

# **Review of Barriers to Entry, Expansion and Exit in Retail Banking**

**Call for Evidence**

**26 May 2010**

OFT1233

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# 1 INTRODUCTION

1.1 The banking sector has seen considerable change over the past 25 years. Technological change has included the growing use of telephone and internet based banking. Changes in organisational and business models have included, in the UK, the demutualisation of some building societies. Structurally, the sector has become more consolidated and concentrated around a handful of larger providers, often part of international groups engaged in a wide mixture of banking and other activities. Since 2007, the global financial crisis has had particularly significant impacts. In the UK:

- the failure, closure or nationalisation of banks and building societies, such as Northern Rock being taken into temporary public ownership
- recapitalisation and the provision of other financial support by the Government, most notably the recapitalisation of Lloyds Banking Group (Lloyds) and the Royal Bank of Scotland (RBS), and
- significant consolidation in parts of the banking sector, including the acquisition by Lloyds of HBOS, acquisitions by Santander and Nationwide and a reduction in the number of building societies.

1.2 Further changes in the UK related to the crisis will include:

- the future sale of Northern Rock assets and required divestments of parts of Lloyds and RBS as a result of conditions placed on the firms by the European Commission in relation to the state aid that they have received, and
- significant regulatory reforms, including to the capital and liquidity standards that banks are required to meet, as well as questions being raised about the structure of the banking system.<sup>1</sup>

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<sup>1</sup> HM Government, 'The Coalition: our programme for government', May 2010, Section 1: Banking states 'We will take steps to reduce systemic risk in the banking system and will establish an independent commission to investigate the complex issue of separating retail and investment banking in a sustainable way'. Available at: [www.cabinetoffice.gov.uk/media/409088/pfg\\_coalition.pdf](http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf)

- 1.3 The crisis and its aftermath has also seen the emergence of new entrants and potential entrants to the retail banking sector, including well-recognised brands from other sectors such as Virgin Money and Tesco Bank.

#### **Barriers to entry, expansion and exit**

- 1.4 Barriers to entry, expansion and exit will be important in determining how the market develops from here. The threat of losing business should spur innovation, provide strong incentives to keep costs and prices down and meet customers' requirements for quality of service and range of products. But this relies in part on having a dynamic market, with the pressure of potential new entrants and expansion by existing participants. Barriers to entry, expansion and exit are critical to this. This may be about many aspects other than just the costs of setting up a bank, for example barriers to customers comparing and switching between banks and to establishing new business models are both likely to be important for example.
- 1.5 The Office of Fair Trading (OFT) and others have considered barriers to entry and expansion in retail banking before:
- the Cruickshank report on banking covering payment systems, personal banking and Small and Medium sized Enterprise (SME) banking in 2000<sup>2</sup>
  - the Competition Commission (CC) investigation of SME banking in 2002 ('the SME report')<sup>3</sup>

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<sup>2</sup> See HM Treasury, 'Competition in UK Banking: A Report to the Chancellor of the Exchequer', March 2000. Available at: [http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/fin\\_bank\\_reviewfinal.htm](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/fin_bank_reviewfinal.htm)

<sup>3</sup> See Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', March 2002. Available at: [www.competition-commission.org.uk/rep\\_pub/reports/2002/462banks.htm#full](http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm#full)

- the CC investigation of personal current account banking in Northern Ireland in 2007 ('the NI banking report')<sup>4</sup>
- the OFT review of the SME undertakings arising from the SME report in 2009,<sup>5</sup> and
- the OFT market study into personal current accounts (PCAs) in the UK in 2008 ('the PCA market study').<sup>6</sup>

1.6 This review will build on the work of these previous reports and seek to understand the extent to which barriers to entry, expansion and exit have changed over time, due to the structural evolution of the market and other longer-term developments, as well as events of the recent financial crisis.

### **Purpose**

1.7 The review will assist the OFT and others in understanding better barriers to entry, expansion and exit in both personal and SME banking. It will also look at building knowledge about retail banking within specific parts of the UK, including Scotland and Northern Ireland. This work will be of value to the OFT and others in understanding the long term competitiveness of the banking sector. For example, it will help in the understanding of decisions and choices facing the Government about the sale of banking assets, between the impact on competition and other public policy goals, such as maximising value.

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<sup>4</sup> See Competition Commission, 'Personal current account banking services in Northern Ireland market investigation', May 2007. Available at: [www.competition-commission.org.uk/rep\\_pub/reports/2007/527banking.htm](http://www.competition-commission.org.uk/rep_pub/reports/2007/527banking.htm)

<sup>5</sup> See OFT937, 'SME Banking: Review of the undertakings by banks following the 2002 Competition Commission report', August 2007. Available at: [www.of.gov.uk/shared\\_of/reports/financial\\_products/of937.pdf](http://www.of.gov.uk/shared_of/reports/financial_products/of937.pdf)

<sup>6</sup> See OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008. Two follow up reports have also been published, outlining developments since the market study on transparency, switching and unarranged overdraft charges. These are all available at: [www.of.gov.uk/OFTwork/markets-work/completed/personal/](http://www.of.gov.uk/OFTwork/markets-work/completed/personal/)

- 1.8 The review is intended to help the OFT and others in:
- assessing and advising on options for change in the regulatory framework for banking
  - assessments of any relevant mergers that may arise in the banking sector, including any such arising from divestments under EC state aid requirements
  - contributing to any relevant reviews or other work undertaken by the Government or other public authorities, and
  - determining future work priorities in retail banking.
- 1.9 The rest of this document is structured as follows:
- Section 2 describes the proposed review scope and approach
  - Section 3 looks in more detail at specific barriers to entry, expansion and exit, including previous assessments where relevant, and how this may have changed, and
  - Section 4 sets out the process for this review and provides contact details for the review team.
- 1.10 Sections 2 and 3 pose questions on which the OFT would welcome evidence. These questions are collected and repeated in the annexe.

