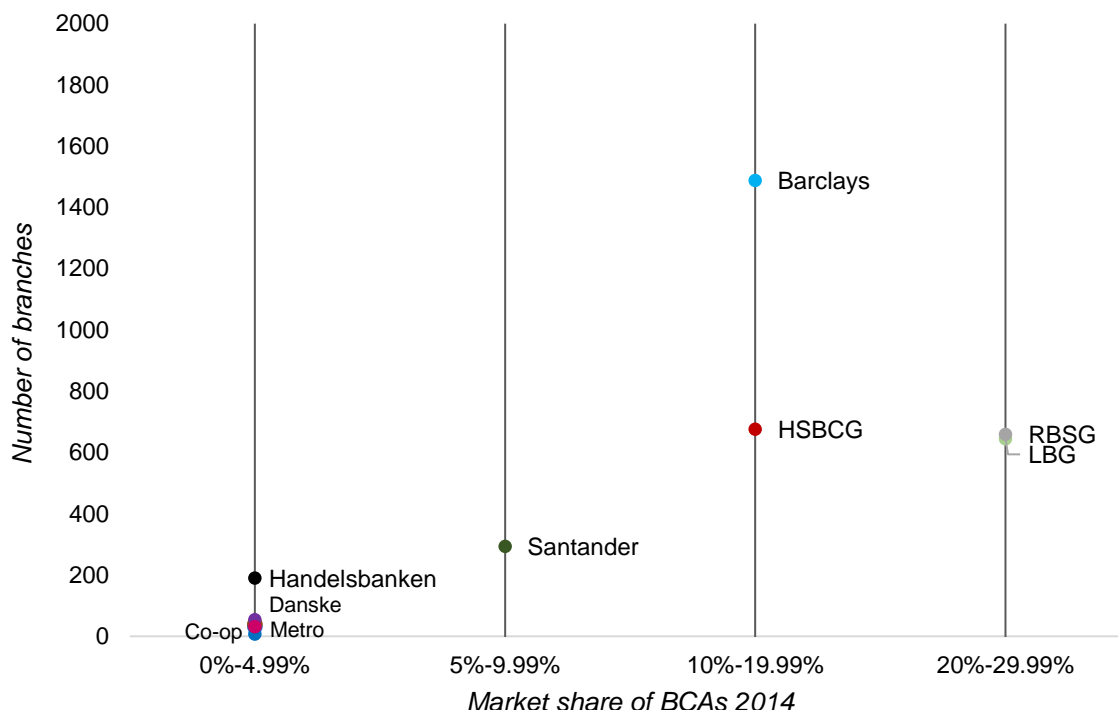
Figure 13: Net PCA openings and branch numbers by banking group 2014*

[✂]

Source: CMA analysis.

[✂]

Figure 14: Market share of BCAs and branch numbers by banking group 2014



Source: CMA analysis.

Note: Barclays considers that all of its branches offer some type of business services.

Figure 15: Net BCA openings and branch numbers by banking group 2014

[✂]

Source: CMA analysis.

[✂]

Customer acquisition

94. Some banks have told us that branches remain at the centre of their customer acquisition strategy.⁷⁶ This is supported by the data presented in Figure 16 below.
95. After day-to-day management of PCAs (which accounts for the majority of total branch visits by consumers),⁷⁷ branches of the banks in Figure 19 (with the exception of Nationwide) are most commonly used by personal banking customers to open a PCA.

Bol

⁷⁶ Metro and TSB.

⁷⁷ 89.4% of all branch visits on average. Average proportion of branch visits for day-to-day account management for Barclays, HSBCG, Nationwide, RBSG, Santander and TSB. Data on day-to-day account management was unavailable for LBG.

Figure 16: Proportion of branch visits to open a PCA, savings account, mortgage, and personal loan in 2014



Source: CMA analysis.

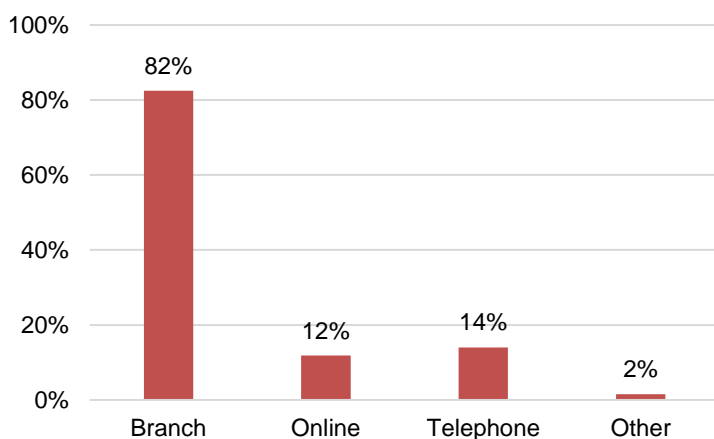


96. On average 78% of PCAs were opened in branch in 2014, down from 81% in 2013.⁷⁸ Nationwide, TSB and Halifax are leading in their customer acquisition via online channels.

97. The number of successful online applications is likely to continue to rise as banks invest in technology that enables online account opening (such as RBS's photo ID checker, an electronic document verification initiative). Barclays told us that technological advances in recent years had enabled significant enhancements in online account opening. Currently [redacted] of Barclays' customers that start an online application successfully open a current account online; [redacted].

98. Although we do not have comparative data on SME customer acquisition by channel, a survey of start-up SMEs undertaken by Charterhouse shows that on average 82% of start-ups open their BCA in branch (see Figure 17). This suggests that branches are important in the acquisition of SMEs, particularly for new businesses.

Figure 17: BCA openings by channel, SME start-ups*



Source: Charterhouse survey. Base: 252 SMEs.

*In response to the survey question 'What channels did you use to open your account?'

⁷⁸ Average calculated from data from Barclays, BoS, Clydesdale, Danske, Halifax, HSBCG, LBG, RBSG, Nationwide, Santander and TSB.

99. For Metro, all of its personal customer relationships began in branch since it did not offer remote account opening,⁷⁹ and the majority of its customer acquisition, it believed, had been driven through expanding its branch network.⁸⁰ It also acquired new SME customers through its local business managers and local directors in its branches. Metro's branches were designed to be large open spaces in prime retail sites on busy high streets and retail parks to attract customers, and were open early and late seven days a week for customer convenience. It told us that by providing a great experience to existing customers and opening new stores, word of mouth drove in new customers.
100. TSB considered that the majority of its customers preferred to open a new PCA in branch. Although TSB told us that it had recently seen an increase in its customers' propensity to open PCAs online, and to a lesser but growing extent through mobile channels, it believed that a bank's ability to attract large volumes of PCA customers online was dependent on the presence of a high street network. This, TSB noted, raised confidence and brand awareness among prospective customers. Branches therefore remained important to TSB's customer acquisition strategy; its internal documents stated that over [X]% of product sales took place in branches.
101. Danske told us that as a consequence of its branch closures since 2007, [X].
102. Handelsbanken also told us that branches were particularly important for the acquisition of SME customers. HSBC told us that it observed a fall in BCA openings following a wider business change initiative that included, among other things, a reduction in the number of business specialists available in its branches.
103. Some banks are recognising the need to invest in their online account opening service. [X]
104. Similarly, LBG is investing in technology that will enable more customers to be successfully acquired through direct channels. LBG told us only half of its online applicants can open a PCA entirely on line. Of those that cannot successfully open an account, only one-fifth visit a branch, which is required to complete the application: the remainder 'drop out of the process'. LBG believed that by reducing or eliminating the number of customers that were unable to complete their application process online, it would successfully

⁷⁹ Metro offers online account opening for secondary accounts only. Online account opening accounted for 0.5% of successful PCA applications in 2013 and 3% in 2014.

⁸⁰ See Appendix 9.1.

acquire more customers through online channels and reduce further the need for branches.

Brand recognition

105. Related to customer acquisition, branches are often viewed by banks as being key to building and maintaining brand awareness and recognition. Branches are increasingly being developed into customer experience centres or showrooms. HSBC, for example, has plans to open high visibility concept stores, designed primarily to build a strong brand presence in key locations. [✂]
106. Santander told us that to create brand awareness in the PCA market as well as ensure it met its existing customers' needs for a local branch network, [✂].⁸¹ Santander also noted that branchless models (either by banks or financial technology companies offering focused retail banking services) were relatively untested. With reference to its own Cahoot brand (which launched in June 2000 as the internet-based banking brand of Abbey National plc)⁸² and other online-only PCA providers, Santander told us that providers had been unable to make significant inroads to the PCA market.
107. Consumer research undertaken by Optimisa for M&S Bank indicates that branches increase confidence in the M&S Bank brand as well as being an important factor in encouraging customers to open a PCA (identified as a pull factor). The research notes that M&S Bank branches make customers feel reassured and confident they made the right decision to switch to M&S Bank.
108. Finally, as stated in our Tesco case study,⁸³ while Tesco Bank accepts PCA applications (and processes other basic transactions) at only three of its stores, it leverages its large national store network primarily to raise awareness of its PCA among Tesco customers, to whom its products are primarily targeted.
109. Whilst providing a practical alternative to owning a large branch network for basic customer transactions, the apparent advantages of branches in building and maintaining brand awareness and recognition cannot be achieved through arrangements such as interbank agency agreements or through use of the Post Office network.

⁸¹ [Santander response to issues statement](#).

⁸² See the [Cahoot website](#).

⁸³ See Appendix 9.1.

Retention

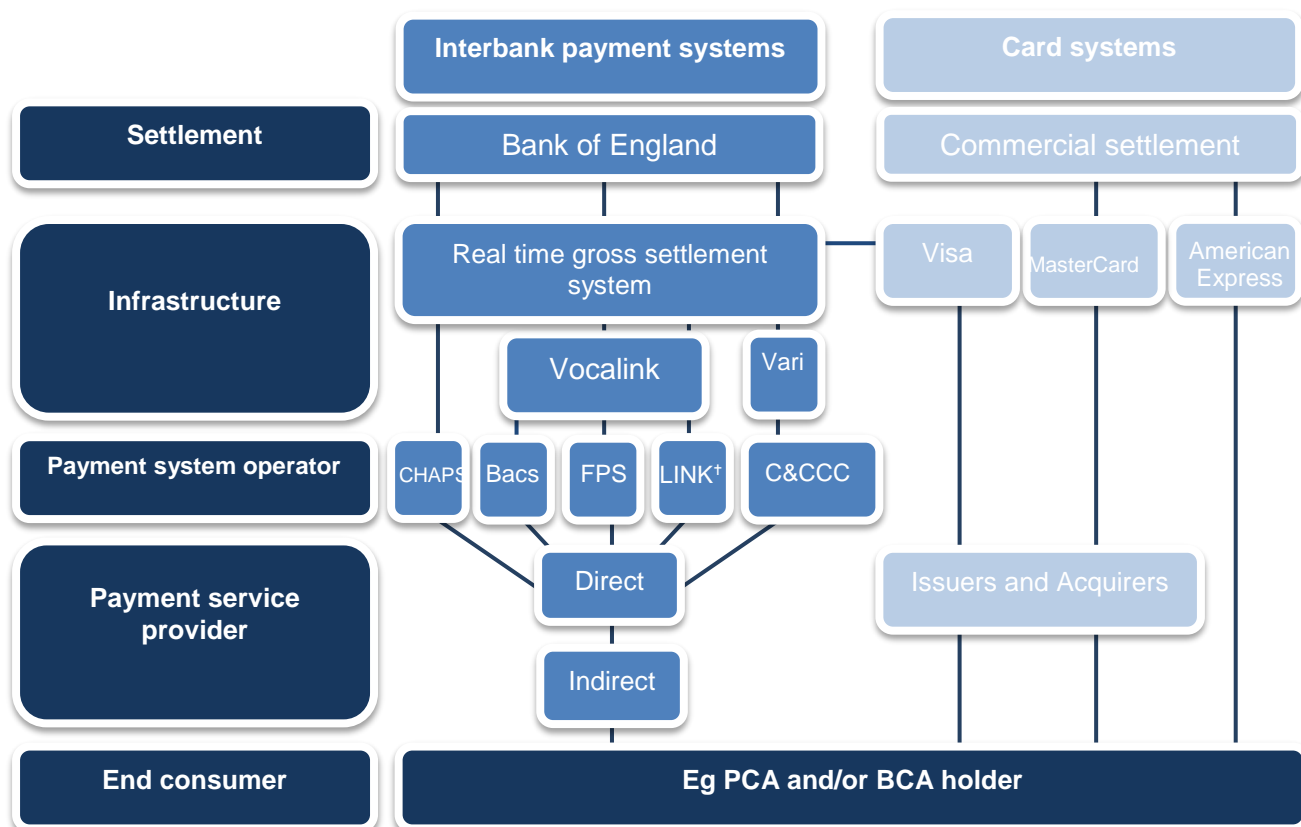
110. Branches may be used by banks to retain their existing customers. Deloitte's report on the future of branches notes that for traditional urban centres (one of the micro-markets it identified) in particular the challenge for banks is to not only attract new customers through their branches but also to build a long-term relationship through high-quality, tailored services.⁸⁴
111. In April 2014, HSBCG undertook a survey of a sample of its business customers to understand their branch preferences. It found that if customers were unable to visit their preferred HSBC branch, retention levels would fall by [X]% (to [X]%) for businesses with annual turnover of less than £2 million and by [X]% (to [X]%) for businesses with annual turnover of between £2 million and £30 million. This was unaffected by distance to the next closest HSBC branch. When analysing alternatives to branches that maximise customer retention, HSBC found that services at the Post Office and self-service machines outside an HSBC branch are the most preferred alternatives (providing respective uplifts to retention of [X]% and [X]%).⁸⁵ Retention is also greatest when the cost of alternative services is lower and when distance to travel to branch is lower (less than 5 miles).

⁸⁴ Deloitte (2014), *Bricks and clicks – Mapping the future of branches*.

⁸⁵ This analysis includes corporate customers with annual turnover in excess of £30 million.

The structure of payment systems

Figure 18: Stylized view UK payment systems



Source: CMA analysis.

†LINK does not have indirect PSPs.

112. These clearing systems (with the exception of LINK and UK card operators) currently operate a two-tier access structure with ‘direct’ settlement members and ‘indirect’ participants. Direct members own an interest in the company (eg CHAPS, Bacs) that manages and operates the payment system and may nominate a director to sit on the operator’s board.⁸⁶ The PSR defines a PSP with indirect access as one that has a contractual agreement with a PSP to enable it to provide services to individuals or businesses who are not participants in the system, for the purpose of enabling the transfer of funds using that payment system.^{87,88} Indirect PSPs are not entitled to nominate

⁸⁶ See FCA (2014), *The PSR and UK payments industry*, p13. It is possible that a board member of one operator also sits on the board of another operator. According to the PSR, this is not likely to happen in practice where individuals have expertise in different payment systems. Also see FCA, *A new regulatory framework for payment systems in the UK*, p31. The PSR is introducing a direction that interbank operators (except NICC) must take all reasonable steps to ensure that individuals may not simultaneously be a director of an interbank operator and a central infrastructure provider to that payment system.

⁸⁷ *Final terms of reference: market review into the supply of indirect access to payment systems*, PSR MR15/1.1.

