

## **Competition in UK Banking**

John Fingleton  
Chief Executive, Office of Fair Trading

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### **Introduction**

First of all, I would like to thank the organisers for the opportunity to speak at this seminar.

Banking is hugely important to the functioning of our economy. By connecting borrowers and savers, managing financial risk and providing mechanisms for storing and transferring value, banks play a key role in generating growth. Banks provide the fundamental infrastructure for making transactions without which other markets simply cannot work. As a large sector, banking makes a substantial contribution to the economy, but it can generate significant consumer detriment when things go wrong.

For too long, competition in the banking sector has not functioned well. The Cruickshank report on 'Competition in UK banking' in 2000 highlighted concerns about a lack of effective competition. Since then, there have been interventions by competition authorities, consumer bodies, regulators and the Government. Even where these have had positive effects, progress has been too slow and incremental, and fundamental concerns remain about the competitive structure and performance of these markets.

These are longstanding issues, not just issues arising from the financial crisis, although the financial crisis has undoubtedly worsened the situation, with concentration increasing across most banking markets.

At the heart of the concerns about these markets is a lack of 'customer focus' on the part of providers. The longstanding lack of competition has made it difficult for those banks who do offer a better deal to increase their market share. New entrants face a particular challenge if there are limited rewards from innovating. While there has been stronger competition for certain types of consumer, across the market as a whole there has been little incentive for innovation, efficiency, or consumer focus. The 'virtuous circle' of well informed consumers driving competitive businesses to deliver what consumers want simply isn't working well enough.

### **The current state of banking**

The Cruickshank report on 'Competition in UK Banking' in 2000 found that banks were making substantial excess profits from their personal and SME customers. The report identified a number of problems with banking markets, in particular that:

- the market was highly concentrated, especially for SME banking
- there was a lack of information provided to personal customers and SMEs, and customers perceived significant barriers to switching current accounts, and
- the banks were effectively in control of the money transmission service, resulting in barriers to entry, poor service levels, high charges and a lack of innovation.

Following the Cruickshank report banking markets have faced increasing scrutiny. Many investigations focused on particular aspects of banking, such as personal current accounts (PCAs), SME banking and Cash ISAs. Others, such as the Independent Commission on Banking (ICB) and the recent Treasury Select Committee (TSC) report, have been more broad-ranging. The European Commission also conducted a sector inquiry into retail banking in 2007.

The various interventions have achieved a number of important changes. But progress in key areas has been slow. Moreover, and as highlighted by the OFT, TSC and ICB, many of the problems highlighted by Cruickshank remain. And, in OFT's work on various banking markets, we have tended to find the same sets of problems arising time and again.

There are three key features that I would draw out as common themes from this work:

- concentrated markets where new entry is difficult and challengers find it hard to expand their market shares
- complex and opaque pricing and low levels of switching, and
- payment systems that are under the control of the banks and lack innovation.

On concentration, most banking markets experienced little change between 2000 and the financial crisis. They saw very sharp rises in concentration levels between 2008 and 2009.

Take for example the PCA market. In 2001, the Competition Commission (CC) inquiry on the Lloyds/Abbey merger found that the big four banks had a strong and entrenched position in the market. The OFT's market study in 2008 found that overall the relative market shares of the 'established' four and the 'challenger' banks were almost unchanged between 1999 and 2007, although HBOS's position had strengthened. The merger between Lloyds and HBOS in 2008 led to this key 'challenger' bank being acquired by the market leader. The OFT had two key concerns about the merger. The first was about the loss of HBOS which had been a major driver of competition in the market. The second was that Lloyds' greater share of the market would encourage it to focus on increasing margins from existing customers rather than acquiring new customers. As slide 2 shows, the Lloyds-HBOS merger increased concentration in an already highly concentrated and non-dynamic market.

On switching, annual switching rates are very low in the PCA market. They are only slightly higher for SME banking and savings accounts. Historically they have been much higher for mortgages and credit cards, although there has been a substantial fall in mortgage switching post 2008.

Looking in particular at PCAs again, the CC's Northern Ireland Banking investigation and the OFT's market study found real and perceived problems with the switching process. These concerns led the OFT to agree steps to improve the performance of the switching process, in particular to reduce the problems arising from misplaced direct debits. The ICB's recommendation for a redirection service, which will ensure all transactions are automatically directed to the correct account, could deliver another big step forward here.