## 2 SCOPE OF THE REVIEW

2.1 This review is intended to be short and focused, looking at barriers to entry, expansion and exit<sup>7</sup> in banking. Its aim is to understand whether and if so how such new entry or expansion are impeded by characteristics of the banking sector. This section describes the proposed scope and approach and asks questions about them.

### **Scope of banking services covered by the review**

2.2 The review will be focused on the provision of retail banking services to individuals ('personal banking') and SMEs ('SME banking'). SMEs are defined for these purposes as businesses with turnover of up to £25 million.<sup>8</sup>

2.3 The OFT believes that there are strong linkages between barriers affecting personal banking and those affecting SME banking. For example, branch networks, problems with switching between providers and the importance of reputation are common themes. The OFT believes that there may also be elements of economies of scope in providing both personal and SME banking. The review will consider each area separately, as well as how the two link together in this review.

2.4 The OFT understands that banking for larger enterprises is substantially different to retail banking. For example, access to a local branch network appears less important and the nature of services provided to larger enterprises may be very different – such as facilitating access to capital markets. The OFT believes that barriers to entry, expansion and exit in banking for larger enterprises are therefore likely to be rather different to

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<sup>7</sup> For a more detailed explanation of such barriers see OFT415, 'Assessment of market power', December 2004, Section 5. Available at: [www.ofg.gov.uk/shared\\_ofg/business\\_leaflets/ca98\\_guidelines/ofg415.pdf](http://www.ofg.gov.uk/shared_ofg/business_leaflets/ca98_guidelines/ofg415.pdf)

<sup>8</sup> We adopt the same definition used by the OFT in reviewing the SME banking undertakings. See OFT937, 'SME Banking: Review of the undertakings by banks following the 2002 Competition Commission report', August 2007.



those affecting personal and SME banking.<sup>9</sup> Given this, the OFT is not proposing to include the provision of banking services to business customers with an annual turnover greater than £25 million within this review.<sup>10</sup>

2.5 Consistent with its scope covering personal and SME banking, this review is intended to cover all major retail banking products provided to these customers. This is intended to include:

- products which only licensed banks<sup>11</sup> are permitted to provide, such as deposit accounts and PCAs
- those which other types of business are permitted to sell, such as mortgages and other forms of lending, but where banks are the most important providers, and
- where appropriate, other products, such as insurance or credit cards where cross-selling may facilitate entry or expansion.

2.6 The review will also aim to establish whether there is a 'minimum' or 'core' product offering required to enter into personal or SME banking as a significant supplier.

2.7 The OFT recognises that different providers may compete in relation to different products and that entry, expansion and exit barriers may also differ as between the markets for different products.

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<sup>9</sup> Lending to larger corporates and possible constraints or barriers to non-banks providing these services has been considered recently by HM Treasury, 'Discussion paper on non-bank Lending', January 2010, paragraphs 3.16 and 3.17.

<sup>10</sup> In parallel to this review, as the OFT has previously announced, including a speech by its Chairman, Philip Collins on 30 March 2010, it is interested in competition issues within the City markets of investment banks. The OFT intends to make a statement about this at a future time. See Philip Collins, 'Making financial markets work well for consumers', third annual Currie lecture at the Cass Business School, March 2010. This speech is available at: [www.of.gov.uk/shared\\_of/speeches/689752/spe0310.pdf](http://www.of.gov.uk/shared_of/speeches/689752/spe0310.pdf)

<sup>11</sup> Throughout this document, 'banks' is intended to refer, unless otherwise stated, to institutions with a banking license, including, for example, building societies. Some of these businesses may be legally restricted in the extent to which they can undertake certain activities.

## Type of entry

2.8 As in previous work, the review will consider different types of market entry and expansion and whether barriers impact differently on them. Past entry has been diverse, including:

- entry from providing services to one group of customers to another, such as demutualised building societies lending to SMEs
- entry from extending a brand from one industry to another, such as Tesco Bank
- foreign entry from outside the market through mergers and acquisition, such as the takeover of Abbey National by Santander, and
- foreign banks establishing a physical presence in the UK, such as Handelsbanken in the SME banking market, or using other channels such as the internet or telephone banking, such as ING Direct.

## Differences within the UK

2.9 The OFT's advice to the Secretary of State for Business Enterprise and Regulatory Reform on the acquisition by Lloyds TSB plc of HBOS plc found a realistic prospect of a substantial lessening of competition in SME banking in Scotland.<sup>12</sup> Further concerns were raised in respect of banking competition in Scotland within the recent report from the Economy, Energy and Tourism Committee of the Scottish Parliament.<sup>13</sup> The OFT intends to examine whether barriers to entry, expansion and

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<sup>12</sup> See OFT, 'Anticipated acquisition by Lloyds TSB plc of HBOS plc Report to the Secretary of State for Business Enterprise and Regulatory Reform', 24 October 2008. Available at: [www.of.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB](http://www.of.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB). The report also found a realistic prospect of a substantial lessening of competition in PCAs and mortgages.