⁸⁸ Indirect participant and agency banks are used interchangeably in this appendix to refer to a bank or building society that accesses payment systems via another bank (its ‘sponsor’) but it should be noted that, whilst agency banks have the use of their sponsor’s unique sort codes, not all indirect PSPs do.

directors and therefore do not have the same opportunity to influence board-level decision making for payment systems. For example, TSB notes that, by the nature of agency bank arrangements, indirect PSPs have less influence over the strategic direction of these systems.⁸⁹

Table 6: Number of current direct participants of payment systems

System	Current direct PSPs
Bacs	16
C&CC	11
NICC	4
CHAPS	21
FPS	10
LINK	37

Source: Websites of individual payment schemes.

Direct access

113. Scheme operators have established a range of access requirements that PSPs must meet to be eligible for direct access:⁹⁰

(a) PSPs must hold a settlement account at the BoE to gain direct access to Bacs, CHAPS, C&CC and FPS. Under the BoE's current policy, banks and building societies⁹¹ are eligible for settlement accounts but e-money institutions and payment institutions are not.⁹²

(b) A range of technical requirements exist that require the commitment of significant time and resources to adhere to.⁹³

114. Other requirements, such as legal, regulatory and risk management requirements, present an additional cost to prospective direct PSPs.⁹⁴ As a result of the above access requirements, there is a cost and resource implication of becoming a direct access user. There is an initial cost that PSPs incur to establish direct access, as well as ongoing fees that operators charge to recover the system's costs.⁹⁵ The PSR estimates the set-up cost associated with becoming a direct member to be in the region of £[£] (though this varies between providers and will not be mutually exclusive of IT expenditures).

⁸⁹ See Appendix 9.1.

⁹⁰ [Access to payment systems, CP14/1.4.](#)

⁹¹ Defined as a deposit-taking institution that is required to report its eligible liabilities. See [Bank of England Act 1998](#), Schedule II, paragraph 1.

⁹² [Bank of England Settlement Accounts](#), p9.

⁹³ [Access to payment systems, CP14/1.4](#), p16.

⁹⁴ [Access to payment systems, CP14/1.4](#), p16.

⁹⁵ [Access to payment systems, CP14/1.4](#), p13.

115. Direct members of the interbank payment system tend to be larger organisations than indirect members (measured by total business revenue) and they tend to process more inbound and outbound transactions (in terms of volumes and values). This could imply that direct membership is only practical or feasible for credit institutions that process large transaction volumes.

Table 7: Direct membership of payment systems by bank

Bank	Bacs	C&CC	CHAPS	FPS	LINK
Barclays*	✓	✓	✓	✓	✓
HSBCG*	✓	✓	✓	✓	✓
LBG*	✓	✓	✓	✓	✓
RBSG*	✓	✓	✓	✓	✓
Santander	✓	✓	✓	✓	✓
Co-op Bank	✓	✓	✓	✓	✓
Clydesdale	✓	✓	✓	✓	✓
Nationwide	✓	✓		✓	✓
Virgin Money	✓				✓
Danske†	✓		✓	✓	✓
AIB	✓				✓
Metro					✓
TSB					✓
Handelsbanken			✓		

Source: Payment systems' websites.

*Currently offers sponsor bank services.

†Danske is not a direct member of C&CC. It is a member of Belfast Bankers' Clearing Company, which in turn is a member of C&CC.

Note: Building societies, with the exception of Nationwide, are indirect participants of payment systems.

116. As a consequence of the cost and time involved in attaining and maintaining direct member status, most new banks opt to access payment systems indirectly via an indirect access provider. Metro told us that the timeline to join different payment schemes varied by scheme and was usually between six and 18 months. Further, Atom told us that the need to run a banking licence application and engagement with payment schemes in sequence could be considered a barrier to entry.

The PSR's work on direct access

117. The PSR's access directions, which came into effect on 30 June 2015, require scheme operators to ensure fair, open and risk-based criteria for access.⁹⁶ Operators are also required to publish their access requirements and on an annual basis report to the PSR on progress and changes. The access obligations are meant to ensure that operators' access requirements do not 'unnecessarily or disproportionately restrict direct participation in payment systems and do not act as a barrier to entry and expansion for new and

⁹⁶ [PSR update on access, August 2015](#).

emerging PSPs'.⁹⁷ The PSR will keep the market under review and if it is of the view that access to a regulated payment system could be improved according to the PSR's statutory objectives, then it can require changes to be made.

118. The PSR told us that operators had also taken steps to make the process less onerous and more proportionate for providers seeking to become a direct member of payment systems.⁹⁸ This had obvious implications for the timing and the on-boarding process associated with becoming a direct member.
119. The PSR also works closely with the BoE which acts as settlement agent for most of the major payment systems in the UK and is also responsible for ensuring payment systems are designed and operated in such a way that improves or maintains UK financial stability. The BoE has indicated support for the PSR's work, in particular the initiatives aimed at improving direct (and indeed indirect) access to payment systems. In its regulatory work, the PSR is required to have regard to the importance of payment systems in relation to the Bank's role as monetary authority and to the importance of maintaining stability of, and confidence in, the UK financial system. The authorities have put in place a Memorandum of Understanding that sets out the various roles and responsibilities of the BoE, the FCA and the PRA in relation to payment systems.

Indirect access

120. Four banks with direct access to payment systems currently provide the vast majority of sponsoring services to indirect PSPs in the UK. Barclays, HSBCG, LBG and RBSG facilitate access to the four main payment systems (Bacs, CHAPS, C&CC and FPS) for indirect participants.⁹⁹ Some sponsor arrangements will also include access to counter services and/or bank branches.
121. The majority of indirect PSPs have just one sponsor bank, but some have an agency agreement with more than one sponsor (for example, [X] accesses some payment systems via [two sponsor banks]). This is to ensure security of supply and/or to meet different business needs.

⁹⁷ See [PSR PS 15/1: A new regulatory framework for payment systems in the UK](#), p4.

⁹⁸ [PSR Hearing Summary](#).

⁹⁹ [Access to payment systems](#), CP14/1.4, p11.

Figure 19: Sponsor bank relationships in the UK

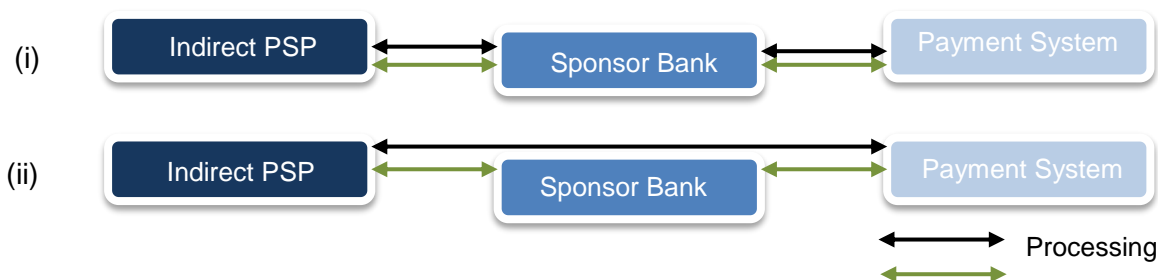


Source: CMA analysis.

Quality of service provision

122. A number of banks that access payment systems indirectly told us that the quality of service they could offer their customers was constrained by the quality of service (in terms of speed, reliability and security of supply) that their sponsor bank provided, thus limiting their ability to effectively compete and innovate. Secure Trust told us in that the service level agreements it had with its clearing bank were not fit for purpose. We have also received evidence that the quality of service provided by sponsor banks can have an impact on the ability of indirect PSPs to participate in certain service offerings. These issues appear to be more pertinent for indirect PSPs that also have indirect technical access (see below) and arise mainly in the context of faster payments.
123. Technical access to payment systems is required for PSPs to send and receive payment messages that enable the processing of fund transfers.¹⁰⁰ Indirect PSPs can gain technical access to payment systems either through their sponsor bank's infrastructure (indirect technical access, as represented by (i) in Figure 20) or by connecting directly into the payment system's central infrastructure (direct technical access, as represented by (ii) in Figure 20).^{101,102} According to the PSR, only one indirect PSP has direct technical access arrangements for FPS;¹⁰³ indirect technical access may be less costly to obtain.

Figure 20: Technical access channels for indirect PSPs



Source: PSR, [Access to payment systems, CP14/1.4](#), p47.

¹⁰⁰ [Access to payment systems, CP14/1.4](#).

¹⁰¹ Direct technical access, which is less common because of the associated costs, enables direct technical connectivity between the indirect PSP and the payment system for the processing of payments, but it still requires the use of a sponsor bank for the provision of settlement services.

¹⁰² [Access to payment systems, CP14/1.4](#).

¹⁰³ [Access to payment systems, CP14/1.4](#).

124. [X] told us that it had inferior access to faster payments compared with its sponsor bank. It told us that, whilst direct PSPs had 24/7 access to faster payments, its current arrangement entitled it to a service limited to between approximately 9am and 5pm Monday to Friday. In addition, [X] customers had experienced delays in payments (including employees' salaries and expenses) as a result of inefficient processing or errors made by its sponsor bank.
125. Tesco Bank also accesses FPS via a sponsor arrangement with [X]. It told us that [X] transmitted payments via SWIFT and, because SWIFT gateways were closed for maintenance between 4pm Saturday and 6am Sunday each week, FPS could not be accessed during this time.¹⁰⁴ This had prevented Tesco Bank from offering Paym services (which required near real-time payment capability). First Trust Bank told us that it, too, had been prevented in the past from offering Paym because of the functionality constraints of its sponsor bank for faster payment transfers. However, First Trust Bank's sponsor bank had informed it that, with effect from June 2015, it would offer the functionality required for it to provide Paym services to its customers. It would be a commercial decision as to whether or not it subscribed to the enhanced functionality.
126. A KPMG report commissioned by the PSR notes that challenges are common with posting and reconciliation of customer accounts 24/7, as in the case of faster payments.¹⁰⁵ When SWIFT is used by sponsor banks to exchange messages between themselves and the agency bank, SWIFT scheduled downtime disrupts faster payments availability. Given that alternative messaging options are available, one might expect to see indirect PSPs switching sponsor banks in order to offer services that rely on near real-time settlement. However, as KPMG's report notes, this can be disruptive for agency banks and their customers because of the requirement to reallocate sort codes.¹⁰⁶
127. Metro has Direct Corporate Access to faster payments that is provided by [X]. This is a form of direct technical access whereby bulk payment files from the corporate (Metro) are submitted directly to FPS.¹⁰⁷ Metro told us that it had experienced outages of its faster payment functionality as a result of outages to the Direct Corporate Access system.¹⁰⁸ Metro noted that this affected only indirect PSPs accessing FPS via this arrangement, and not direct members. These outages had an impact on all of its customers who

¹⁰⁴ See Appendix 9.1.

¹⁰⁵ [UK Payments Infrastructure: Exploring Opportunities](#).

¹⁰⁶ [UK Payments Infrastructure: Exploring Opportunities](#).

¹⁰⁷ [FPS and Direct Corporate Access](#).

¹⁰⁸ See Appendix 9.1. [X]

attempted to make transactions online, via the mobile application and/or via the contact centre. Its customers awaiting funds were also affected by outages, as were any beneficiaries of payments made from Metro accounts.

128. Agency banks may also rely on their sponsor banks to notify them in the case of scheme outages. Tesco Bank told us that this put them at a disadvantage compared with direct PSPs and sponsor banks, which were able to receive and react to information regarding outages in a timelier manner. It gave us an example of an outage to FPS in 2014. The notification to FPS members was supported by real-time unsolicited messages that had not been passed on to Tesco Bank by its sponsor bank. It told us that, because the outage had occurred outside normal office hours, it had not been notified until the following day, which had been too late to alert its customers to prevent customer detriment.

Fee arrangements between sponsor banks and indirect participants

129. As discussed earlier, there is a cost implication in acquiring and maintaining direct membership of payment systems. Direct PSPs incur fees and charges that are paid to scheme operators and infrastructure providers to recover the costs of running the interbank payment systems.¹⁰⁹ Interbank payment systems are run as not-for-profit entities and scheme operators set charges to only recover costs.¹¹⁰ The costs involved in running the payment systems include the scheme operators' infrastructure and staff and administration costs. These are usually apportioned on a tiered basis according to the volume of transactions processed by each direct member.
130. Sponsor banks charge the indirect PSPs to which they provide access to payment systems.¹¹¹ The fees and charges that indirect PSPs pay to their sponsor bank are levied on transactions. For example, indirect PSPs are charged fees on inbound and outbound payments for FPS and Bacs services, and cheque-clearing fees for C&CC services. There may also be fixed fees or fees for other ad hoc services. Tesco Bank told us that it also paid connectivity charges for each payment system it accessed, and the costs of changes made to those systems.
131. The per-transaction fee, which indirect PSPs focused on when speaking to us, is dependent upon the volume of transactions processed by the agency bank.

¹⁰⁹ [Access to payment systems, CP14/1.4](#), p13.

¹¹⁰ FCA (2014), [Ownership, governance and control of payment systems, CP14/1.3](#), p11.

¹¹¹ This is the case for indirect PSPs that have indirect technical access through an arrangement with a sponsor bank. They will have a single contractual agreement with their sponsor bank. Indirect PSPs, which have direct technical connectivity, have at least two contractual relationships: (1) with the infrastructure provider/third-party provider for technical access, and (2) with the sponsor bank for settlement and other support services.

This means entrants that do not have the scale advantages of larger banks are charged a higher price for access. [REDACTED]

132. Metro and Tesco Bank told us that they believed they were charged significantly for indirect access to payment systems, and that this was reflected in a mark-up on the transaction fee that the sponsor bank paid to the scheme operators. For example, Metro understood that direct members of FPS were charged a fee of £[REDACTED] per transaction, [REDACTED] of what Metro had told us it was paying to [REDACTED]. Tesco Bank told us that it paid [REDACTED] for each outgoing faster payment vis-à-vis the £[REDACTED] that it understood direct members of FPS were charged.
133. Secure Trust told us that it had no negotiation power and its clearing bank had repeatedly refused to engage with it to negotiate the charges it levied. It said that charges in addition to the per-transaction levy were penal.
134. Handelsbanken told us that its discussions with CHAPS about becoming a direct member confirmed that the tariffs charged by sponsor banks for access to those schemes acted as a barrier to entry, making direct membership a far more cost-effective option.
135. However, we are aware that it is not only the marginal cost of transactions the clearing bank fee that direct members of payment systems have to recover. As described earlier, there are a number of fixed costs involved in being a direct member that indirect PSPs are not explicitly charged by the scheme operator or their sponsor bank. The PSR will be assessing the price of access as part of its indirect access market review.¹¹²

Information provision by sponsor banks

136. Information about fee structures and service provision in the payment systems industry is complex and opaque according to some parties we have spoken with. This applies to the information that is provided to both prospective indirect and direct PSPs.¹¹³ Atom told us that there was a lack of consistency in information provision across schemes, both with regard to the type of information available and its presentation. In Atom's case, it was necessary to 'tease [information] out' of the sponsor banks. Atom believed that new entrants were not likely to be well informed and therefore might not ask the right questions. This asymmetry of information could reduce the power of prospective PSPs to compare offerings and to negotiate terms and prices.

¹¹² [Final terms of reference: market review into the supply of indirect access to payment systems, PSR MR15/1.1.](#)

¹¹³ We have only heard from indirect PSPs about this particular issue – namely Atom – but the PSR notes in its consultation document, [Access to payment systems, CP14/1.4](#), that this is an issue for direct PSPs.