It is also noteworthy that the OFT found further evidence of poor switching arrangements when it looked at the cash ISA market in 2010.

It is not enough to make it easy to switch. Customers also need the right prompts to exercise their choice of provider. In banking markets consumers frequently face difficulties in understanding the true cost of running their account and comparing deals from alternative providers. Often their attention is not focused on the areas where banks earn their revenues. Again, this is particularly true in the PCA market. The OFT's market study found that consumers paid little attention to unarranged overdraft charges and forgone interest despite the fact that these make up the vast bulk of banks' revenues.

The OFT's work led to industry initiatives to improve transparency in the market through annual summaries, improved information on monthly statements and charging scenarios. Despite the disappointing Supreme Court judgment on unarranged overdraft charges, this work has made a difference. As Slide 4 indicates, there have been significant reductions in charges and new control mechanisms for customers, such as text message alerts, have been introduced. But, as already noted, large banks can continue to focus on earning revenues from existing customers rather than providing attractive offers to new active customers.

Some of the concerns about payment systems highlighted in the Cruickshank report also remain. Payments systems are still under the control of banks. Although it has recently reversed its position, the Payments Council's decision to abolish cheques raises questions about the extent to which consumers' views are adequately reflected in the

governance of the system. There are also questions about the pace of innovation when it is organised collectively, reflected for example in the time it took to introduce Faster Payments. Some questions have also been raised about whether access to payment systems creates a barriers to entry, although both the OFT and the ICB found limited evidence to support this view. It is certainly right that we ask ourselves whether our frameworks for regulating and overseeing payments are appropriate for future technology, such as mobile payments.

### **Where do we go from here?**

More than a decade on from the Cruickshank report, we still have a banking sector where competition is manifestly not working well for consumers. This is not just the OFT's view – the ICB and the TSC also reached the same conclusion.

We are potentially at a turning point. There are two important sources of potential pressure for a more meaningful response to these persistent issues. These come from opportunities for new competition in retail banking and from a new approach to regulation.

In terms of new competition, we have already seen the entry of Metro Bank and of Virgin Money through the acquisition of Northern Rock. And the Lloyds Banking Group divestments are intended to create an effective 'challenger' bank. Tesco also looks set to enter the market, although it has recently announced a delay to its plans. More fundamentally, new technology may provide scope for increased competition from outside the traditional banking model, for example from mobile and on-line payments or other technological innovation.

As already highlighted, these new competitors face real challenges to being successful. The biggest barrier to entry and expansion is likely consumer inertia, particularly in the crucial current account market. On the one hand, the automatic redirection service should mark a significant step forward in reducing problems from personal current account and business current account switching. And there may be more that can be done to promote transparency. For example downloadable transaction histories may enable more personalised comparisons and information on interest forgone may become more important as interest rates increase.

However, customers themselves will also need to be more engaged with their banking services. And it may be difficult for entrants to attract customers from their existing provider if those customers perceive that their banking is free, or to use a different charging model when the 'free if in credit' model prevails across the sector.

It is also important that regulatory processes do not act as a barrier to entry. We have committed to working with the PRA to review the application of prudential requirements, to ensure that new entrants and smaller banks are not disproportionately affected, for example, by requirements to hold proportionally more capital than incumbents. Competition from outside the traditional banking model may also create challenges for the process of granting authorisation. It is important that regulators do not unduly constrain competition by taking the business model of incumbent and traditional banks as the starting point for the design of new rules in ways that could disadvantage new technologies and innovative providers.

On the theme of regulation, the second key potential source of change in the banking sector is the creation of the Financial Conduct Authority (FCA), with a different approach to the regulation of firms' conduct. We have argued strongly (as did the ICB) that it is critical for the FCA to have a top line objective to promote competition, expressed in terms of using its powers to make markets work well for consumers. It is important to ensure that the regulation of financial markets does not create rules that inhibit static or dynamic competition, and that the new FCA does not see incumbency protection or weaker rivalry as way to achieve financial stability. Competition and financial stability are perfectly consistent, providing there is proper regulation to tackle excessive risk taking. We welcome the Government's decision to give the FCA a clear remit to place effective competition at the heart of its regulatory approach, so that it regards competition as a key mechanism for achieving effective outcomes for consumers.

We welcome also the decision not to grant the FCA powers to make market investigation references to the CC in respect of financial services. As I argued in my evidence to the TSC's inquiry, such a step would have created unnecessary duplication and fragmentation, weakening the ability of the competition regime to tackle structural competition problems, and

to provide an independent bulwark against the tendency for regulation to create barriers to effective competition.