<sup>13</sup> Economy, Energy and Tourism Committee, 'Report on the way forward for Scotland's banking, building society and financial services sector', March 2010. The Scottish Parliament Economy, Energy and Tourism Committee wrote to the OFT on 18 March 2010 calling for a formal investigation into competition in banking in Scotland. The OFT wrote back on 20 April 2010 noting that this review will take into account any particular problems in parts of the UK including Scotland. Available at: [www.scottish.parliament.uk/s3/committees/eet/index.htm](http://www.scottish.parliament.uk/s3/committees/eet/index.htm)

exit differ across parts of the UK, such as the role and nature of branch networks and costs of establishing them.

- 2.10 The provision of banking services also appears to be different in Northern Ireland than in Great Britain. Most notably, the main banks in Northern Ireland are not the same as those in the rest of the UK. The review therefore also intends to assess whether there are significant differences in respect of barriers to entry, expansion and exit in Northern Ireland.

**Question 1:** Do you agree with the proposed scope laid out in paragraphs 2.2 to 2.10 for the purposes of reviewing barriers to entry, expansion and exit in banking within the UK?

### **Key themes**

- 2.11 The review will be considering those barriers to entry, expansion and exit which may prevent an inefficient incumbent bank declining in favour of more efficient companies. This may be about many aspects other than just the costs of setting up a bank, barriers to customers comparing and switching between banks and to establishing new business models are both likely to be important. The bullet points below set out the areas that the review will focus upon. There are four areas of focus identified.
- **Regulatory requirements.** This covers the authorisation (often referred to as a 'banking licence') from the FSA that firms that wish to provide savings or current accounts must obtain, and key aspects of the regulatory requirements that go alongside them, especially concerning capital and funding. Proposed changes in bank regulatory requirements could affect barriers to entry, expansion and exit.
  - **Essential inputs.** This covers access to specific infrastructure, most importantly payment systems and access to credit risk information.
  - **Barriers to achieving scale.** This covers lack of switching due to customer inertia, the cost of customer acquisition, the cost of setting up branch networks and the value of an established brand or reputation.

- **Barriers to exit.** This includes aspects of the operation of the Special Resolution Regime set up to assist in the orderly exit of firms in the banking sector.<sup>14</sup>

**Question 2:** Do these themes capture the most important elements of barriers to entry, expansion and exit?

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<sup>14</sup> The Banking Act 2009 has established a permanent Special Resolution Regime (SRR) which provides authorities with the necessary tools to deal with banking institutions in financial difficulties in order to allow for the sale of assets and to ensure depositors are protected under the Financial Services Compensation Scheme (FSCS).

### **3 BARRIERS TO ENTRY, EXPANSION AND EXIT**

3.1 This section sets out previous work that has been carried out on specific barriers to entry, expansion and exit, discusses how these barriers may have changed and indicates the type of information that would be helpful to the review.

#### **Regulatory requirements**

3.2 Firms that wish to provide savings or current accounts must obtain authorisation from the FSA before they can accept deposits.<sup>15</sup> The Budget in March 2010 set out expectations for improvements in this licensing process. It stated: 'The Government welcomes the FSA's intention to deliver further improvements to the bank licensing process, for example, improved guidance on initial applications and more structured communication on the status of applications. This builds on advances already made, particularly in the pre-application process, and will help to ensure new entrants continue to drive a vibrant and competitive marketplace.'<sup>16</sup>

3.3 Authorised firms must comply with certain requirements, including the need to hold a certain amount and type of capital against assets funded by deposits (for example customer loans). Further changes are expected to regulatory requirements.<sup>17</sup> Changes to capital and liquidity regulation will require banks to reduced their leverage, and all other things remaining equal this will lower the expected returns from banking for prospective new entrants.

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<sup>15</sup> With the exception of firms in the European Economic Area who can accept deposits through a branch in the UK using a 'passport' from their home state regulator.

<sup>16</sup> See HM Treasury, 'Budget 2010: Securing the recovery Economic and Fiscal Strategy Report and Financial Statement and Budget Report', March 2010, paragraph 3.54. Available at: <http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/budget2010.htm>

<sup>17</sup> Changes to the capital and liquidity requirements are typically emanating from EU Directives.

- 3.4 The PCA market study found that 'although obtaining regulatory authorisation may be time-consuming for a new entrant, it does not represent a major barrier to entry'.<sup>18</sup>
- 3.5 The SME report also considered the regulatory requirements on banks, in particular whether the relatively high regulatory asset requirements for smaller banks might deter entry. The CC concluded 'regulatory asset requirements should not prove a difficulty for cross-entry from, for example, some of the ex-building societies which have similar ratios to the clearing banks and who remain the most likely source of entry to the SME market' and as such 'we do not regard regulatory requirements as a major barrier to entry to the SME market'.<sup>19</sup>
- 3.6 Banking regulation is necessary for financial stability and may play a role in encouraging entry, by maintaining confidence in banks (including new entrants). The financial crisis has substantially changed the environment for banking. Changes have been proposed to the capital and liquidity requirements.<sup>20</sup> These may impact on the ability for smaller banks to enter and expand in the market.
- 3.7 Given the wide range of regulatory activities in banks, this review intends to focus on the following aspects of regulation:
- the licensing process for deposit taking activities without which companies cannot undertake many banking activities, and
  - capital and liquidity requirements, to understand the extent to which these significantly add to barriers to entry and expansion.
- 3.8 The OFT would welcome evidence on the following questions.