137. TSB noted that a criticism of payment systems with regard to new entrants had been the lack of transparency in agency bank charging arrangements. TSB told us that it was unable to judge accurately whether the fees it paid to [X] to access payment systems represented good value in comparison to those of other banks. However, Tesco Bank, which migrated from [X] for its access payment systems, told us that prices were relatively easy to compare.
138. Tariff cards, which detail the cost of access (fees) and services available to indirect access users, are obtained once negotiations between the prospective indirect PSP and sponsor bank are underway. Examples of tariff cards were collected during the OFT's phase 1 market study; these are long and complex documents and not easily comparable across banks.
139. Finally, the lack of transparency and comparability of information provided by sponsor banks on prices and service offerings also potentially creates a barrier to indirect members switching sponsor banks. Switching sponsor banks is often perceived to be complex, time consuming and costly.

The PSR's work on information provision

140. In addition to its access rule, the PSR has introduced a direction requiring the four primary sponsor banks to publish access-related information for prospective indirect PSPs.¹¹⁴ The PSR believes this will enhance transparency and improve PSPs' ability to make informed choices about their sponsor services. The direction came into effect on 30 June 2015. The Building Societies Association noted in its response to the PSR's consultation that the direction was a positive step towards increasing the competitive pressures on sponsor banks and strengthening the bargaining position of indirect PSPs.¹¹⁵
141. The PSR also expects that the industry code of conduct will help to address concerns around the communication of information. This will be kept under review and, subject to its findings, the PSR will consider whether it is appropriate to broaden the coverage of the direction and the code of conduct to include additional providers of indirect access. The PSR also supports the launch of the Information Hub, a website developed by industry to improve the disclosure and transparency of information for PSPs wishing to access payment systems.¹¹⁶

¹¹⁴ [PSR specific direction on access.](#)

¹¹⁵ [Building Societies Association response to PSR, CP14-1: A new regulatory framework for payment systems in the UK](#) (provided to the CMA by the Building Societies Association).

¹¹⁶ [Access to Payment Systems website.](#)

Direct reliance by indirect members on downstream competitors

142. Banks that access payment systems via an agency agreement are directly reliant upon their sponsor bank, with which they compete in the downstream (retail) market for this service. Certain aspects of this vertical relationship could disadvantage indirect PSPs and weaken their competitive position relative to their sponsor bank.

Information sharing between indirect PSPs and indirect access providers

143. Before they can provide the indirect PSP with access to payment systems, sponsor banks must ensure that they have the capacity and capability to provide these services. In order to do so, sponsor banks may obtain potentially commercially sensitive information about the agency bank's business strategy and projected sales volumes and values.
144. Currently, there is no legal framework or incentive structure governing the handling of that information. The PSR's policy statement notes that the purpose of the code of conduct is to address concerns about the supply of indirect access provided by sponsor banks.¹¹⁷ This includes concerns around the sharing of commercially sensitive information with sponsor banks that are also downstream competitors.
145. Although one PSP noted its concern around the sharing of potentially commercially sensitive information with its sponsor bank in response to the PSR's consultation,¹¹⁸ we do not have evidence from indirect PSPs to suggest that the requirement to share information with their downstream competitors has had any implications for competition in the retail banking market.
146. Once an indirect PSP has secured access to payment systems, information sharing should be limited. Metro told us that transactions were delivered through a straight-through process via secure messaging links, and that it had not encountered any issues with information sharing at any stage of the commercial relationship.

Reduced incentives to compete

147. The nature of the vertical relationship between sponsor and agency banks may limit or reduce incentives for the sponsor bank to improve the services it

¹¹⁷ PSR, *A new regulatory framework for payment systems in the UK*.

¹¹⁸ *Access to payment systems*, CP14/1.4, p40.

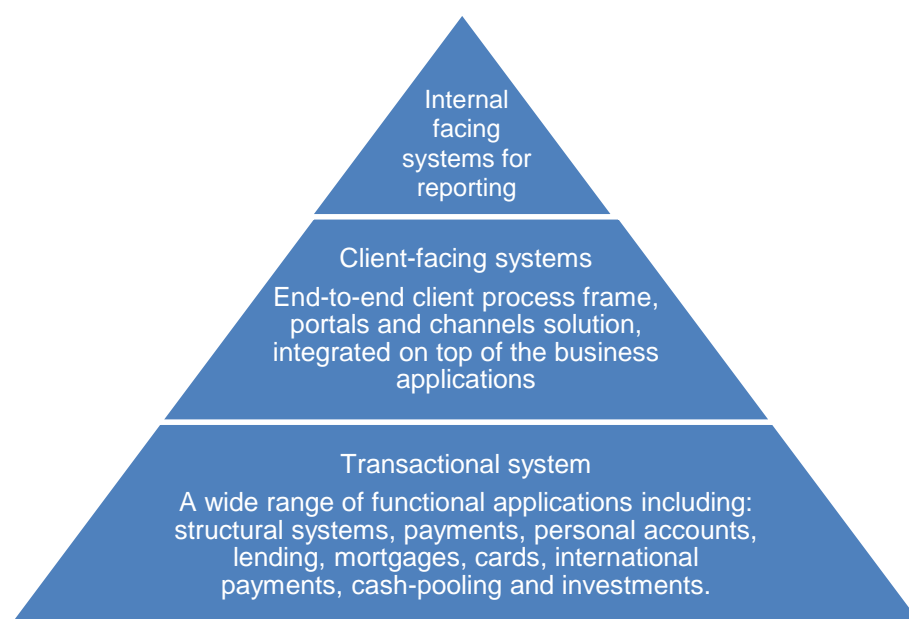
provides to indirect PSPs. It may also give sponsor banks an incentive to charge a higher price of access to their competitors.

148. Metro commented in its case study submission on the reliance of indirect PSPs on their competitors to access payment systems; it believed that the evidence pointed to the fact that payment systems must be independent of banks. Handelsbanken told us that the main driver in its decision to become a direct member of CHAPS in 2013 was a desire to gain independence from third party sponsor banks. Handelsbanken is also seeking direct access to LINK.¹¹⁹

IT systems and infrastructure

149. PCA provision and the provision of retail banking services to SMEs require the setting up and maintaining of complex IT systems (see Figure 21). This presents a sunk cost of entry that has historically been significant: HSBCG told us that IT systems had traditionally accounted for around two-thirds of the cost of market entry in retail banking.

Figure 21: Structure of IT systems in retail banking



Source: Based on Santander's depiction of a high-level and basic overview of its IT systems.

¹¹⁹ A process that Handelsbanken noted had been problem free.

150. [X] Tesco Bank's experience: the IT costs associated with its PCA launch in 2014 accounted for [X]% of the total investment to implement that programme.¹²⁰
151. However, the advent of off-the-shelf core banking platforms and outsourced solutions that can be accessed on a pay-as-you-grow basis¹²¹ means that cheaper solutions are now more readily available for new banks seeking to enter the market. In addition to the cost advantages, new IT systems are designed to be more flexible and to facilitate the addition of new functionality.¹²²
152. Virgin Money told us that it expected the upfront entry costs of IT to continue to fall further as new technology providers made it possible for banks to establish IT capabilities without having to build their own IT infrastructure. HSBCG believed that the development of 'off-the-shelf' IT solutions had virtually eliminated IT as a fixed cost of entry.
153. The example of Atom provides evidence of falling IT costs; it estimates that IT costs will account for around [X] of its first year's operating costs. Atom believed that technology had been a 'game changer' for firms entering the retail banking market.
154. The evidence we have collected shows that firms' experiences as regards the cost of IT associated with their entry or expansion in retail banking vary widely. Some banks have incurred or been faced with very high costs of building, and possibly integrating, IT systems required to support the provision of PCAs (eg Tesco Bank) and SME banking products (eg Nationwide, for whom the costs, relative to other options to invest in its retail infrastructure, were a key reason for not entering the market). Others have faced much lower costs (eg Metro, Atom), particularly when outsourced solutions were adopted and integration was not required. These differences between IT costs appear to be explicable in terms of:
- (a) when the initial IT investment was made; and
 - (b) the complexity of the project (for example, the extent to which it entailed integrating a new platform with legacy systems and/or migrating customers across to a new platform, as well as the nature of the products to be supported).

¹²⁰ See Appendix 9.1.

¹²¹ A charging structure based on the number of transactions processed.

¹²² ACI industry guide, [Replacing legacy payment systems](#).

Timing of initial IT investment

155. Metro, which entered in 2010, selected from six potential suppliers an ‘out-of-the-box’ core banking platform solution from Temenos.¹²³ Metro chose to employ Temenos’s pre-configured ‘T24 Model Bank’ solution given the high level of fit with its own business model.
156. According to a report by Temenos, a key requirement for Metro was that the core banking platform underpinning its operations be supplied on an outsourced basis to minimise the size of the initial capital outlay.¹²⁴ The T24 application is hosted for Metro by a third party, niu Solutions,¹²⁵ and accessed via the internet. Metro also has a services contract with niu Solutions to provide it with virtually all the functionality it requires outside the T24 platform. Metro pays a fixed monthly rental to niu Solutions and has an account-based pricing agreement with Temenos, which means that it pays for what it uses each month. Temenos notes that this arrangement enables Metro to better control its cash flows.¹²⁶
157. Metro told us that choosing the pre-configured ‘model bank’ solution enabled it to deploy the application in a relatively shorter time and to operate as a full service retail bank from the first day of operation. [✂]
158. According to its website, Temenos’s T24 solution has been developed using a service-oriented architecture that is modular, so that banks can deploy and integrate the required functionality alongside the needs of their business.¹²⁷ Metro supported this and explained that it had customised (and continued to customise) its core banking platform by purchasing new applications and licences that were horizontally integrated into the T24 platform. These were, whenever possible, SaaS solutions (where a vendor hosts an application on behalf of a customer and provides access through the internet). SaaS solutions had become one of the fastest growing segments of the IT industry.¹²⁸ They also circumvented the need for firms to periodically update their systems: repair, maintenance and system updates could be run centrally to the benefit of all users of the applications.
159. CivilisedBank will follow a similar approach to that taken by Metro. It plans to use a ‘bank-in-a-box’ solution to be supplied by Profile (a Greek technology

¹²³ See Appendix 9.1.

¹²⁴ [Temenos’s Metro case study.](#)

¹²⁵ [niu Solutions Holdings Limited.](#)

¹²⁶ [Temenos’s Metro case study.](#)

¹²⁷ [Temenos T24 Core Banking.](#)

¹²⁸ Software as a Service (SaaS) is a software licencing and delivery model in which software is licenced on a subscription basis.

company). CivilisedBank told us that such a system allowed for substantial scalability. The core banking platform, which would be hosted in a private cloud environment, [REDACTED].

160. Atom has acquired an outsourced IT solution from FIS.¹²⁹ Atom told us that it wanted to enter the retail banking market with systems that were brand new, without the constraints of technology legacy and the associated costs of running legacy systems. Atom noted that the SaaS solutions now available avoided the need for significant upfront investment and meant initial small scale was of no disadvantage.
161. Although Atom experienced some difficulties in acquiring an appropriate IT system – in particular, the due diligence involved – it told us that once an IT partner had been chosen the process was fairly straightforward. [REDACTED]
162. Based on its anticipated SaaS contract, Atom has projected total IT costs for year 1 of £[REDACTED] (equivalent to [REDACTED]% of its total operating costs in that year).¹³⁰ These are forecast to grow to around [REDACTED]% of operating costs in its fifth year of operation as projected transaction volumes rise.

Complexity of the project

163. The evidence we have gathered from market participants suggests that some financial products (eg current accounts) are more expensive to support than others (eg SME lending products), and that the need to integrate new systems with existing ones can complicate (and delay) entry and increase costs substantially. Each of these is considered in turn below.

Product type

164. The information we have collected from parties and through speaking with technology providers suggests that the costs associated with developing/accessing and maintaining appropriate IT systems are likely to be lower for a specialist provider (eg one that only offers SME lending products) than for a firm that offers a broad suite of products including current accounts.
165. Fiserv, a global provider of IT solutions for the financial industry, told us that it would be possible to support a monoline business using a modified pre-paid debit card platform for an upfront investment of less than £1 million whilst the costs associated with building a core banking system that supported full

¹²⁹ FIS UK.

¹³⁰ £[REDACTED] spend consists of £[REDACTED] allocation to SaaS and £[REDACTED] for 'other IT costs'.

service provision had for recent entrants ranged from tens to hundreds of millions.

166. TSB noted that it considers that IT costs create a considerable barrier to entry for challengers who aim to provide a full-service multi-channel offering. In TSB's experience, no one IT provider is able to provide a comprehensive IT solution with all the functionality that would be required by a full-service multi-channel bank. Arguably, however, Metro's experience (described earlier) suggests that this is not a barrier for all firms.
167. Tesco Bank told us that the transactional nature of current accounts meant that the required processing speeds for a number of different payment types were greater than those required for lending and savings products. Tesco Bank's card transaction processing required uplifting to process 30 times more transactions than before launching its PCA whilst the system that processed Bacs payments needed to be 70 times faster.
168. Co-op Bank told us that the outlay associated with IT costs in the provision of PCA services remained considerable. [✂]
169. Nationwide recently considered launching a BCA for SME customers (see Appendix 9.1 and Nationwide case study for more information). Nationwide found IT costs to be sufficiently high, relative to other options to invest in its retail infrastructure, to be a key reason for not entering the market. It estimated that the IT spend required to launch a BCA would amount to around £[✂]. It also anticipated the project would require significant technology management resource and expertise, which would further increase its costs of expansion into the provision of BCAs.

Integration of legacy systems

170. Some banks¹³¹ suggested that the IT systems owned by larger banks were increasingly being viewed as a disadvantage compared with the relatively low-cost solutions available to potential entrants. Whilst older systems were deployed to manage bulk and batch-based processes, there was, according to a report by ACI, little room for scalability or agility in older systems that were not designed for flexibility or real-time processing.¹³²
171. Barclays told us that it considered that new entrants were often able to adapt more nimbly to technological innovations than Barclays, which incurred costs associated with integrating new technology with its existing legacy

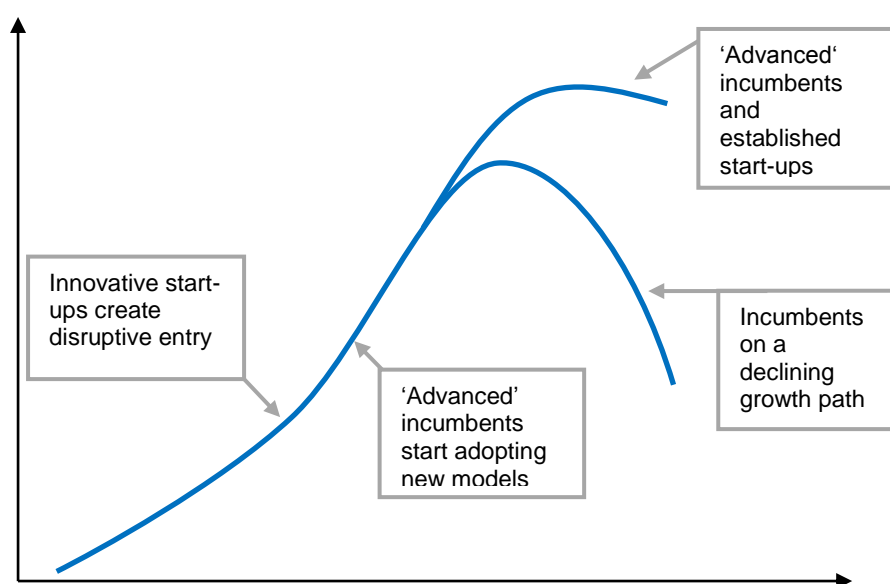
¹³¹ HSBCG, LBG, RBSG.