In a recent speech, Martin Wheatley talked about shifting away from the FSA's approach of talking to management and looking at systems and controls, to a new approach where the FCA will go further, to see what the customer experience is like in reality, with a greater emphasis by firms on improving the way they design and sell products.

We welcome these indications of the approach that the FCA will take to regulation and supervision. Many of the issues that competition authorities have been grappling with stem from a lack of 'customer focus' on the part of providers. Putting the customer experience at the heart of regulation, and taking account of the benefits of dynamic market change through competition, gives an opportunity for the FCA use its rule-making powers to tackle the longstanding problems in the market.

Take for example the issue of PCA pricing. While the OFT has made some progress in tackling unarranged overdraft charges, we still have concerns that charges are not adequately disciplined by competitive pressure from other providers or by the decisions consumers make about how they use their current PCAs. More generally, there are real questions about the 'free if in credit' charging model. On the one hand, there are arguments that it is not fair to customers as a whole and can dampen competition and incentives for efficiency. On the other hand, it is not yet clear that the market is sufficiently dynamic to constrain prices if alternative forms of charging, such as monthly fees, are used. Equally, attention has been drawn to the cross-subsidy between inert and active consumers, and the ability of banks to price products selectively, and the consequences this may have for competition. A regulatory focus on business models and product design, with the emphasis on consumer experience, could lead to fundamental change. It is important that these opportunities are grasped.

The OFT will also continue to take an active interest in the market. We have a great deal of experience of the banking sector to contribute. Our broader competition and consumer remit can bring a different perspective, for example bringing insights from our work in other sectors. We see a continued role for a specialist competition authority working alongside a

regulator that has competition and consumer protection more clearly built into its DNA.

We intend to build on our previous work on banking to achieve further change. We have already indicated that we will conduct a review of the PCA market in 2012, which we will undertake in the second half of this year so we can consider the implementation of the final stages of the transparency initiatives. We will also consider options for other work where these fit with our priorities.

We will also work with the FCA, sharing our competition expertise and learning from its experience, for example through secondments and, where the opportunity arises, joint projects. And we will act as a constructive challenger, identifying areas where we see a risk that regulation may act as a barrier, rather than a driver, of effective competition.

So, new competition and a new approach to regulation could lead to a new direction in banking. This means change on the part of providers. Competition and regulation need to be spurs for a more 'customer focused' approach from banks.

For too long banks have needed pressure, often sustained, from regulators and enforcers to introduce things they should already have been doing. It shouldn't need a super-complaint for banks to provide clear information to consumers on obvious areas such as the interest rate paid on their saving account or the charges they pay when using their cards abroad.

If we do not see real change from banks, then a more radical approach needs to be considered. We cannot just continue working with business on incremental change if this does not deliver results. The ICB recommended that a market investigation reference (MIR) to the CC should be actively considered if the market has not changed by 2015, and if the OFT has not already made an MIR following our proposed review in 2012. The CC can take a detailed and fresh look at a market, and has a range of behavioural and structural remedies at its disposal, up to and including requiring the break-up of incumbents, as it did in its airports inquiry.

There are two key criteria that the OFT would need to consider and that must be met for an MIR to be made. Firstly, there must be reasonable grounds to suspect that 'features' of the market prevent, restrict or distort competition. Longstanding issues of concentrated markets, low levels of switching and transparency and lack of innovation typically point towards such features. Indeed the ICB considered that that its report provided evidence of features of both the Personal and Business Current Account markets that prevent, restrict or distort competition. Secondly, it needs to be appropriate for OFT to exercise its discretion to make a reference, taking into account the likelihood that features will persist and action by other regulators.

I said earlier that we are potentially at a turning point. Changes are taking place aimed at increasing switching and reducing entry barriers, combined with State Aid divestments and new entry and a new approach to regulation by the FCA. Banks need to anticipate these changes rather than be dragged along reactively, and the FCA needs to support and encourage this, if necessary with rules that prevent a race to the bottom.

A step change is needed in the banking sector. Going forward we need to see evidence which demonstrates that the market dynamics of entry and switching are sufficient to drive stronger customer-focused competition. Without this the obvious question is whether the concentrated market structure of UK banking is the problem. And one way to consider this question is a reference to the CC.