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<sup>18</sup> OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraph 3.43.

<sup>19</sup> See Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', March 2002, paragraph 2.221.

<sup>20</sup> For example see FSA, 'CP09/29: Strengthening Capital Standards 3', December 2009, available at: [www.fsa.gov.uk/pages/Library/Policy/CP/2009/09\\_29.shtml](http://www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_29.shtml) and FSA, 'Strengthening liquidity standards including feedback on CP08/22, CP09/13, CP09/14', October 2009, available at: [www.fsa.gov.uk/pubs/policy/ps09\\_16.pdf](http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf)

**Question 3:** How does the licensing process for deposit taking activities and the capital and liquidity requirements affect the ability of firms to enter into the provision of banking services or expand their provision of banking services?

**Question 4:** To what extent do any other regulations, such as anti-money laundering rules and consumer credit licensing requirements, form significant barriers to entry or expansion? Are there any more subtle sources of regulatory requirements which nonetheless form a significant barrier to entry or expansion?

### **Essential inputs**

3.9 Banks require access to payment systems and access to credit risk information on customers. The OFT refers to these as 'essential inputs'. Both, to varying extents, rely on actions of existing banks, given their role in the membership or control of networks and their role in sharing credit data.

#### **Access to payment systems**

3.10 Payment systems are the backbone of retail banking activities as they guarantee secure and fast financial transfers between individuals, between businesses, or between individual customers and businesses. In the UK, the main systems are the clearing schemes: Bacs (including direct debit and direct credit payments), CHAPS (for real-time gross settlement payments), Faster Payments (for low value spontaneous electronic and telephone banking payments), Cheque and Credit Clearing Company (for cheque and credit payments), the card networks (Visa and Mastercard) and LINK the UK's main network of cash machines.

3.11 For a new bank to provide the payment services that customers are expecting, it first has to set up its own (decentralised) payment system.<sup>21</sup> Once a bank has designed its system, it must have access to the centralised payment systems. It can do so either directly, by becoming a settlement member of the relevant scheme, or indirectly, by

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<sup>21</sup> The term 'decentralised' system refers to a bank's own infrastructure developed to provide payment services, as opposed to the 'centralised' system, which refers to a clearing scheme (a system that centralises multi-lateral transmission orders).

establishing an agency relationship with a settlement member (the agency bank). It is this part of establishing a bank that will be the focus.

- 3.12 The Cruickshank report raised concerns about the payment systems in the UK. The report uncovered 'profound competition problems and inefficiencies in the market for money transmission services' and noted that many of these 'can be traced back to the structure of the UK payment systems market which consists of a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers.'<sup>22</sup> This led to the establishment of the Payment System Task Force, later followed by the creation of the Payments Council, and has led to some improvements to the access and governance arrangements for the UK clearing schemes.<sup>23</sup>
- 3.13 The SME report considered whether agency agreements put the banks that use them at a disadvantage in terms of price, quality or service. It found that difficulty in changing agency arrangements was likely to reinforce the scope for clearing banks to charge for agency agreements in excess of costs. However, the CC concluded that this 'would not, however, affect the ability to compete of those existing clearing banks with limited SME banking activities, which we have identified as the most likely source of new competition, and hence in our view does not constitute a barrier to expansion by such firms.'<sup>24</sup>

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<sup>22</sup> See HM Treasury, 'Competition in UK Banking: A Report to the Chancellor of the Exchequer', March 2000, paragraph 36.

<sup>23</sup> See OFT1071, 'Review of the operations of the Payments Council: A follow-up to the work of the Payment Systems Task Force', March 2009. Available at: [www.offt.gov.uk/shared\\_offt/reports/financial\\_products/oft1071.pdf](http://www.offt.gov.uk/shared_offt/reports/financial_products/oft1071.pdf). The review found that the payments industry has benefitted from more strategic direction and from greater openness and accountability. The review also found other areas where improvement could occur and provided five specific recommendations for immediate improvement to the Payments Council as well as two recommendations to improve the performance of the Payments Council through a clear evaluation process. Details are contained within the report.

<sup>24</sup> See Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', March 2002, paragraph 2.234.



- 3.14 The PCA market study identified access to payment networks and access to appropriate infrastructure to process payments as a potential barrier to entry and expansion. However the market study noted that while 'one bank expressed concern about the difficulty of processing payments and becoming part of the payment network... we have seen no evidence that this significantly impedes competition' and concluded that 'difficulties in accessing appropriate infrastructure to process payments can be overcome especially if the new entrant already provides similar services in other markets.'<sup>25</sup>
- 3.15 Access to certain payment systems is subject to the Payment Services Regulations 2009 (PSRs).<sup>26</sup> Part 8 of the PSRs provides powers to the OFT to examine rules on access to a payment system and take action to ensure a level playing field for access, if required. To date the OFT has not taken any action in relation to access to payment systems under the PSRs.<sup>27</sup>
- 3.16 The reliance on centralised networks may also prevent or inhibit new entrants seeking competitive advantage through offering better payment services than those already available in the market.
- 3.17 The OFT will consider whether any new concerns have arisen as a result of the financial crisis. The OFT will also consider the experience of any

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<sup>25</sup> See OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraphs 3.35 and 3.38.