¹³² ACI industry guide, [Replacing legacy payment systems](#). ACI Worldwide delivers systems to process payments for banks, processors and retailers around the world.

infrastructure. These costs included, for example, ensuring compatibility with its legacy systems and conducting scale tests to ensure that any new system was able to cope with the number of transactions Barclays would need to process and that the systems were robust enough to withstand this volume.

172. Replacing IT systems is costly, resource intensive and disruptive (to business and its customers). As a result, larger (established) banks tend to operate a hybrid of old and new systems: locally customising existing systems and integrating 'add-ons'. Only Santander has migrated onto a new platform: moving the systems used by the businesses it acquired in the UK onto a Partenon and Alhambra platform. Santander told us that this approach was preferred to ensure it could customise and develop as needed to create innovative payment tools.
173. A report by Deutsche Bank¹³³ predicts a material increase in IT spend by large banks over the next ten years. It notes that core systems are generally old and rely on too many applications patched too many times to cope with rising transaction volumes, regulatory change and digital channel changes. The required investment will, Deutsche believes, drive up to a 10% increase in overall operating costs for the banks.

Figure 22: Disruptive technology and the growth path in retail banking



Source: RBSG.

174. Figure 22 depicts RBSG's prediction that 'incumbent banks' that do not upgrade their systems and adopt new models will end up on a lower and declining growth path. RBSG told us that the impact of digital and non-bank

¹³³ Deutsche Bank Equity Research, UK Retail Banking 2014, *Bank to the Future*, p4.

functionality was causing it to change the way it operated its PCAs and other products.

175. RBSG described its own IT infrastructure as a [redacted]. It was currently undertaking a project to simplify, rationalise and increase the robustness, usability and functionality of its IT architecture and software. The updating of its systems would be costly and time consuming but the investment was, in RBSG's view, necessary to remain competitive in what it described as a new digital era. It noted that its ability to respond quickly to shifts in the market trailed that of entrants with IT systems built using the latest technology.
176. In addition to the constraints on functionality and efficiency that larger banks' legacy systems imposed, RBSG told us that they were extremely costly to maintain compared with newer IT systems that were available off-the-shelf and centrally managed and updated.¹³⁴
177. Similarly, HSBCG told us that the larger banks were required to undertake significant investments to upgrade their service offerings, and to adopt new digital and mobile technology to configure them for changing customer requirements and demands. These included investments in branches to offer self-service machines and Wi-Fi access, for example. HSBCG explained that for larger banks with legacy systems, these investments involved significant risk when they related to new technology and IT.
178. For Tesco Bank, the launch of its PCA in 2014 required substantial investment in IT. At the point of taking full control of the business from RBSG in 2008, Tesco Bank had none of its own IT infrastructure or applications to support its banking products. In order to remove its dependency on RBSG, it acquired and built a number of IT components before migrating the existing (legacy) customer base to its own system.
179. Tesco Bank chose to use Fiserv's platform solution that had elements of off-the-shelf functionality. However, Tesco Bank told us that it required significant development and customisation to meet the needs of its customers in the UK market.
180. IT costs accounted for £[redacted] of the £[redacted] investment involved in Tesco Bank's current account launch programme. This included the integration of components from other suppliers, upgrading of 49 systems and completion of 85,000 IT tests. [redacted]. In addition to the above programme costs, an additional

¹³⁴ Whilst hosted or outsourced solutions are centrally updated, off-the-shelf core banking platforms that are hosted internally require updating periodically (at the sole expense of the individual bank).

£[redacted] a year had been added to its existing IT support costs as a result of launching the PCA.

181. In addition to the cost implication, the end-to-end implementation, the upgrading of IT systems and the introduction of CASS were time-consuming and delayed the launch of Tesco Bank's PCA.
182. However, Barclays told us that it had been active in leading the development of innovations in retail banking, particularly in respect of payment services (such as enabling customers to pay for bus journeys with Pingit, or to pay utility bills at ATMs), despite being constrained to some extent by its legacy IT infrastructure.

Viability of new models

183. TSB suggested that the new IT solutions available to entrants ceased to be adequate as the bank expanded beyond a particular scale.¹³⁵ However, we have not received any further evidence to support this. On the contrary, HSBCG stated that innovative low-cost IT solutions were fully scalable. HSBCG pointed to Metro as being a 'prime example of an efficient operator successfully expanding in the PCA and SME banking markets' with an off-the-shelf IT solution.¹³⁶ HSBCG also noted that to the extent that a bank faced IT costs as it expanded, there was no difference in adapting an off-the-shelf (hosted) solution to the difficulties faced by any other bank wishing to expand, including those with legacy systems.
184. As discussed above under *integration of legacy systems*, off-the shelf IT solutions may be more difficult to adopt for firms with existing legacy IT systems. Santander told us that for banks other than those entering the market by pure organic growth, off-the-shelf solutions might not be adequate due to issues with integrating legacy IT systems. Indeed, [redacted]. While it was possible to migrate to an off-the-shelf solution, Santander told us that this required a long-term approach, migrating back book products as they matured.

¹³⁵ [Barriers to entry and expansion: capital requirements, IT and payment systems](#), paragraph 69.

¹³⁶ Metro told us that, so long as firms maintained some discipline about the 'add-ons' they integrated, it should be possible to achieve scale and to avoid 'legacy' issues.

Appendix 10.1: Previous discrete changes in market structure

Introduction

1. In the last ten years, there have been two mergers affecting the PCA and SME markets: Santander's acquisition of Alliance & Leicester in October 2008;¹ and Lloyds TSB's acquisition of HBOS in January 2009. Though these mergers were proposed at the time of the 2008 financial crisis and hence were affected by exceptional events, they still provide examples of changes in market structure. In considering these changes in market structure, we recognise that we do not observe what would have happened in the absence of the merger and furthermore there are other changes in the market which are difficult to disentangle from the effects of the merger.

Santander's acquisition of Alliance & Leicester

2. The two banks had small shares of the PCA and SME markets and there appeared to be no grounds for expecting a weakening of competition.² However, we considered that the merger was likely to have had some beneficial effects on competition, in particular in the SME market, where the two banks appear to have had complementary capabilities – Alliance & Leicester appears to have had a greater pre-merger position in the SME market, with the focus on larger SMEs, while Santander (prior to the merger operating in the UK via its Abbey National brand) had a stronger position in PCAs and Business Banking,³ which is relevant to competition for SME start-ups. We found that both Santander and Alliance & Leicester had been expanding rapidly prior to the merger; that Alliance & Leicester had experienced financial difficulties during the 2007/08 credit crunch, and that following a post-merger dip, Santander has continued to expand, introducing the innovative 123 reward PCA in 2012.

LBG, HBOS and TSB

3. The events surrounding LBG's acquisition of HBOS provide an example both of a discrete increase in concentration (LBG's acquisition of HBOS) and of a discrete decrease (the subsequent divestment of TSB), though it should be noted that HBOS's share of the market at the time of the original acquisition was larger than TSB's share subsequently divested. In the case of the PCA

¹ During 2008, Santander also acquired from the government the deposits and branches of another bank (Bradford and Bingley) which however did not compete in the PCA and SME markets.

² [European Commission, Case No. COMP/M.5293 - SANTANDER / ALLIANCE & LEICESTER.](#)

³ See Section 4, Table 4.1 for more information on the business segmentation applied by Santander.

market, HBOS's share was about 13% while TSB's divested share was about [0–5]%.⁴

LBG's acquisition of HBOS

4. With respect to the provision of PCAs, we noted the following points regarding the intensity of competition post-merger:
 - (a) LBG has maintained Halifax as a separate brand for personal customers, and Halifax's offering in the PCA market is significantly different to that of Lloyds – LBG described Halifax to us as a 'challenger brand', which reflected customers' view of the Halifax brand.⁵
 - (b) Halifax offers one of the PCAs with a specific promotional offer aimed at switchers (its Reward account offers a £5 per month reward subject to conditions)⁶ and offers £100 for switching via CASS (£125 until recently). It is also the brand that attracted the second largest number of switchers under CASS in 2014.
 - (c) The Lloyds and BoS brands also appear to have been relatively active competitors. Shortly before the merger, Lloyds introduced interest paying PCAs and these have been maintained post-merger.⁷ LBG recently introduced a new product (Club Lloyds) in response, we were told, to competitor activity by Santander in particular. Our PCA pricing analysis suggests that the Lloyds and BoS brands have relatively high average prices.
 - (d) The total share of the PCA market of the LBG brands has remained broadly constant since the merger and has not declined.⁸ Total market share across all three brands (Lloyds, Halifax, BoS) was broadly constant both before and after the merger, though before the merger Lloyds' market share decreased while that of HBOS increased while after the merger market shares of all three brands remained broadly constant.
5. HBOS' share of the SME banking market was smaller than its share of the PCA market, and we note:

⁴ In both cases, shares of the SME market were much smaller, but it remains the case that the HBOS share acquired was much greater than the TSB share subsequently divested.

⁵ LBG has also retained BoS as a separate brand in Scotland, but the products of Lloyds and BoS appear broadly similar.

⁶ Conditions for £5 per month reward are paying in £750 per month, paying two different direct debits per month and staying in credit.

⁷ Lloyds' interest-paying Vantage set of accounts was introduced shortly before the merger in the summer of 2008.

⁸ Source: GfK FRS data 2005-2014 for GB (shares include TSB for comparability). See Figure 5.1.

- (a) There has been minimal impact on the combined BCA market share in GB of the LBG SME banking brands since the merger⁹ (BoS and Lloyds).
 - (b) From the BCA pricing analysis, LBG is among the lowest priced BCA providers under three of the four customer profiles analysed.
 - (c) LBG withdrew the BoS brand from NI approximately 18 months following the merger. However, LBG told us that this was due to the impact of the financial crisis¹⁰ rather than a strategic reduction in the intensity with which the group was competing in NI with its market rivals.
 - (d) LBG maintained BoS as a separate brand alongside the Lloyds brand. However unlike the differentiation in product offerings between the Lloyds and Halifax brands on the PCA side, the BCA tariffs of Lloyds and BoS brands are very similar. Furthermore, the minimal overlap in the operating areas of the respective brands, particularly in England and Wales, means that customers for whom branch access is important are unlikely to view the brands as substitute providers.
6. We did not find strong evidence of a reduction in competition following LBG's acquisition of HBOS.

LBG's divestment of TSB

7. We have also considered LBG's divestment of TSB.
- (a) At the point of divestment, TSB had a PCA market share of around [0–5]%. In the first year post-divestment, TSB launched its Classic Plus PCA, offering customers 5% interest on balances up to £2,000 accompanied by an extensive television and print media advertising campaign. Subsequently, TSB enhanced the offer by offering 5% cashback on the first £100 of contactless payments each month from 1 September 2015 until 31 December 2016 and with a linked savings offer.¹¹ The 5% interest rate offered on the TSB Classic Plus account is higher than on Lloyds' Classic Vantage account but the maximum balance on which interest is paid is lower.¹² We noted that at about the time TSB introduced its Classic Plus account, Lloyds took Classic Vantage off sale and replaced it with

⁹ Source: FCA & CMA market study for 2005 and Charterhouse BBS for 2010–2013. See Section 7 for further details.

¹⁰ BoS' NI operations were heavily specialised in the property segment, which was the housing market in the UK most affected by the financial crisis.

¹¹ 5% AER Monthly Saver interest on savings of between £25 and £250 a month.

¹² There are also differences in other terms, eg lower minimum payment in (£500 per month for TSB Classic Plus compared to £1,000 for Classic Vantage).

the new Club Lloyds account.¹³ Despite the investment of substantial resources to promote TSB Classic Plus, the impact on TSB's market share has been relatively limited, with an increase of around [X] percentage points in the first year post-divestment. TSB has grown its overall market share but still experienced an outflow to other banks, including those which also offer reward accounts ([X]). Our PCA average pricing analysis suggests that TSB's average prices are similar to those of LBG's from which it was recently divested.

(b) With respect to SME banking, TSB said that it had yet to put the same strategic focus on its BCA business as it did on its PCA business. TSB did not consider the growth of its BCA business to be a strategic priority, citing a customer base that is heavily weighted towards sole traders, [X].

8. We considered that it was probably too early to reach a view about the overall impact of TSB's divestment on the market, especially as this may change in light of its subsequent acquisition by Sabadell.

¹³ Club Lloyds interest rates were higher, ie 1% on balances of up to £1,999, 2% on balances between £2,000 and £3,999 and 4% on balances between £4,000 and £5,000, though minimum eligibility criteria were different than on the Classic Vantage account (a minimum credit of £1,500 per month for Club Lloyds compared to £1,000). In comparison, TSB offers 5% interest on balances up to £2,000. There is no account fee, however a minimum monthly payment of £500 is required in order to receive interest.

Appendix 10.2: Relationship between concentration and outcomes: review of empirical literature

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Introduction and overview

1. Our second theory of harm concerned concentration giving rise to market power of some banks and leading to worse outcomes for customers. In this appendix we summarise the economic literature relevant to this theory of harm, in particular literature covering the empirical link between concentration and competition in banking. Accordingly, in this appendix we only include those papers that are specifically focused on the banking sector and we have chosen to omit the papers that analyse the general link between concentration and competition.
2. The papers reviewed in this appendix provide a context for assessing the specific UK markets that are the focus of the retail banking market investigation. However, this appendix is not intended to provide a more detailed explanation of the mechanisms identified in Section 10 that describe the link between concentration and outcomes, nor should it be interpreted as evidence of a causal link between concentration and competition.
3. We have divided the literature into the following categories:
 - (a) Single-country studies focused on the UK market.
 - (b) Cross-country studies including the UK.
 - (c) Other single-country studies.
 - (d) Other cross-country studies.
4. A variety of approaches are taken to measuring concentration and competition. Concentration is usually measured by a concentration ratio (combined market share of the largest firms – often the four or five largest

firms) or the Herfindahl-Hirschman Index (HHI).¹ Competition may be measured by estimating a specific economic model or using some measure of market outcomes, for example: margins, profits, pass-through of costs, and the extent to which cost changes are associated with market share changes. Annex A contains a detailed discussion of the different measures of concentration and competition.

5. The majority of papers² suggest that the structure of banking markets is important and that greater concentration leads to worse outcomes for consumers, such as lower interest rates on deposits and higher rates on loans and overdrafts – for example Degryse and Onega (2008), Scherer (2010), Bikker et al (2002, 2006a), van Leuvensteijn et al (2008) and Mulder (2014). Some papers, eg Berger and Hannan (1998) and Koetter et al (2012) find evidence in support of the ‘quiet life’ hypothesis, ie that banks with market power are prone to cost and profit inefficiencies. Finally, cross-country analysis finds significant differences across countries and different markets.
6. Most of the reviewed papers focus on the market for banking services as a whole without distinguishing between different banking sectors, such as PCAs and SME banking. There are however several papers, eg Heffernan (2002, 2003), Heffernan and Fu (2009), Corvoisier and Gropp (2001) and Gondat-Larralde and Nier (2006), that focus on specific segments of the banking sector, such as deposits, mortgages and different types of loans, or analyse separately the markets for personal and SME customers.
7. Several papers, eg Carbó Valverde et al (2009), Bikker (2010) and Bolt and Humphrey (2015), which focus on testing different measures of competition, report that the different measures are only weakly correlated with each other and could provide different measures of competition.³
8. Some papers, eg Heffernan and Fu (2009) and Corvoisier and Gropp (2001), investigate the relationship between market structure and performance using market power and efficient structure hypotheses. Under the market structure hypotheses it is presumed that concentration or individual market power leads to higher prices for consumers and higher profits for banks, whereas the efficient structure hypotheses argue that concentration is caused by the rapid growth of efficient banks which, in turn, may lead to more favourable prices for consumers. The findings of these papers suggest that the market power hypotheses tend to be confirmed more often, resulting in less competitive

¹ The HHI is the sum of the squared market shares of all the firms in the market.