<sup>26</sup> The PSRs originate from a European Community law, the Payment Services Directive (Directive 2007/64/EC) (PSD).

<sup>27</sup> Part 8 of the PSRs governs rules to access a payment system by authorised Payment Institutions (PIs) and small PIs. Rules that prevent, restrict or inhibit access are only allowed insofar as they are necessary to protect the system against specific risks, or to protect the financial and operational stability of the system and can be applied in a way that is objective, proportionate and non-discriminatory. The OFT is the competent authority responsible for enforcing Part 8 of the PSRs. If the OFT finds that a rule or condition breaches the Part 8 access requirements, it can impose a fine of an amount it considers appropriate on such person (or persons) as it considers appropriate. It may also give such directions as it considers appropriate to such person or persons as it considers appropriate. The directions can require the person to change any rule or condition so that it no longer contravenes the law, and can relate to the conduct of a person in implementing any rule or condition.

recent entrants and whether the conclusions from previous work is confirmed by their experiences.

3.18 The OFT would welcome evidence on the following questions.

**Question 5:** Are there any ways in which payment systems operate which you consider restrict entry or expansion in the provision of banking services?

**Question 6:** Do different settlement members compete to provide indirect access to smaller banks and if so, to what extent does this act as a protection from higher prices and/or lower service quality levels?

#### **Access to risk information**

3.19 The Cruickshank report found that 'competition could also be sharpened by making more information about SMEs available to potential suppliers. This would help to reduce entry barriers into banking markets by making it easier for new entrants to construct credit scoring models'.<sup>28</sup>

3.20 The SME report found that access to relevant skills including credit assessment was a barrier to entry. It also found 'What is missing, however, is financial information on individual smaller SMEs that do not file accounts. This is currently immediately available only to their clearing bank, in the form of bank statements, repayment of loans etc. This is a material handicap in new entrants' attempts to market their services in a targeted way to individual customers or therefore to build up market share quickly'.<sup>29</sup>

3.21 The PCA market study considered whether access to information regarding customer risk could form a barrier to entry and expansion. The report found that both new entrants and established players used credit scorings from third party providers. The report agreed with the NI

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<sup>28</sup> See HM Treasury, 'Competition in UK Banking: A Report to the Chancellor of the Exchequer', March 2000, paragraph 55.

<sup>29</sup> Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', March 2002, Paragraph 2.206.

banking report<sup>30</sup> that there was no evidence of this being a particularly complex or expensive process. The Home Credit market investigation considered similar issues: 'few home credit lenders share repayment information with each other, either directly or via CRAs [credit reference agencies]. This increases the extent to which new entrants face the risk of adverse selection and the magnitude of the advantages enjoyed by established lenders. We were told by the Managing Director of Park that the costs of entry would have been much lower if home credit lenders shared repayment information.'<sup>31</sup> This led to a remedy requiring the sharing of information on payment records of customers.

3.22 The OFT would welcome evidence on the following questions.

**Question 7:** Does access to financial risk information for the provision of personal banking services remain an unimportant barrier to entry or expansion?

**Question 8:** Are there strong information asymmetries in relation to SMEs that make it difficult for a business to enter or expand in the provision of SME banking?

**Question 9:** To what extent have third party providers of credit risk information arisen in SME banking similar to the role played by Experian and Equifax in personal banking?

### **Barriers to achieving scale**

3.23 Expansion by new entrants in the provision of banking services in order to achieve economies of scale or scope may be important if they face high fixed costs of IT development, developing branch networks and call

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<sup>30</sup> Competition Commission, 'Personal current account banking services in Northern Ireland market investigation', May 2007.

<sup>31</sup> Competition Commission, 'Home credit market investigation', November 2006, Paragraphs 26 and 5.30. Available at: [www.competition-commission.org.uk/rep/pub/reports/2006/517homecredit.htm](http://www.competition-commission.org.uk/rep/pub/reports/2006/517homecredit.htm)

centres. The ability of a new entrant to achieve scale will also be important in the amount of competitive pressure it can exert.<sup>32</sup>

### **Customer inertia and cost of acquiring personal banking customers**

- 3.24 The PCA market study identified customer inertia as a significant barrier to entry and expansion.<sup>33</sup> The study noted that the slow growth of the market (around 4 to 5 per cent a year since 2000<sup>34</sup>) and low levels of switching were making it difficult for smaller banks to build a significant customer base. Switching rates for PCAs were found to be lower than for other products such as mortgages.<sup>35</sup>
- 3.25 The market study identified a number of reasons why switching rates may be low for PCAs. Consumers find it relatively hard to compare the costs of accounts, and thus the potential benefits of switching are hard to assess. In addition there was a perception amongst consumers that switching was both complex and risky, with some real risk of the switching process going wrong. It also found that when the switching process does go wrong consumers can find themselves bearing a significant proportion of the resulting costs.<sup>36</sup> Combined, these factors create consumer inertia which can make it difficult to acquire a significant customer base.

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<sup>32</sup> See, OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraph 3.2, ' These barriers include low levels of consumer switching which increases the importance of establishing a wide branch network and the importance of an established brand name. Together these have constrained the ability of challenger banks to expand quickly; and low consumer switching in particular appears to have reduced incentives to compete'.

<sup>33</sup> See, OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraph 3.52.

<sup>34</sup> As measured by either net new accounts (opened minus closed PCAs) in 2006, or the average increase in the total number of accounts from 2000 to 2006.

<sup>35</sup> The PCA report found over the previous five years 13 per cent of consumers had switched PCA whilst 20 per cent had switched savings account and 38 per cent had switched mortgage.

<sup>36</sup> Similar findings emerged from the NI banking report, See, OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraphs 5.48 and 5.49. For the perceived benefits of switching see paragraph 5.28.

3.26 In October 2009<sup>37</sup> the OFT announced a range of initiatives agreed with the industry and Bacs (the payments processor) to improve the process of switching bank accounts and to increase consumers' confidence in the process. This review will not be reopening how these issues have been addressed.<sup>38</sup>

3.27 The OFT is also currently conducting work on a super-complaint from Consumer Focus concerning cash ISAs (Individual Savings Accounts). This includes work on switching that may be relevant to this review.<sup>39</sup>

3.28 The OFT would welcome evidence on the following questions.

**Question 10:** How significant are the issues associated with building up and expanding a customer base to achieve a viable scale in personal banking?

**Question 11:** To what extent are issues on customer inertia in personal banking aggravated or alleviated by the range of products offered by either the entrants or incumbents?

**Question 12:** Are there ways of overcoming customer inertia which may lower the barriers to entry and expansion these represent?

### **Customer inertia and cost of acquiring SME customers**

3.29 Acquiring customers was identified within the SME report as a significant barrier to entry and expansion. The key factors identified were the ability to negotiate to dissuade SMEs from switching providers, difficulties in price comparison, the pressure to offer free banking to start-ups when this comprises the majority of SME customers of new entrants, perceived difficulties and time taken to switch and the importance of having a reputation for providing the required quality of service. The report also found that most new business came from

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<sup>37</sup> OFT1123, 'Personal current accounts in the UK: A follow up report', October 2009.

<sup>38</sup> As announced in March 2010, the OFT is continuing to actively monitor the PCA market, and this includes tracking developments and trends around switching.

<sup>39</sup> Further information concerning the Cash ISA super-complaint is available here: [www.of.gov.uk/OFTwork/markets-work/super-complaints/cashISAs/#](http://www.of.gov.uk/OFTwork/markets-work/super-complaints/cashISAs/#)

existing personal customers or recommendations from other SMEs and intermediaries in which the main players have a marked advantage.<sup>40</sup>

3.30 Behavioural undertakings were put in place to address these concerns including some transitional price controls. The OFT's review of the transitional undertakings in 2007 also considered the overall impact of the behavioural undertakings on competition more generally. It noted that several smaller banks had increased their market share in SME banking. The OFT found that competition had increased but noted that concerns remained including:

- no significant increase in switching since 2002<sup>41</sup>
- difficulty for SMEs in comparing offers between banks, and
- lack of confidence in the switching process by some SMEs.

3.31 The OFT's review of the transitional undertakings in 2007 found that 'retaining the price restrictions on the four main banks could distort competition by...limiting the opportunities for entry to and expansion in the market by smaller players'.<sup>42</sup> The price controls were subsequently lifted.<sup>43</sup>

3.32 Since 2007 the impact of the credit squeeze has been particularly pronounced on SMEs. This has led to Government initiatives to alleviate

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<sup>40</sup> For further details and a full list of the concerns raised see, Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', 2002.

<sup>41</sup> See OFT937, 'SME Banking: Review of the undertakings by banks following the 2002 Competition Commission report', August 2007. The review found estimates of switching rates for SME banking services in the range of 2 to 4.6 per cent a year. The review found that in 2006 13 per cent of customers had switched in the last three years in comparison with 12 per cent in 2000.

<sup>42</sup> See OFT937, 'SME Banking: Review of the undertakings by banks following the 2002 Competition Commission report', August 2007, paragraph 1.8.

<sup>43</sup> See Competition Commission News Release, 'CC lifts SME bank price controls but keeps other measures', 21 December 2007. Available at: [www.competition-commission.org.uk/press\\_rel/2007/dec/pdf/68-07.pdf](http://www.competition-commission.org.uk/press_rel/2007/dec/pdf/68-07.pdf)

problems in accessing credit that SMEs have faced.<sup>44</sup> SMEs dissatisfied with their current banks should provide opportunities for existing players to expand or new entrants to capture customers.

3.33 The OFT would welcome evidence on the following questions in relation to SME banking.

**Question 13:** What are the challenges in acquiring SME customers for a newly established bank or a smaller bank seeking to expand?

**Question 14:** To what extent, and how, might any difficulties in acquiring SME customers be overcome?

**Question 15:** Has the financial crisis led to reduced confidence in the viability of smaller institutions such that potential entrants into SME banking will find it more difficult to enter and small banks to expand?