² Full references are provided in Annex B.

³ The differences in the estimates provided by these measures are attributed to different indicators measuring different characteristics.

pricing by banks, although the results vary depending on the market investigated.

9. Research based on the Panzar-Rosse H-statistic measure of competition⁴ provides conflicting results. Some papers, eg Claessens and Laeven (2004), find evidence that more concentration leads to increased competition and that it is the contestability of the market and not the market structure that really matters for competition. However, later studies, eg Bikker et al (2006a, 2006b, 2012) and Goddard and Wilson (2008) show that models based on the H-statistic suffer from misspecification, leading to biased results. Still, most of the papers applying the H-statistic find that the nature of competition can best be described as monopolistic competition and that concentration is negatively related to competition.
10. We recognise that there are some limitations to our review of empirical literature, which we have taken into account. First of all, there has been only a limited number of studies that focus on UK banking markets and, secondly, the majority of the studies focus on banking markets as a whole, with only a few focusing on the markets directly relevant to our investigation, ie the provision of PCAs and SME banking services. Nevertheless, we consider that the findings from the papers focused on other countries as well as the papers focused on the banking markets as a whole or other banking products can provide valuable insights into the markets under investigation. However, we take into account the caveats associated with such comparisons.
11. Although some of the papers summarised in this appendix are from the early 00s or late 90s, we think that the analysis presented in them and the methods used are still likely to be relevant – the approaches taken and the results given are not dissimilar to those in later papers.
12. We take into account various methodological issues associated with different competition measures and different specifications used in empirical analysis. Although, in general, in this paper we relied on a presumption that theoretical foundations and empirical specifications of the models used were correct, where possible, we tried to identify and take into account such concerns. For instance, we note in several instances that certain specifications of Panzar-Rosse H-statistic seem to lead to the negative effect of increased concentration on competitive outcomes being underestimated (or can even change the sign of the relationship as seen in Claessens and Laeven (2004)) and we interpreted such results accordingly.

⁴ See Annex A for an explanation of the H-statistic and other competition measures.

13. Finally, we recognise that some papers might provide conflicting results as can be reasonably expected. We are, however, focusing on the main trend, which confirms that an increase in concentration can lead to worse outcomes for consumers, independently of the markets or countries analysed.

Literature summary

(a) Single-country studies focused on the UK market

Heffernan, SA (2002), How do UK financial institutions really price their banking products?

14. The paper analyses different types of pricing behaviour of UK banks for different products: savings accounts, interest earning current accounts (chequing), mortgages, credit cards and personal loans. Two models of imperfect competition are tested: the Salop-Stiglitz⁵ model of monopolistic competition with 'bargains' and 'rip-offs', and Cournot behaviour.⁶
15. The author uses a generalised linear pricing model to estimate the price of the product using the London Interbank Offered Rate (LIBOR) as a proxy for the perfectly competitive market interest rate.⁷ The paper shows that, with the exception of mortgage products, deposit and loan interest rate setting by UK financial institutions is best described by the Salop-Stiglitz model of monopolistic competition. Perfect contestability is largely ruled out. Even in the largely competitive mortgage market the authors find signs of price discrimination. The results point to substantially lower competition for savings, current accounts (chequing), credit cards and personal loans. Heffernan concludes that financial firms exhibit different types of price-setting behaviour depending on the banking product concerned, and that firms should be required to produce information that enables consumers to compare different products for consumers, thereby helping to contain the loss of consumer surplus in imperfectly competitive markets.

⁵ Under the Salop-Stiglitz model, consumers face unseen information costs. Some know the distribution of prices and others do not. The former buy only 'bargains', whereas the latter buy randomly. A firm can survive either by charging a low price ('bargain') or a high one ('rip-off'). 'Rip-off' firms stay in business as long as there are enough purchases by the inert consumers. Firms offering 'bargain' products profit from a higher volume of sales, because well-informed customers buy their cheaper products. Thus, relative 'bargains' and 'bad buys' coexist.

⁶ The Cournot model assumes that an increase in the total number of firms should lead to lower prices, ie that deposit interest rates should go up and loan interest rates should go down as more firms enter the market.

⁷ The analysis rests on the presumption that LIBOR is set competitively. However, it was later discovered that banks were manipulating their rates, which could have had an effect on the outcomes of the model.

Heffernan, SA (2003), UK bank services for SMEs: are they competitively priced?

16. The paper assesses the nature and degree of competition among UK banks in the provision of SME banking services during the period from 1996 to 2001. It applies the technique described above (Heffernan 2002) to SME banking services: BCAs, business investment accounts, company mortgages and business loans. The paper tests for different forms of imperfect competition: Cournot behaviour and the applicability of the Salop-Stiglitz model.
17. The paper finds different⁸ tactical pricing behaviour by financial institutions in response to a change in LIBOR, a proxy for competitive or market interest rate. Three types of response are observed: (i) immediate, near-complete adjustment, (ii) complete pass-through but with delay, and (iii) staggered, delayed adjustment with incomplete pass-through. The findings show that even the biggest four banks at the time (NatWest, Lloyds TSB, Barclays and HSBC) differed in the way they adjusted their rates, both within and between products.
18. The author finds a marked disparity in prices for particular products. Although some of the price dispersion could be attributed to non-price features, there is a residuum in the regression which the author interprets to be strongly suggestive of switching costs and imperfect information. Hence, the Salop-Stiglitz model is thought to fit well. Margin analysis shows that larger banks were offering 'rip-offs' in the deposit market, but three of the then biggest four banks were offering 'bargains' in the market for business loans. There is also some evidence supporting the Cournot model for savings accounts, current accounts and commercial mortgages.
19. The paper also investigates the effect of branches on the product price measured by deposit and loan interest rates. The results show that the deposit interest rate falls with an increase in the number of branches. This indicates that SMEs pay for the convenience of having a branch nearby. The author concludes that SMEs doing business with banks with large branch networks pay for the privilege. The results also show a negative relationship between the number of branches and business loan rates. The author suspects that this could be explained by banks with larger branch networks being able to pool the risks⁹ and therefore offer lower interest rates.
20. The author recognises widespread SME inertia and argues that competition would increase if SMEs were encouraged to switch to other banks.

⁸ In a highly competitive market (or a monopoly) firms would display identical pricing behaviour.

⁹ Banks with large branch networks are able to collect more information on SME risk profiles because their loan volumes are higher.

Gondat-Larralde, C and Nier, E (2006), Switching costs in the market for PCAs: some evidence for the United Kingdom

21. The paper examines how changes in market shares respond to price differentials and which model of competition¹⁰ best fits the data. In order to assess the level of competition in the market for PCAs, the authors derive elasticities of bank market shares with respect to the set of PCA prices. Controlling for non-price characteristics, such as the extent of the branch network, the number of automated teller machines (ATMs) and the scope of telephone and internet banking, they find moderate sensitivity of changes in market share to differences in the PCA interest rates (including the rate paid on positive balances, the rate of arranged overdrafts and the rate paid on individual savings accounts (ISAs)) overall across banks.
22. In addition, changes in market share were found to be sensitive to PCA rates on positive balances, but less sensitive to the rate of arranged overdraft and the rate paid on ISAs.¹¹ This suggests that a bank that offers a higher ISA rate or lower overdraft rate than its rivals offer on average would not experience any significant increase in market share for PCAs.
23. The authors also find a positive relationship between the levels of market share and price. These findings are also consistent with a moderate degree of imperfect competition with switching costs in the market for PCAs and the theory of margin enhancement, ie that the bank's current market share determines its pricing incentives: the larger the market share, the higher the incentive to raise the price of PCAs and vice versa.¹² The paper also predicts that the relationship between market share and price should be stronger, the lower the elasticity of demand with respect to price. Thus, the relationship between market share and price is strongest for the overdraft rate, which has the lowest elasticity of demand.

Heffernan, SA and Fu, X (2009), The structure of retail markets: what do we learn from bank-specific rates?

24. The paper investigates the relationship between market structure and performance in the UK retail banking market from 1993 to 2004. The authors

¹⁰ Among the models examined are dynamic competition model with switching costs, Salop-Stiglitz model with switching costs, perfect competition and oligopoly without switching search or costs.

¹¹ For overdraft and ISA interest rates, coefficients are not significantly different from zero for most specifications.

¹² The paper finds a positive relationship between the overdraft rate and the market share and a negative relationship between the PCA interest rate and the market share. As for the ISA rate, the evidence seems to point to the market for ISAs being unrelated to the market for PCAs.

test four major hypotheses that focus on the impact of concentration on banks' pricing behaviour:

- (a) Market power hypotheses – concentration or individual market power leads to higher prices and bank profits:
 - (i) Structure-conduct-performance (SCP) paradigm¹³ – bank concentration impairs competition, resulting in higher loan interest rates, lower deposit interest rates and greater profitability.
 - (ii) Relative market power hypothesis – banks with a greater market share and well-differentiated products are able to exert market power in setting prices to earn supernormal profits, independent of the degree of market concentration.
 - (b) Efficient structure hypotheses – concentration is due to the rapid growth of relatively efficient banks:
 - (i) X-efficiency measures the efficiency with which banks use their inputs to produce a given bundle of outputs. It can be described as the ratio of the predicted minimum costs that would be incurred if the bank were as efficient as the best-practice bank in the sample to the predicted actual costs.¹⁴ X-efficient banks have lower costs, meaning that consumers face more favourable prices and firms enjoy greater market share, resulting in higher profits.
 - (ii) Scale efficiency measures whether banks operate at a scale-efficient point. Under the scale efficiency hypothesis, banks with similar management skills and production technology but producing at output levels closer to minimum average cost point (ie being more scale-efficient) will have lower costs, which may lead to more favourable prices for consumers, along with greater concentration or market share and profits.
25. The authors test the hypotheses using two measures of concentration – the HHI¹⁵ and the number of firms, which serve equally well as concentration measures.
26. The authors find that the market power hypotheses seem to prevail, although the results vary depending on the market investigated.¹⁶ For example, the

¹³ See Annex A for a more detailed description of the SCP paradigm.

¹⁴ Even though the best-practice bank itself may not be efficient when compared to banks outside the sample.

¹⁵ See Annex A for an explanation of HHI and other measures.

¹⁶ The following markets were investigated: business savings, personal savings, PCAs, personal loans, credit cards and mortgages.

market power hypotheses are supported for all credit products and the majority of deposit products, although there are some instances where banks' behaviour is consistent with the efficient structure hypotheses, which may be due to consumer attitudes or inertia. In 79% of the cases considered, either larger banks offered worse interest rates or higher concentration led to worse interest rates. Overall, market power is found to be present more often in the markets for credit than in those for deposit products. Although the findings suggest that in general banks tend to adopt different pricing strategies depending on the number of near substitutes and consumer attitudes, the authors do not find evidence of the top five banks¹⁷ adopting different pricing strategies compared with smaller banks and building societies.

27. The notion that banks enjoy a 'quiet life', ie banks with market power may be less concerned about costs, meaning that larger banks are less efficient, is largely not supported.¹⁸

(b) Cross-country analysis including UK

28. The papers in this section are grouped as follows: (i) papers applying the Panzar-Rosse model and (ii) other cross-country studies.
29. To better understand the role of the Panzar-Rosse H-statistic, it is helpful first to note that Claessens (2009)¹⁹ distinguishes between three types of approach to measuring competition:
 - (a) Market structure and associated indicators – the SCP paradigm implies that the structure of the market can directly or indirectly determine performance (eg lower concentration leads to more competitive behaviour of firms, which in turn leads to less market power and greater social efficiency). However, the SCP approach fails to take into account that structure is not necessarily exogenous, since it can itself be affected by firms' conduct and hence by performance; and that the degree of concentration does not give straightforward answers to the level of competition: for example, even concentrated markets can be competitive and vice versa. Therefore, traditional performance measures, such as the size of banks' net interest margins, profitability or transaction costs in stock markets, do not necessarily indicate competitiveness of a financial system.²⁰

¹⁷ HSBC, RBS, HBOS, Barclays and Lloyds TSB.

¹⁸ The 'quiet life' hypothesis held in only a few sub-markets: a third of deposit products and mortgages.

¹⁹ See paragraphs 43–46 for a full description of the findings in Claessens (2009).

²⁰ These performance measures are also influenced by a variety of factors, such as a country's macroeconomic performance and stability, the form and degree of taxation of financial intermediation, the quality of the country's

- (b) Contestability and regulatory indicators to gauge contestability – the theory of contestability argues that it is the degree of entry and exit barriers, rather than actual entry, that matters for competitiveness. For example, incumbents in markets with low barriers to entry will not be able to charge prices above marginal costs, as this would induce new entry that would push the prices down. The theory recognises that competitive outcomes are possible even in concentrated markets and that above normal profits do not necessarily mean that a firm is harming consumers.
- (c) Formal competition measures – the paper distinguishes between three different empirical approaches to measuring competition:
 - (i) measuring concentration, which relies on the SCP paradigm;
 - (ii) measuring regulatory indicators and entry barriers to gauge the degree of contestability; and
 - (iii) the Panzar-Rosse H-statistic that proxies the reaction of output to input prices.

(i) Papers applying the Panzar-Rosse model

Bikker, JA and Haaf, K (2002), Competition, concentration and their relationship: an empirical analysis of the banking industry

- 30. The authors set out to test empirically the effect that concentration has on competition. First, they regress the Panzar-Rosse H-statistic on a number of banks in a sample of 23 industrialised countries (including the UK). The results show that banking markets in the industrial world are characterised by monopolistic competition. Small banks, on average, seem to operate under less competitive conditions (lower H-statistic of 0.63) than large banks (H-statistic of 0.86). The medium-sized banks occupy an intermediate position (H-statistic of 0.75). Or, to put it differently, local markets are less competitive than national and international markets. The results also show that in Europe competition seems to be stronger and that all large banks appear to operate in a very tight competitive environment. The estimates of the H-statistic over time indicate a significant increase in competition.
- 31. The authors also apply the Bresnahan conjectural variation model to deposit and loan markets in nine EU countries (including the UK). The measure of competition from the Bresnahan model indicates for both markets that the

information and judicial systems, and financial institution-specific factors such as leverage, the scale of operations and risk preferences. As a result, these measures can be poor indicators of the degree of competition.

degree of competition is high within all nine EU countries. This is in line with the results given by the Panzar-Rosse model.

32. Finally, the authors estimate k-firm concentration ratios and HHIs for the same 23 industrialised countries. To investigate the relationship between competition and concentration, they regress the H-statistic on various concentration indices and the absolute number of banks in these markets. The results show that the market structure has a significant effect on competition, the relationship being strongest when the 3 firm concentration ratio (CR₃) is used. The results imply that increasing concentration decreases competition (reduces the H-statistic). This appears to confirm the observation that a few large banks can restrict competition and that a multitude of small competitors is unable to engender competition.