**Question 16:** Have levels of switching between banks by SMEs increased since 2007?

### **Brand**

3.34 The PCA market study and the SME report identified developing a successful brand as a barrier to entry. Both consumers and SMEs need confidence that their money is in safe hands. The PCA market study found that the vast majority of customers were reluctant to leave an existing bank that they trusted for one that they did not know.<sup>45</sup> The SME report found 'new entrants need therefore to establish a reputation for providing the required quality of service, and for being supportive of SMEs in provision of overdrafts and loans... a reputation for supporting SMEs can only be developed from providing services to SMEs. For a new entrant, even one already established in other financial services, or in

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<sup>44</sup> For example see Box 4.2 of HM Treasury, 'Economic and Fiscal Strategy Report and Financial Statement and Budget Report', April 2009. Available at:

[http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/bud\\_bud09\\_index.htm](http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/bud_bud09_index.htm)

<sup>45</sup> In a survey conducted for the PCA market study, 83 per cent of consumers said that they were reluctant to leave an existing bank they trust for one they did not know. See OFT1005, 'Personal current accounts in the UK: An OFT market study', July 2008, paragraph 3.45.

particular niches of SME banking services, it may well take a long time to establish such a reputation'.<sup>46</sup>

3.35 The financial crisis may well have impacted on the brand and reputation of the established banks in both personal and SME banking. This may create opportunities for new entry but it may also hinder entry where a bank does not have some form of brand or reputation. If the government's financial services compensation scheme is trusted, this may not be significant. In part this may depend on consumers' views on the speed of the compensation process.

3.36 The OFT would welcome evidence on the following questions.

**Question 17:** How significant are the costs of developing and marketing a new brand for retail banking in personal and SME banking?

**Question 18:** How has the financial crisis affected trust in banks in general and incumbent banks in particular? How does this affect the ability of new entrants to join the market or smaller providers to expand in retail banking?

**Question 19:** Does the risk of damaging an existing brand that is strong outside of banking represent a deterrent to entry?

### **Branch networks**

3.37 The PCA market study, NI banking report and the SME report all identified the need to operate branch networks as a significant barrier to entry and expansion. The costs associated with establishing a branch network have been found to be substantial and at least some of these costs are sunk.<sup>47</sup> This can make it difficult to recoup the cost of investment especially when combined with slow and expensive customer acquisition.

3.38 The 2007 review of the SME banking undertakings noted that within this sector new technology is playing an increasingly important role. It found

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<sup>46</sup> See, Competition Commission, 'The supply of banking services by clearing banks to small and medium-sized enterprises', 2002, paragraph 2.216.

<sup>47</sup> A sunk cost cannot be recovered upon exit from the market.



that in parts of the market the increasing proportion of customers using internet technology has reduced the importance of branch access to servicing customers.<sup>48</sup>

3.39 The OFT intends to examine whether the importance of branch networks has changed over the last few years (for example due to increased use of the internet and mobile banking). The OFT also intends to examine whether the opportunities for establishing and expanding branch networks has changed since the financial crisis.

3.40 The OFT would welcome evidence on the following questions.

**Question 20:** Are there regional differences in the ability for new entrant to establish, and small banks to expand, their branch networks?

**Question 21:** Has the need for a physical high-street presence in order to enter the retail banking market reduced and, if so, why?

**Question 22:** Does the prospective divestment of branch networks by RBS and Lloyds significantly change the barriers to entry or expansion?

### **Barriers to exit**

3.41 Regulation and supervision of financial firms have proved to be necessary to prevent disorderly bankruptcy, and to protect financial stability. In addition, the Banking Act 2009 has established a permanent Special Resolution Regime (SRR) which provides the tools to deal with banks and building societies in financial difficulties.<sup>49</sup> The SRR's purpose

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<sup>48</sup> See OFT937, 'SME Banking: Review of the undertakings by banks following the 2002 Competition Commission report', August 2007, paragraph 1.5 and paragraphs 4.105 to 4.110. The report found that internet banking had doubled over the four years previous to the study.

<sup>49</sup> These include powers for the Bank of England to:

- transfer all or part of a bank's shares or business to a private sector purchaser
- transfer all or part of a bank's business to a bridge bank - a subsidiary of the Bank of England – pending a future sale to the private sector
- place a bank into temporary public ownership (the Treasury's decision), and
- apply to put a bank into the Bank Insolvency Procedure (BIP) which is designed to allow for rapid payments to depositors who are eligible claimants under the Financial Services Compensation Scheme (FSCS) and apply for the use of the Bank

is to strengthen the framework for financial stability and depositor protection.

- 3.42 The SRR is intended to prevent disorderly failure, which would create systemic risk, and contributes towards an important policy objective of maintaining financial stability. This aims to ensure a robust financial infrastructure with protection for depositors leading to trust and confidence in banks. The SRR allows for government to take control of the assets and liabilities and sell them in whole or part whilst providing safeguards (including the possibility of compensation) for their former owners. This can help protect competition, given that disorderly failure by one bank could lead to other bank failures and reduce the number of competitors in an already concentrated market.<sup>50</sup> Such failures can also reduce trust in banks and this may impact on customer confidence in switching between banks.
- 3.43 However, protection and support for failing institutions may have detrimental effects on markets. It may allow the rescue of inefficient firms, preventing their replacement by more efficient institutions, which may in turn have less incentive to compete and to innovate. The need for speedy transfer of assets and liabilities of failing banks may favour incumbents who may be best placed to raise finance at short notice and will already meet regulatory requirements.
- 3.44 We intend to focus on the way in which regulation and supervision of failing financial firms impacts upon entry of new firms and expansion of existing ones and whether there are ways in which these regulations could be made more competition friendly.
- 3.45 The OFT would welcome evidence on the following questions.