Claessens, S and Laeven, L (2004), What drives bank competition? Some international evidence

33. Using the Panzar-Rosse H-Statistic the authors estimate competitiveness in their study of 50 countries' (including UK) banking systems. The authors find that a greater foreign bank presence and fewer activity restrictions in a country's banking sector lead to a more competitive banking system. They also find some evidence that entry restrictions on commercial banks can reduce competition, which suggests that being open to new entry is the most important competitive pressure.
34. The authors, however, find no evidence that their measure of competition decreases with increasing concentration. On the contrary, they find that more concentrated banking systems are more competitive. The results imply that it is contestability that is the most important for competition, and that market structure is not necessarily related to the degree of competition.

Bikker, JA, Spierdijk, L and Finnie, P (2006a), The impact of bank size on market power

35. Using a large sample of more than 18,000 banks in 101 countries (including the UK) over more than 16 years, the paper sets out to estimate the relationship between bank size and market power using the Panzar-Rosse H-statistic.²¹ The authors find a positive relationship between market power and bank size: for example, the average H-statistic corresponding to large banks equals 0.42, whereas the H-statistic for small banks averages 0.68; monopoly

²¹ The paper extends the traditional Panzar-Rosse model by introducing a direct role for bank size.

is rejected less often and perfect competition is rejected more often for large banks than for small banks.

36. The authors argue that the drivers behind the market power of the large banks are bank size itself and the ability of the large banks to operate on different product and geographical submarkets.
37. The findings of this paper contradict some of the previous studies, which find that competition increases with bank size. The authors show that the latter result is due to misspecification²² of the models used to derive the H-statistic in the previous literature.

Bikker, JA, Spierdijk, L and Finnie, P (2006b), Misspecification of the Panzar-Rosse model: assessing competition in the banking industry

38. The paper aims to demonstrate that all the empirical papers using the H-statistic suffer from misspecification and that the level of competition in the existing Panzar-Rosse literature is systematically overestimated. The misspecification results from the dependent variable being calculated as a ratio of a bank's revenues to total assets ('the price equation') instead of being calculated as unscaled bank revenue ('the revenue equation') and introduces bias towards perfect competition (H-statistic = 1). The results show that the average value of H-statistic obtained from the Panzar-Rosse revenue equation is much smaller than the average value resulting from the Panzar-Rosse price equation (0.504 and 0.742 respectively). The authors also show that the inclusion of scale variables as explanatory variables in the estimation has a similar distorting effect.

Bikker, JA and Spierdijk, L (2008), How banking competition changed over time

39. The paper investigates the developments in banking competition in 101 countries during the previous 15 years using the Panzar-Rosse H-statistic approach. The authors find that competition in major Western economies has reduced over time (for example, competition decreased by almost 60% in the EU-15 over the study period) and attribute this to the process of consolidation, which generally creates larger banks with greater market power. Furthermore, the authors suggest that the continuous shift over time from traditional intermediation to more sophisticated and complex products may also have reduced competition.

²² See paragraph 388.

Goddard, J and Wilson, JOS (2008), Measuring competition in banking: a disequilibrium approach

40. The paper argues that the Panzar-Rosse model suffers from a misspecification bias in the revenue equation. The standard procedure for estimating the H-statistic involves the application fixed effects estimation. Under this procedure, the correct estimation of the H-statistic relies upon an assumption that markets are in long-run equilibrium at each point in time when the data is observed.
41. The authors show that misspecification bias arises when adjustment towards market equilibrium is partial and not instantaneous, leading to H-statistic measures being severely biased towards zero. In contrast, applying an appropriate dynamic panel estimator to a correctly specified dynamic revenue equation permits virtually unbiased estimation of the H-statistic. This also eliminates the need for a market equilibrium assumption and also incorporates instantaneous adjustment as a special case. The different specifications of Panzar-Rosse H-statistic are tested using data from six developed countries (including the UK). The results confirm that dynamic panel estimator conveys most accurate H-statistic. The paper largely focuses on methodological issues and does not provide new evidence on the relationship between concentration and pricing.
42. The authors also concur with Bikker et al (2006) that inadvertent misspecification of the revenue equation as a price equation, through either rescaling the dependent variable or including a logarithm of assets as a control variable, constitutes another form of misspecification bias affecting the estimation of the H-statistic.

Claessens, S (2009), Competition in the financial sector: overview of competition policies

43. The paper provides an overview of competition policies and different methods to measure competition in the financial sector. The author argues that the assessment of competition in the financial industries should be done carefully, and that the effects that competition has on financial stability and access to financial services²³ should be taken into account: 'The view that competition in financial services is unambiguously good is more naïve than in other industries.' When analysing competition in financial markets, the author contends that it is necessary to consider a broader set of objectives, including efficiency, access to services and financial sector stability, as well as possible

²³ Eg increased competition can undermine the incentives of banks to invest in information acquisition and thereby lower their lending to information-intensive borrowers.

trade-offs between these objectives. Factors such as entry and exit, contestability, and the fact that the provision of financial services is relying on various networks, such as the use of ATMs and credit bureaus' information, should be considered.

44. The paper argues that the traditional competition measures, such as concentration indices, have only limited applicability and that more sophisticated measures such as the H-statistic are necessary. However, the paper recognises the difficulties in applying such measures – the unclear production function for financial services, the tendency to produce and sell bundles of services, the weaker and more volatile data, the changes in ownership structure, and the presence of network properties and two-sided network effects in the markets for payment systems are some of the difficulties mentioned.
45. The paper reports significant differences between the measures in H-statistic reported by Claessens and Laeven (2004) and Bikker and Spierdijk (2008) for individual countries (the correlation is only 0.38, and the rank correlation only 0.29).²⁴ This is another indicator that caution must be taken in using the H-statistic to capture the degree of competition.
46. The paper also provides an overview of the findings of various cross-country or countrywide/regional studies. The studies report that making markets more contestable by reducing entry and exit barriers, increasing the flow of cross-border capital and especially inducing entry by foreign banks can have favourable competitive effects on the development of domestic banking systems. Finally, the paper provides an overview of the possible implications for competition policy.

Bikker, JA, Shaffer, S and Spierdijk, L (2012), Assessing competition with the Panzar-Rosse model: the role of scale, costs, and equilibrium

47. The paper is largely focused on methodological issues and provides further evidence that the Panzar-Rosse model suffers from misspecification biases. The authors show that neither a price equation nor a scaled revenue function yield a valid measure for competitive conduct. Even when using an unscaled revenue function, additional information about costs and market equilibrium is needed in order to infer the degree of competition correctly. The results are confirmed by empirical analysis using a sample of more than 100,000 bank-

²⁴ Interestingly, the H-statistic values for the UK are similar – 0.76 in Bikker and Spierdijk and 0.74 in Claessens and Laeven – despite the fact that the two papers provide conflicting results – Claessens and Laeven report a positive relationship between concentration and the level of competition, whereas Bikker and Spierdijk contradict this finding.

year observations on more than 17,000 banks in three countries during the period from 1994 to 2004. The paper, however, does not provide any new evidence concerning the relationship between concentration and competition in banking.

Andrieş, AM and Căpraru, B (2014), The nexus between competition and efficiency: the European banking industries experience

48. Using the Panzar-Rosse model, the authors estimate the degree of banking competition in the EU countries for the period from 2004 to 2010. The authors find that the H-statistic used to measure competition in banking varies considerably across EU countries. The measure of H-statistic indicates that the EU banking sector operates under monopolistic competition. The authors also observe a significant increase in competition in the EU between 2004 and 2010, particularly in the Eurozone countries. The H-statistic for the UK (0.729) is just below the EU average (0.731).
49. By applying convergence tests, the authors also assess the evolution of competition in the EU member states by measuring the convergence of competition in the EU banking systems towards the sample mean. The results show differences in convergence levels among different subgroups of countries (non-euro zone and euro zone) and different sub-periods (pre-crisis and crisis). In general, the results confirm that the convergence process occurs in banking systems with above-average competition levels.
50. Finally, the authors also find that with the exception of non-Eurozone countries²⁵ the competition–efficiency hypothesis is confirmed, showing that an increase in competition determines a significant increase in profit efficiency.

(ii) Other

van Leuvensteijn, M, Bikker, JA, van Rixtel, A and Sørensen, CK (2007), A new approach to measuring competition in the loan markets of the euro area

51. This is the first paper that applies the Boone indicator²⁶ measure of competition to the lending markets of the five major Eurozone countries²⁷ as well as the UK, the USA and Japan. The Boone indicator measures the effect of efficiency on firms' performance using information on firms' profits and market shares, eg more efficient firms are expected to earn higher profits and

²⁵ Results were insignificant for non-Eurozone countries.

²⁶ See Annex A for a description of the Boone indicator.

²⁷ This includes Germany, France, Spain, Italy and the Netherlands.

have higher market shares. The Boone approach assumes that competition enhances the performance of efficient firms and impairs the performance of inefficient firms, which is reflected in their profits and market shares. The advantage of this measure compared with other applied competition measures is that it can be used to measure competition in specific market segments²⁸ and also requires relatively little data. However, specific limitations of this measure should be taken into account: for example, the Boone indicator assumes that banks generally pass on at least part of their efficiency gains to their customers and ignores differences in product quality and design, as well as attractiveness of innovations.

52. The estimation is based on the following assumptions: (i) that banks pass on at least part of their efficiency gains to their customers, eg by translating lower costs into lower output prices to gain market share; and (ii) that banks over time provide more or less similar quality levels, ignoring possible differences in product quality and design. The authors improve the original model by calculating marginal costs by using a translog cost function instead of approximating marginal costs by average variable costs.
53. The authors find that over the period from 1994 to 2004 the USA had the most competitive market for loans, whereas overall the loan markets in Germany and Spain were among the most competitive in the EU. The UK market for loans was generally less competitive.²⁹ The paper also measures competition between specific types of bank (commercial, savings and cooperative), finding that commercial banks tend to be more competitive.

Carbó Valverde, S, Humphrey, D, Maudos, J and Molyneux, P (2009), Cross-country comparisons of competition and pricing power in European banking

54. The authors compare the results of five well-known indicators of banking market competition (the net interest margin/total asset ratio,³⁰ the Lerner index, the return on assets,³¹ the H-statistic and the HHI) for a cross-section of 14 European countries (including UK) over the period from 1995 to 2001. The authors find that, despite providing consistent rankings of competition across countries at the extremes, these measures are only weakly positively

²⁸ Other competition measures, eg the Panzar-Rosse model, measure competition for the entire banking sector.

²⁹ However, the paper reports that these results differ from other empirical studies using alternative measures of competition. For instance, Carbó et al (2006) (a more recent version of this paper was published in 2009) suggest that on average banking competition seems to be strong in the UK, followed by the Netherlands and France, and lower in Spain, Italy and Germany. The authors think that such differences are normal given the differences in methods used.

³⁰ This measure reflects the loan–deposit interest spread or interest rate mark-up after controlling for different sized banks by deflating by total asset value.

³¹ The ratio of bank net income to the value of total assets. This is a profitability measure that considers all sources of income, not just that from traditional loan and security asset holdings.

correlated with each other. They are even less correlated (with only three out of 14 countries displaying a positive correlation) when within-country comparisons of different competition measures are made. The UK is consistently among the more competitive markets (ranging from second to sixth depending on the competition measure used), a finding that is different from other studies reported above.

55. The authors explain the low degree of correlation between the different indicators by the fact that these indicators are used to measure different things and are also influenced by cross-country differences in cost efficiency, fee levels, real economic growth and inflation.
56. In order to develop more consistent cross-country estimates of bank competition, the authors then propose a new, adjusted measure of bank pricing power, where they subtract the influence of country-specific effects from non-structural competition measures by using an approach from the frontier efficiency literature. The results given by this estimator imply that banking market competition in Europe may well be stronger than implied by traditional measures.

Bikker, JA (2010), Measuring performance of banks: an assessment

57. The paper examines the performance of different competition measures using data on 46 countries over the period from 1996 to 2005. Various different models are compared, including the Lerner index, the SCP model (using the HHI and 3 firm concentration ratio (CR₃) as indicators),³² the Cournot model (using market share as an indicator),³³ the Boone indicator, the Panzar-Rosse model and various models measuring efficiency costs, profit and market structure (the HHI, concentration ratios, number of banks). The analysis is based on the banking market as a whole, without regard to possible product differences.
58. The results show that the indicators, although behaving in accordance with their theoretical frameworks, are only moderately correlated with each other and differ strongly in quality. The author argues that this is due to the indicators measuring different things – competition is not the same as efficiency or profitability.

³² Measures the effect of concentration on profit.

³³ Measures the effect of market share on profit.

59. The results given by various competition estimates for the UK show exceptionally high cost levels, high interest margins and high profits, which are hard to reconcile with a competitive climate.

Goddard, J, Liu, H, Molyneux, P and Wilson, JOS (2010), The persistence of bank profit

60. Using a persistence of profit approach, the paper measures the strength of bank competition in 65 countries over the period from 1997 to 2007. The persistence of bank profit approach applies a dynamic view of bank competition and is consistent with the view that potential entry is as important as actual entry in determining the intensity of competition.
61. The main hypothesis tested is that entry and exit are sufficiently free to eliminate any abnormal profits quickly, so that bank profit rates converge rapidly towards their long-run equilibrium. Alternatively, entry may be prevented by structural characteristics, specialist knowledge or regulatory advantages enjoyed by the established banks, leading to abnormal bank profits persisting from year to year.
62. The paper reports the presence of the persistence of profit, with banks in developed countries exhibiting higher persistence of profit on average than those in developing countries – the persistence of profit is relatively high in North America and Europe and relatively low in East Asia, the Pacific and sub-Saharan Africa. The authors conclude that barriers to entry and exit are sufficiently high to enable banks to retain a significant portion of their abnormal profits from year to year. The paper also finds that the persistence of profit is stronger in those markets that are sheltered from competition by legally imposed barriers to entry.

Liu, H, Molyneux, P and Wilson, JOS (2013), Competition in banking: measurement and interpretation

63. The paper provides a detailed overview of various approaches used to measure the relationship between concentration and competition in banking: SCP-based models (ie concentration ratios and HHI) and new empirical industrial organisation measures, eg the Panzar-Rosse H-statistic, the Lerner index, the Boone indicator and the persistence of profits approach.
64. The persistence of profits approach argues that if entry and exit are sufficiently free, it will eliminate any abnormal profit quickly and all banks' profit rates will converge to the same long-run average value. On the other hand, if the established banks are able to delay or block entry, abnormal

profits tend to persist and differences in firm-level long-run average profit rates may be sustained indefinitely.

65. The authors apply the above-mentioned measures³⁴ to test the degree of competition in nine EU banking markets, including the UK, over the period from 2000 to 2009. The results for the UK show that the UK market was one of the least competitive of the nine examined. The authors conclude that different competition measures can provide different results and that most of the competition measures do not provide consistent evidence of the competitive conditions across their sample countries.