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Administration.Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration.

<sup>50</sup> Banking is unlike most other industries where failure of poorly performing firms is likely to benefit competition through providing opportunity for more efficient firms, or firms better able to cater for customer needs, to expand.

**Question 23:** Does the operation of the Special Resolution Regime as it currently stands favour large incumbents as potential bidders for assets being sold under the Regime?

**Question 24:** Are there any other significant barriers to exit in retail banking?

## 4 PROCESS AND TIMETABLE OF THE REVIEW

4.1 This section sets out the process of the review, our timescales and the submission of evidence to the review.

### Process

4.2 This document initiates the review of barriers to entry, expansion and exit in banking in the UK. It sets out the initial questions we shall be addressing and provides the opportunity for all interested parties to submit evidence to the review.

4.3 During the course of the review we shall also be sending specific information requests to various parties as well as holding meetings and testing the evidence we receive.

4.4 The OFT intends to publish the findings of the study in the autumn.

### Responding to the Call for Evidence

4.5 We welcome relevant submissions on this review. Responses which contain evidence to support the points being made are the most helpful.

4.6 Submissions should be sent to:

Barriers to Entry in Banking Review Team  
4th Floor  
Fleetbank House  
2-6 Salisbury Square  
London EC4Y 8JX

4.7 Alternatively they can be emailed to: [b2ebanking@oft.gsi.gov.uk](mailto:b2ebanking@oft.gsi.gov.uk)

4.8 **The OFT ask for submissions to be sent by Thursday 8 July 2010.**

4.9 If submissions include data or financial figures, if possible please provide any definitions, as well as the dates and source of the data. If submissions include comparators, if possible please provide the reasons why you consider the comparator to be appropriate. If you are willing to answer questions further to your submission, please indicate a named point of contact and contact details including telephone number.

- 4.10 Please note that we may choose to refer to comments received in response to this call for evidence in our published findings. In deciding whether to do so, we will (among other considerations) have regard to the need for excluding from publication, so far as that is practicable, any information relating to the private affairs of an individual or any commercial information relating to a business which, if published, would or might, in our opinion, significantly harm the individual's interests or, as the case may be, the legitimate business interests of that business ('confidential information').
- 4.11 If you consider that your response contains such information, that information should be marked '**confidential information**' and an explanation given as to why you consider it is confidential.
- 4.12 The OFT must reserve the right to disclose any information provided by you (including confidential information) for the purposes set out in sections 170 and 240 – 243 of the Enterprise Act 2002, where it considers such disclosure to be appropriate. In particular, the OFT may choose to put information provided by you to third parties, such as other government departments and other parties providing information to the OFT, for the purpose of facilitating this examination of barriers to entry, expansion and exit in banking. If the OFT later chose to carry out further work in this area, disclosure under sections 170 and 240-243 of the Enterprise Act 2002 could also include, for example, disclosure for purposes related to the OFT's functions under Part 8 of the Payment Services Regulations 2009. Prior to any such disclosure, the OFT would have regard to (among other considerations) the need for excluding, so far as that is practicable, any confidential information.
- 4.13 The OFT is also bound by the Freedom of Information Act 2000 (the 'FoIA'). Where a person makes a request in accordance with the FoIA the OFT may have to disclose whether it holds the information sought and the information itself (including confidential information). The FoIA contains exemptions (including one which may exempt confidential information) and the OFT will not have to make those disclosures if an exemption applies. If you consider that any information you provide may be exempt from such disclosures you should say so and explain why.

4.14 Similarly, to the extent that information you provide constitutes personal data under the Data Protection Act 1998, the OFT will process such data in accordance with that Act.

## **ANNEX: QUESTIONS RAISED IN THIS DOCUMENT**

**Question 1:** Do you agree with the proposed scope laid out in paragraphs 2.2 to 2.10 for the purposes of reviewing barriers to entry, expansion and exit in banking within the UK?

**Question 2:** Do these themes capture the most important elements of barriers to entry, expansion and exit?

**Question 3:** How does the licensing process for deposit taking activities and the capital and liquidity requirements affect the ability of firms to enter into the provision of banking services or expand their provision of banking services?

**Question 4:** To what extent do any other regulations, such as anti-money laundering rules and consumer credit licensing requirements, form significant barriers to entry or expansion? Are there any more subtle sources of regulatory requirements which nonetheless form a significant barrier to entry or expansion?

**Question 5:** Are there any ways in which payment systems operate which you consider restrict entry or expansion in the provision of banking services?

**Question 6:** Do different settlement members compete to provide indirect access to smaller banks and if so, to what extent does this act as a protection from higher prices and/or lower service quality levels?

**Question 7:** Does access to financial risk information for the provision of personal banking services remain an unimportant barrier to entry or expansion?

**Question 8:** Are there strong information asymmetries in relation to SMEs that make it difficult for a business to enter or expand in the provision of SME banking?

**Question 9:** To what extent have third party providers of credit risk information arisen in SME banking similar to the role played by Experian and Equifax in personal banking?

**Question 10:** How significant are the issues associated with building up and expanding a customer base to achieve a viable scale in personal banking?

**Question 11:** To what extent are issues on customer inertia in personal banking aggravated or alleviated by the range of products offered by either the entrants or incumbents?

**Question 12:** Are there ways of overcoming customer inertia which may lower the barriers to entry and expansion these represent?

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