Tabacco, GA (2013), A new way to assess banking competition

66. The paper proposes a new empirical measure to estimate competition in banking. The method applies Sutton's (1991)³⁵ approach and involves two steps: (i) estimation of the lower bound concentration which refers to symmetric collusive equilibria involving single product firms and (ii) calculating the distance from the observed market structure to the lower bound.
67. For the industries characterised by exogenous sunk costs, the framework follows a two stage model where firms first decide simultaneously on entry to the market and then those which have entered compete in price. For the endogenous sunk cost industries, a three-stage model applies, where firms first make entry decisions, then, in stage two, they make demand-enhancing or cost-reducing investments in sunk costs, such as R&D and advertising, and, finally, in stage three, firms compete in price.
68. The paper shows that for industries characterised by either exogenous or endogenous sunk costs, as well as for markets with asymmetric firms and those with the presence of first mover advantages, equilibrium market structure is higher as price competition becomes tougher, meaning that the distance to the lower bound has a positive relationship with toughness of competition.

Tabacco, GA (2015), Market structure and intensity of price competition in EU banking

69. The paper analyses the relationship between market structure and the intensity of price competition in the EU banking industry. The author uses

³⁴ For the Panzar-Rosse model, the paper uses the estimation suggested by Bikker et al (2012) which addresses possible endogeneity issues reported.

³⁵ See, Sutton, J (1991), 'Sunk costs and market structure: price competition, advertising and the evolution of concentration', *MIT Press*. For more information on Sutton's approach, see paragraph 70.

John Sutton's framework to empirically measure the relationship between market size and market concentration and then, using his own recently developed framework, measures the intensity of price competition in the then 27 EU member states from 2007 to 2012.

70. Sutton's approach can be briefly described as follows. Industries are grouped into exogenous and endogenous sunk costs industries:
- (a) Exogenous sunk cost industries are those with homogeneous products or with horizontal product differentiation, and the firms operating in such industries compete on price. The following outcomes are expected to occur in markets characterised by exogenous sunk costs: (i) negative relationship between market size and concentration; (ii) concentration converging to 0 as market size becomes large; and (iii) tougher price competition leading to a more concentrated market structure at any given market size.
 - (b) Endogenous sunk cost industries are those with vertically differentiated products, for which quality becomes extremely important. The key feature in such industries is that product quality is enhanced by means of fixed sunk cost investments, such as research and development and advertising. Expansion of the market does not attract any further entry, but instead induces established banks to increase expenditure on endogenous sunk costs.
71. The results suggest that there is a null relationship between the total size of the market and concentration, in support of Sutton's endogenous sunk costs model. The author suggests that banks possibly compete on quality by investing in endogenous sunk costs such as advertising, branch network, coverage, number of employees per branch and salary per employee.
72. Furthermore, the results from the author's own newly developed measure of banking competition³⁶ suggest that price competition is rather soft in the majority of EU member states and that banks compete on service quality. In terms of price competition, the UK's banking industry is ranked as the third-lowest of the 27 countries evaluated.

³⁶ The empirical implementation of Sutton's approach requires defining a lower bound, ie the minimal level of concentration admissible, below which nothing can happen in long-run equilibrium. On and above the lower bound, any market structure is consistent with the theory. To evaluate the degree of price competition the author then measures the distance of the lower bound to concentration, which ranges from -1 to 1. The higher the value, the greater the intensity of price competition.

(c) Other single-country studies

Berger, AN and Hannan, TH (1998), The efficiency cost of market power in the banking industry: a test of the 'quiet life' and related hypotheses

73. The paper examines whether firms in more concentrated markets show lower operating efficiencies and tries to measure the magnitude of the resultant costs to the entire banking industry.
74. The authors use the 'quiet life' hypothesis that the market power exercised by firms in concentrated markets allows them to be less concerned about minimising costs, which may result in lower cost efficiency through one or more of several mechanisms – shirking by managers; the pursuit of objectives other than profit maximisation; political or other activities to defend or gain market power; or simple incompetence.
75. Based on the data from over 5,000 US banks and measures of local market concentration (using the HHI), the authors find strong evidence in support of the 'quiet life' hypothesis – the results show that banks in more concentrated markets show poorer cost efficiency.
76. The authors also estimate the costs resulting from concentration-induced losses in bank efficiency and compare them with estimates of the social loss associated with the misallocation of resources from non-competitive pricing as measured by the welfare triangle. They find that the additional operating costs attributable to market concentration appear to be substantially larger than the social loss due to the non-competitive pricing of bank outputs, suggesting that anticompetitive mergers entail large social costs.

Dick, AA (2007), Market size, service quality, and competition in banking

77. Using cross-section data for 2002 on 318 US banking markets defined at the metropolitan statistical area level, the paper measures the impact that quality plays in bank competition.
78. The paper finds that markets remain similarly concentrated, as measured by HHI and single firm concentration ratio (CR_1), and the correlation between concentration and market size is found to be close to zero. The findings show that the total number of banks is highly correlated with the market size, however the number of large (dominant) banks remains virtually unchanged regardless of the market size.
79. The author finds that service quality, which is measured by the advertising intensity, size of branch and ATM networks, branch staffing, geographic

diversification of the bank network and employee compensation,³⁷ varies significantly between large and small markets, with larger markets being associated with higher service quality. The service quality is also higher for larger banks, showing that larger banks do relatively more advertising, have more branches per square mile, more employees at the branch, a larger geographic presence and pay higher salaries. The results also show that larger banks in larger markets provide a significantly higher level of branch density and geographic coverage, whereas the fringe banks show a lower level of branch density in larger markets. The paper also finds, that the larger banks charge slightly higher interest rates on loans, higher fees on current accounts, and pay lower deposit interest rates, which might be explained by the differences in quality. Larger banks also appear to perform better than smaller banks in terms of accounting profits.

80. The author argues that the results indicate that bank competition involves endogenous sunk costs³⁸ and the banks can be grouped into two categories: the high quality dominant banks and lower quality fringe banks. It appears that the large banks use fixed-costs quality investments to capture additional demand when market size grows, thereby raising barriers to entry.³⁹ Unlike dominant banks, competition among the fringe banks does not appear to be driven by the fixed-cost provision of quality.
81. Finally, the results also show that dominant banks do not segment the markets but rather compete closely with each other and the fringe banks within the whole geographic market. However in terms of the product market, large and small banks might focus on different sectors, with larger banks focusing on the retail market and fringe banks focusing on serving smaller businesses.

Tregenna, F (2009), The fat years: the structure and profitability of the US banking sector in the pre-crisis period

82. The paper analyses the effects of structure on bank profitability in the USA in the pre-crisis period from 1994 to 2005. The results show that concentration led to increased bank profitability. This finding holds even when the largest banks are excluded from the sample, suggesting that the relationship between concentration and profitability acts in a generalised structural way, not merely through channels such as economies of scale.⁴⁰ Part of banks' very high

³⁷ This assumes that higher paid employees are more qualified and can provide better service.

³⁸ This is based on the mechanism developed by Sutton (1991), which is summarised in paragraph 70.

³⁹ Eg, the large branch networks act as an entry deterrent because new entrants are not able to match the size and density of the incumbent networks.

⁴⁰ In fact, the author finds that the largest banks are above a size which would appear to be 'optimal' in terms of economies of scale.

profits in the pre-crisis period can thus be regarded as deriving from the increasingly concentrated structure of the industry.

83. The author finds that the overall positive relationship between concentration and profitability is not just a reflection of the positive effects of concentration on the profitability of the largest banks, but that concentration positively affects the profitability of the rest of the banking sector. The results also suggest that the effects of bank concentration on bank profitability come at the expense of non-bank entities and could be detrimental to the rest of the economy.
84. The results do not support the X-efficiency hypothesis, suggesting that the very high profits during the pre-crisis period should not be attributed to the banks being run more efficiently.

Hannan, TH and Adams, RM (2011), Consumer switching costs and firm pricing: evidence from bank pricing of deposit accounts

85. The paper assumes that competition is local for deposit markets and that pricing of deposit accounts varies by geographical area. Using data measuring migration level into and out of the local US markets, the authors test banks' pricing strategies in areas experiencing different levels of migration into and out of these local markets.
86. The paper explores the pricing relationships implied by existence of switching costs in deposit markets. Because of these switching costs, the banks face a trade-off between attracting new customers and exploiting old ones.
87. The authors predict that in addressing this trade-off, all else being equal, the banks will offer higher deposit interest rates in the areas (and during periods) experiencing more inward migration, and lower deposit rates in the areas (and during periods) experiencing greater outward migration.⁴¹ Consistent with these predictions, regression results show a strong and robust relationship between bank deposit rates and the rates of inward and outward migration: deposit rates are found to increase with the rate of migration into a market and decline with the rate of migration out of the market, with the rate of outward migration having a more negative effect on deposit rates when the rate of inward migration is higher. The results imply that switching costs are very important in explaining bank deposit rates, and the negative relationship between bank deposit rates and the rate of outward migration implies, in

⁴¹ Because greater outward migration implies that a locked-in customer will not stay with the bank for many temporal periods.

particular, that banks take into account the future profitability of locked-in depositors in choosing current deposit rates.

88. The authors also find a negative relationship between HHI and deposit interest rates, a result consistent with the assumption that more concentrated markets lead to a greater exercise of market power.

Bolt, W and Humphrey, D (2012), A frontier measure of U.S. banking competition

89. The authors find that the three main measures of competition, the HHI, the Lerner index and the Panzar-Rosse H-statistic, are uncorrelated with each other for US banks.⁴² This could be explained by the fact that these three standard measures focus on traditional bank loan and deposit activities, while neglecting increasingly important fee-based services, and incompletely adjust for input productivity differences among banks.
90. To correct this, the paper proposes an efficient frontier measure of competition similar to the one developed by Boone.⁴³ The authors use available separate revenue data for traditional banking products (consumer and business loans) along with securities and two fee-based services (payments and investment banking activities). Bank retail prices and pricing revenues are assumed to be essentially determined by the level of underlying costs and market interest rates, the productivity of the banks in producing their services and the degree of market competition, which may permit revenues to exceed a normal return on invested capital or equity.
91. This model is then applied to five major bank service lines listed above using data for the period from 2008 to 2010. The authors find that these banking activities can be ranked by their degree of relative competition in the following order (most competitive first): business loans, security operations, payment activities, consumer loans, and investment banking and related services.

Koetter, M, Kolari, JW and Spierdijk, L (2012), Enjoying the quiet life under deregulation? Evidence from adjusted Lerner indices for U.S. banks

92. Using a sample of approximately 350,000 observations containing annual data for all insured US commercial banks from 1976 to 2007, the authors test

⁴² The paper also reports that the measures are only very weakly correlated for European banks, where banking concentration is considerably greater.

⁴³ See Annex A for a description of the Boone indicator.

for the 'quiet life' hypothesis, ie that firms with market power are prone to cost and profit inefficiencies.⁴⁴

93. To test for potential cost and profit inefficiencies the authors use efficiency-adjusted Lerner indices.⁴⁵ The findings show that adjusted Lerner indices are on average about 30% higher than conventional Lerner indices suggesting an increase in market power in the US banking industry from 1998 to 2007. The authors also investigate the causal relation between market power and inefficiency, finding evidence in support of the 'quiet life' hypothesis.⁴⁶
94. The paper also estimates the effects of deregulation on the 'quiet life' hypothesis. The findings again are in support of the 'quiet life' hypothesis in terms of profit efficiency. The effect of deregulation on efficiency is found to be generally positive, though fairly small.

Overvest, B and Tezel, G (2014), Notes on the margin: an overview of NMA's mortgage market study

95. The paper provides an overview of a sector study conducted by the Netherlands Competition Authority (NMA) on the Dutch mortgage market. The NMA's study analysed various aspects of the market, including the changes in concentration, barriers to entry and exit, consumer preferences, switching costs and the likelihood of (tacit) collusion. The paper is focused on the findings concerning the developments relating to bank margins.
96. The authors find that following the financial crisis, average bank margins increased significantly, reaching historically high levels, and then fell back to pre-crisis levels in early 2011. The authors conclude that these developments can be explained by changes in market structure: (i) the increase in margins was preceded by a merger between two major banks, thus reducing the competitive pressure exerted by 'challenger banks'; and (ii) stabilisation of financial markets and increase in the sales of challengers led to a decrease in concentration levels and margins. The study finds no indication that the changes in margins were driven by collusive conduct.

⁴⁴ The profit inefficiencies arise when firms do not fully exploit their pricing opportunities, for example requiring too little collateral and charging too low interest rates when lending.

⁴⁵ The Lerner indices are adjusted to account for the possibility of forgone rents, avoiding the assumption of full efficiency. A better description of a conventional Lerner index is given in Annex A.

⁴⁶ The paper reports a significant negative relationship between adjusted Lerner indices and profit efficiency, showing that profit efficiency declines with the increase of market power. With regard to cost efficiencies, neither conventional nor adjusted Lerner indices provide any evidence supporting the 'quiet life' hypothesis. In general, the results show that profit and cost efficiencies are often different for adjusted versus unadjusted Lerner indices.

Mulder, M (2014), The impact of concentration and regulation on competition in the Dutch mortgage market

97. The paper investigates the effects of industry structure and regulatory pricing constraints on competition in the Dutch mortgage market during the financial crisis. The author estimates the effect of the changes in concentration levels (estimated by the four firm concentration ratio⁴⁷ (CR₄) and the HHI) on the Lerner index over the period from 2005 to 2010.
98. The paper finds that the increase in concentration levels has a negative effect on competition. It links this to the decline in competitive pressure from fringe suppliers, thus enabling the larger banks to charge higher interest rates. It also finds indications that the regulatory pricing constraints imposed by the European Commission have negatively influenced competition, with the less aggressive pricing policy of the state-supported banks resulting in less intensive competition.

Bolt, W and Humphrey, D (2015), Assessing bank competition for consumer loans

99. The paper analyses and compares the performance of several competition indicators, including the HHI, the Panzar-Rosse H-statistic, the Lerner index, mark-up⁴⁸ and two newer measures based on frontier analysis,⁴⁹ in measuring the competitiveness of banks in the provision of consumer loans.
100. Looking at a sample of 2,644 banks in the USA over the period from 2008 to 2010, the paper finds that the competition measures are only weakly correlated to each other, showing that the assessment of competition largely depends on the measure used.
101. Using each competition measure the authors rank the banks from most to least competitive and then match the findings with banks having the lowest to highest average price of consumer loans. The authors find that the best matches are given by the Lerner index, the mark-up and the competition efficiency frontier measure, and conclude that these measures can be considered as the 'best' in identifying the price conduct aspect of the SCP paradigm. HHI provides no matches that are significant.

⁴⁷ A broader description of concentration ratios and other measures is given in Annex A.

⁴⁸ Measured as the difference between the average price of consumer loans and average cost of deposits, divided by the average price of consumer loans.

⁴⁹ These include an efficiency-adjusted Lerner index as proposed by Koetter, Kolari and Spierdijk (2012) and a competition efficiency frontier measure similar to the Boone indicator.

(d) Other cross-country studies

Corvoisier, S and Gropp, R (2001), Bank concentration and retail interest rates

102. The authors maintain that the impact of concentration on the pricing behaviour of banks can be summarised by two opposing hypotheses: (i) banks will collude and use market power to extract rents (the 'structure-performance' hypothesis) and (ii) concentration will increase the overall efficiency in the sector. According to the latter hypothesis, concentration is due to more efficient banks growing more rapidly than less efficient banks, or more efficient banks taking over less efficient ones. If this were the case, banks would price their services more competitively (the 'efficient structure hypothesis'). The authors also raise a further possibility that higher contestability can lead to an overall increase in competition, irrespective of the level of concentration.
103. The authors construct HHIs for selected euro area countries for different bank products, including overall, short-term and long-term customer loans, mortgages, and demand, fixed-maturity and saving deposits, covering the period from 1993 to 1999. They then estimate a country-specific, product-specific Cournot model where banks are assumed to behave as price setters in the loan market, while they face a given deposit rate on their liabilities.⁵⁰ They regress banks' margins on HHIs, parameters for risk and costs and other variables.
104. The authors find that increasing concentration in a sample of EU countries (the UK not included) may have resulted in less competitive pricing by banks for loans and demand deposits. However, for savings and time deposits, evidence that concentration affects interest rates is not found.

Berger, AN, Demirgüç-Kunt, A, Levine, R and Haubrich, JG (2004), Bank concentration and competition: an evolution in the making

105. The paper provides an overview of the economic literature dealing with the impact of bank concentration and competition on bank performance. The paper is mainly based on studies of the US markets.
106. The authors note that new research is moving away from the traditional concentration measures, such as HHI or concentration ratios, in order to test the SCP paradigm, and starting to apply alternative models, such as the efficient structure hypothesis, the Bresnahan conjectural variation model, the

⁵⁰ The authors assume that banks behave as Cournot competitors in the sense that the loan rate of one bank does not affect the behaviour of any of its competitors in the loan market.

Panzar-Rosse model and structural demand models based on consumer choice under product differentiation.

107. The new research distinguishes between concentration and competition and generally finds that bank competition is 'good' from a social perspective. However, the papers report only weak evidence of concentration effects on pricing – while greater concentration is generally associated with less favourable prices for consumers, higher profitability and reduced access to credit, these findings are frequently not robust when other measures of bank competition, such as regulation or foreign bank entry, are included.
108. The findings of studies based on the measures of competition other than concentration are generally robust, showing that policies that restrict bank competition – regulation, barriers to foreign bank participation, and direct state control of banking resources – tend to be associated with 'bad' outcomes, such as higher prices, less access to credit, reduced stability of the financial system and diminishing overall economic performance.

van Leuvensteijn, M, Sørensen, CK, Bikker, JA and van Rixtel, A (2008), Impact of bank competition on the interest rate pass-through in the euro area

109. Using the Boone indicator, the paper investigates the impact of loan market competition on the interest rates applied by the euro area banks to loans and deposits during the period from 1994 to 2004.
110. Three outcomes are tested:
 - (a) the effect of loan market competition on the level of bank loan and deposit rates;
 - (b) the effect of loan market competition on the long-run equilibrium pass-through of bank interest rates to changes in corresponding market interest rates; and
 - (c) the effect of loan market competition on the immediate adjustment of bank interest rates to changes in market interest rates.
111. The results provide evidence that stronger competition implies significantly lower spreads between bank and market interest rates for most loan market products, ie stronger competition leads to lower interest rates and stronger pass-through of market interest rates.
112. Furthermore, the authors observe higher bank spreads (ie lower bank interest rates) on current account and time deposits when loan market competition is stronger. This suggests that bank competition is heavier in the loan market, so

that banks compensate for their reduction in loan market income by lowering their deposit rates.

Degryse, H and Ongena, S (2008), Competition and regulation in the banking sector: a review of the empirical evidence on the sources of bank rents

113. The paper provides an overview of findings from empirical banking literature. This includes a review of 12 papers on the effect of concentration on deposit markets and 18 on the effect of concentration on loan markets. The authors find that increased concentration tends to lead to higher loan interest rates, but that the magnitude of this result varies widely depending on the study. For deposit rates, they find that overall most papers report a negative impact of an increase in concentration on time⁵¹ and savings deposit rates. However, demand deposits⁵² seem less affected by market concentration.

Scherer, FM (2010), A perplexed economist confronts 'too big to fail'

114. The paper provides a short summary of previous analysis of structure-performance relationships in retail banking. The literature indicates that higher levels of local bank market concentration lead to lower interest rates for depositors and, with some complex exceptions, higher interest rates for borrowers. One study also find that young (ie newly established) borrowers tend to pay lower interest rates for their loans, which can be described as 'bargains'. Once such consumers are locked in, the loan interest rates are increased.

115. The literature reviewed also finds definite economies of scale and scope in banking, but in most cases these are exhausted at relatively low thresholds. The paper also finds evidence of a positive relationship between an increase in market concentration (usually, following a merger) and new entry, suggesting that market forces may mitigate at least some of the anticompetitive effects associated with high concentration.

⁵¹ Time deposits are those that cannot be withdrawn for a specific period of time without incurring a penalty.

⁵² Accounts from which deposited funds can be withdrawn at any time without any advance notice.

Annex A: Overview of different methods used to measure competition in banking

1. The most common methods used to measure competition in banking can be summarised as follows:
 - (a) Structural and related methods, such as various concentration indices, entry analysis and the Lerner index, which often have low data requirements, but exhibit weaknesses in theoretical foundations, eg concentration levels do not necessarily reflect the level of competition in the market.
 - (b) The Panzar-Rosse H-statistic, which has low data requirements, but is mainly used to test the competitiveness of the banking system as a whole, rather than focusing on specific product markets. This is the most widely applied model; however, serious misspecification issues were reported by several studies,⁵³ resulting in biased estimates.
 - (c) The Boone indicator, which has low data requirements and can be used to test the competitiveness of specific banking sectors. However, it faces identification issues if firms compete on quality and design.
 - (d) Other measures, eg conjectural variation models, profit margins, persistence of profits approach and measures based on frontier analysis.
2. A more detailed description of these methods is given in Léon (2014).
3. This paper provides an overview of the most frequently used structural and non-structural measures of competition in banking, providing a detailed description of the advantages and disadvantages of each method.
4. It divides the approaches used to estimate competition into two main groups:
 - (a) Structural models are based on traditional industrial organisation and focus on the linkages between market structure and performance (the SCP paradigm). Under the SCP paradigm, high concentration increases market power and incentives to collude, which, in turn, leads to higher prices and profitability. The paper outlines the following structural measures used to measure competition:

⁵³ See for example Bikker et al (2006a, 2006b, 2012), Goddard and Wilson (2008).

(i) There are various concentration measures: the number of firms, concentration ratios and the HHI:

i. The number of firms is the simplest of the concentration measures and is calculated as the sum of firms in the market. The different market shares of each firm are not taken into account.

ii. The k -firm concentration ratio measures the market share of top k firms in the market and can be described as the sum of the market shares of the k largest firms. The most commonly used k values are 3, 5 and 10.

$$CR_k = \sum_{i=1}^k s_i$$

The concentration ratio focuses on the market share of the top k firms only and does not take into account the size distribution of the remaining firms.

iii. The HHI is the concentration measure most frequently used by national competition authorities and researchers and is computed by summing the square market shares of all N firms on the market.

$$HHI = \sum_{i=1}^N s_i^2$$

The HHI assigns greater values to higher market shares, thus giving more importance to larger firms.

Advantages

Have low data requirements
Do not require firm-level variables

Shortcomings

Have weaknesses in theoretical foundations – alternative theories show that concentrated markets can be competitive (eg Bertrand duopoly, market contestability) and collusion can also be sustained in the presence of many firms
Are not exogenous and may reflect differences in firms' efficiency
Require relevant markets to be defined; are subject to data availability issues

(ii) Contestability theory focuses on regulatory and supervisory frameworks, entry and exit conditions.

Advantages

Data available for a large number of countries
Does not require firm-level variables

Shortcomings

Omits non-regulatory barriers and sunk costs
Entry and exit in banking industry can be influenced by non-legal (eg technological and informational) barriers, especially in developing countries

(b) New empirical industrial organisation models focus on non-structural measures of competition, and were developed as a response to deficiencies in the SCP paradigm. These models try to assess directly the competitive conduct of firms. The paper outlines the following measures:

- (i) The Lerner index provides a firm-specific measure of market power which is simple and straightforward to interpret and does not pose stringent data requirements, with a possibility to study evolution of pricing over time. This method does not require defining the relevant market.

Advantages

Offers a firm-specific measure of market power
 Have low data requirements
 Is simple and straightforward to implement
 Offers flexibility
 Market definition not required

Shortcomings

Has weaknesses in theoretical foundations (measuring market power is not the same as measuring competition), eg it is theoretically possible that market power increases with more intense competition; fails to take into account reallocation effect from inefficient to efficient firms
 Cannot capture degree of product substitutability
 Requires firm-level variables and information on prices
 Can be distorted by spending on other activities and inefficiency

- (ii) Conjectural variation (Iwata and Bresnahan-Lau) models aim to control for changes in the Lerner index due to demand changes and to isolate firms' competitive behaviour. The conjectural variation model can be described as an elasticity-adjusted Lerner index.

$$L_i = \frac{P - C'_{qi}}{P} = - \frac{(1 + \lambda_i)S_i}{\varepsilon_i}$$

The conjectural variation parameter λ_i measures firm i 's expectations about the reactions of its rivals and ranges from -1 to $N - 1$ (where N is the number of firms). In a collusive situation if firm i chooses to increase its production by 1, all firms will do the same. Hence, the full exploitation of market power exercised by firm i coincides with $\lambda_i = N - 1$ and the total output increases by N unities. $\lambda = -1$ implies that firms are competing under perfect competition and $\lambda = 0$ – under Cournot.

The value of demand elasticity ε can be obtained from the demand equation and the conjectural variation parameter λ – from the modified supply equation.

Advantages

Gives direct estimate of firm's conduct that is continuous and maps all oligopoly solution concepts

Shortcomings

Structural model requires specifying of functional forms for demand and supply equations and requires a large number of observations, including prices
 Small sample issues – identification and instability

Remains valid if regulatory restrictions apply or firms do not maximise profits
 Can cope with monopsony power in deposit market

Is sensitive to market definition – results are biased if sample fails to span the complete market
 Has same limitations as Lerner index
 Unable to take into account interest rate regulations

(iii) The Panzar-Rosse model is the most widely applied competition assessment technique in the banking literature. This indicator captures the influence of input prices on firms' revenues – weak influence (low values) is interpreted as indicating market power whereas strong influence (high values) indicate a higher degree of competition. The model is estimated by using a reduced form revenue equation which regresses revenue (in logarithm) on input prices (in logarithm) and other control variables.

$$\ln(Rev_i) = \alpha + \sum_{l=1}^L \beta_l \ln(w_{l,i}) + \sum_{k=1}^K \gamma_k Z_{k,i} + \varepsilon_i$$

The H-statistic, the parameter measuring the degree of competition, is calculated as the sum of the elasticities of the bank's total revenue with respect to that bank's input prices, and ranges from $-\infty$ to $+1$.

$$H = \sum_{l=1}^L \beta_l$$

Under perfect competition, input prices and total revenues increase by the same percentage and the H-statistic = 1. The H-statistic ≤ 0 indicates a monopoly, and the H-statistic in a range from 0 to 1 indicates monopolistic competition.

H-statistic is a good measure of competition in a static perspective; however, it requires strong assumptions that cannot always be checked.

Advantages

Can be estimated by simple, single-equation linear model
 Requires a limited number of observations
 Does not require market definition

Shortcomings

Has identification issues: some important assumptions have to be verified, eg the market has to be in long-run equilibrium (ie the number of firms is endogenous and the bank profits are uncorrelated with input prices)
 Interpretation of the H-statistic depends on the hypotheses assumed regarding the market equilibrium, demand elasticity and cost function
 Requires information on prices
 Monopsony power could mask monopoly power

(iv) The Boone indicator takes into account the reallocation effect and is based on the presumption that more efficient firms achieve superior performance, in terms of higher profits at the expense of their less

efficient rivals, and also attract greater market share. The Boone indicator uses relative differences in profit to measure the level of competition. The intensity of competition is estimated by using a simple profitability equation:

$$\ln\pi_i = \alpha + \beta \ln c_i + \varepsilon_i$$

The coefficient β gives the profit elasticity, ie the drop in profits caused by an increase in costs, and should be negative, reflecting the fact that higher marginal costs are associated with lower profits.

Efficient banks may choose to translate lower costs either into higher profits or into lower output prices in order to gain market share. To estimate the effect of costs on market share van Leuvensteijn et al (2007) uses the following equation:

$$\ln s_i = \alpha + \beta \ln c_i + \varepsilon_i$$

In both cases, higher β (in absolute terms; we are expecting the relationship between costs and profits/market share to be negative) implies higher competition. Both equations can also be run by introducing fixed effects or instrumental variables in order to take into account unobserved heterogeneity.

The Boone indicator catches the dynamic aspects of competition but may sometimes fail to identify the degree of competition in the short run. It is also a recently developed tool and has not yet been properly scrutinised.

Advantages

- Has strong theoretical foundations
- Can be estimated by simple, single-equation linear model
- Requires a limited number of observations
- Gives continuous measure of competition
- Considers (partially) non-price strategies

Shortcomings

- Efficiency should be one-dimensional and observed, which is not always the case
- Efficiency gains may not be translated into lower prices or higher profits in the short run
- Different forms of competitive situation cannot be distinguished
- Requires firm-level variables and information on prices
- Has identification issues in some cases (eg if firms compete on quality), leading to positive β

Annex B: Summary list of sources

1. Single Country studies focused on the UK market:
 - Heffernan, SA (2002), 'How do UK financial institutions really price their banking products?', *Journal of Banking and Finance*
 - Heffernan, SA (2003), 'UK bank services for SMEs: are they competitively priced?', *Cass Business School working paper*
 - Gondat-Larralde, C and Nier, E (2006), 'Switching costs in the market for PCAs: some evidence for the United Kingdom', *Bank of England working paper*
 - Heffernan, SA and Fu, X (2009), 'The structure of retail markets: what do we learn from bank-specific rates?', *Applied Financial Economics*

2. Cross-country analysis including UK:
 - (a) Papers applying the Panzar-Rosse model:
 - Bikker, JA and Haaf, K (2002), 'Competition, concentration and their relationship: an empirical analysis of the banking industry', *Journal of Banking and Finance*
 - Claessens, S and Laeven, L (2004), 'What drives bank competition? Some international evidence', *Journal of Money, Credit and Banking*
 - Bikker, JA, Spierdijk, L and Finnie, P (2006a), 'The impact of bank size on market power', *DNB working paper*
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 - Bikker, JA and Spierdijk, L (2008), 'How banking competition changed over time', *DNB working paper*
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- Andrieș, AM and Căpraru, B (2014), 'The nexus between competition and efficiency: the European banking industries experience', *International Business Review*

(b) Other:

- van Leuvensteijn, M, Bikker, JA, van Rixtel, A and Sørensen, CK (2007), 'A new approach to measuring competition in the loan markets of the euro area', *European Central Bank (ECB) working paper*
- Carbó Valverde, S, Humphrey, D, Maudos, J and Molyneux, P (2009), 'Cross-country comparisons of competition and pricing power in European banking', *Journal of International Money and Finance*
- Bikker, JA (2010), 'Measuring performance of banks: an assessment', *Journal of Applied Business and Economics*
- Goddard, J, Liu, H, Molyneux, P and Wilson, JOS (2010), 'The persistence of bank profit', *Bangor Business School working paper*
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- Tabacco, GA (2013), 'A new way to assess banking competition', *Economic Letters*
- Tabacco, GA (2015), 'Market structure and intensity of price competition in EU banking', *Journal of Competition Law and Economics*

3. Other single country studies:

- Berger, AN and Hannan, TH (1998), 'The efficiency cost of market power in the banking industry: a test of the "quiet life" and related hypotheses', *Review of Economics and Statistics*
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