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Treasury Committee

Competition and choice in retail banking

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Volume III

Additional written evidence

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List of additional written evidence

(published in Volume III on the Committee's website www.parliament.uk/treascom)

Written evidence

Written evidence submitted by the Campaign for Community Banking Services (CCBS)

Executive Summary

Branch dependent individuals and small businesses in over 1000 urban and rural communities effectively have no choice of banking provider and as the banks and building societies continue to close branches this number is expected to increase because of the post crisis pressure on profits and further consolidation within the industry. New entrants face a big challenge in not having access to a national, neutral branch network.

Against a historic background of active resistance by the industry, the committee is urged to recommend the re-launch of an improved and re-priced inter bank agency service, a trial of neutral shared branching, recognition by the competition authorities of local markets as well as a national market for retail banking services and to press for a UK version of the US Community Reinvestment Act, inter alia, to protect delivery of banking services to local communities.

Introduction

The Campaign for Community Banking Services (CCBS) is a coalition of 22 national charities and membership organisations who share concerns about the decline in local access to, and choice in, banking services, in particular the closure of local bank branches: see attached statistics. We assist local communities in campaigning against closures and promote viable alternatives including neutral shared branching and inter bank agency arrangements.

Concerns

1. CCBS' primary concern is with those communities, urban and rural, which lose all their bank branches—nearly 1,000 have done so—and the adverse impact this has on community commercial sustainability.

2. However, for branch dependent bank customers, the 1,050 communities with only one bank branch effectively have no choice of bank unless they are prepared to lose time and incur cost in banking elsewhere. The 500 communities with only two banks remaining offer limited competitive choice.

3. According to 2007 research by the Federation of Small Businesses, 60% of small businesses visit their bank branch at least once a week and 10% do so every day.

4. CCBS has been told by one of the major banks that SMEs account for over 30% of their counter traffic which would seem to reflect the need pattern identified above.

5. Although small businesses are the primary concern, similar limitations of choice apply to many vulnerable individuals, particularly those without convenient local access to free ATMs, cashback, on-line banking, post office access, etc. In that category would be numbers of the elderly, disabled people, those with mobility problems and full time carers.

Branch Closures

1. The latest available national statistics on bank branch closures is contained in the CCBS annual *Branch Network Reduction Report***.** That for 2010 is attached and is also available on the CCBS website.

2. The situation is worsening as the dominant retail banks: RBS/NatWest, Barclays, Lloyds TSB and HSBC, who are responsible for 95% of bank presence in communities with only one or two banks, address their post crisis cost base in the light of growing use of technology by some sectors and seek to reduce costs by closing branches and/or reducing hours of availability.in communities perceived to have low sales opportunity.

3. As shown in the attached report, all four major banks have a history of closing branches. Currently the most active is HSBC which has closed 111 branches since 1 January 2009 and continues its attack on communities where it is the last bank or will leave another in that situation. NatWest has closed few recently but has reduced hours of opening (often a prelude to closure) in 80 communities over the same period. Lloyds formally abandoned in 2006 its pledge to remain open where "last bank" and is currently closing the remining 265 Halifax agencies which are often in communities with little or no banking competition.

Implications of Financial Crisis/Consolidation

1. Britain's banks and building societies had already experienced very considerable consolidation, compared to other countries, even before the recent crisis.

2. Having lost all its independent local and regional banks prior to 1970, the UK retail banking market is very dependent upon a few, largely multinational, names which make arbitrary decisions on branch closures and take little or no account of community opposition.

Example

The 15,000 population town of Shepshed, Leicestershire has lost its four retail banks, HSBC was the last to close in January 2007, but the local Shepshed Building Society remains, regrettably unable to offer current or small business accounts.

Even this low level of provision, with no competition, is unlikely to be sustained as the smaller building societies are acquired by larger ones as a result of the crisis and experience shows such locations to be vulnerable to closure.

Example

Lloyds closed the only bank branch in Ramsbury, Wiltshire in 2000 leaving only the Ramsbury Building Society, founded 1856, which later was acquired by the Portman Building Society which closed the Ramsbury branch in 2002 before it was itself acquired by Nationwide.

3. In 2005 the last of Britain's regional banks, Yorkshire and Clydesdale, owned by National Australia Bank, closed 100 branches, 22% of its network.

4. Post crisis these trends are likely to continue.

5. The EU Competition Directorate having imposed branch sell-offs on government backed RBS and Lloyds, the prospect of this producing significant new competition looks extremely doubtful. However the acquisition of the 311 branch RBS network outside Scotland has the potential to give Santander sufficient critical mass in the small business market to make a difference but Santander's network, even after incorporation of the RBS branches, will not significantly alter the competitive position in sole and dual bank communites. The c 250 Lloyds TSB branches in England to be sold have yet to be identified but will not comprise a viable network on their own.

Barriers to Entry

1. New entrants to the full service UK retail banking market face a considerable challenge, not least the still extensive branch networks of the established Big Four and the tradition of "free" banking for personal current accounts.

2. A physical staffed presence "on the high street" is still important to customers of the established banks and to potential customers of new entrants to the retail banking market. The reasons include:

- Secure convenience for deposit of cheques and cash, their acknowledgment and instant entry into the banking system.
- Convenience for withdrawing larger sums of cash in secure surroundings and specifying denominations, including change provision.
- Convenient human point of contact for resolving problems with existing accounts, opening new ones and producing identity documentation.
- Convenient and private facility for discussion of financial product needs with the bank's relationship managers and specialist advisers.
- Reinforcement of confidence in an institution entrusted with one's funds.

3. That the bank concerned should have, or have access to, a national network of branches is important to individuals and especially to SMEs in a society that is increasingly mobile. A presence convenient to employment and home, moving home or business location, changing job, travel for business or pleasure, adding business sites, acquiring additional or replacement businesses. These and similar events should not, of themselves, necessitate a change from an established banking relationship.

4. In view of its Bank of Ireland financial services partnership agreement the Post Office is not seen as a neutral network, has question marks over service delivery standards and in any event could not cope logistically with small business agency counter traffic on behalf of the major banks.

Issues requiring Attention

Inter Bank Agency Arrangements

Facilitates use of a local bank's counter by small business customers of other banks (established and new entrant), thus preserving competitive choice and helping to sustain existing branches and the communities they serve.

1. The absence of a convenient branch of the account holding bank, or an easily accessible agency arrangement with another bank on *"fair, reasonable and non-discriminatory terms"* (Competition Commission 14 March 2002), significantly reduces the SME opportunity for a new entrant bank or smaller bank seeking to

expand. For branch dependent customers in communities with only one or two banks it also militates against customers switching accounts and relationships between the established Big Four.

2. An improved and promoted IBAA service could help in both the above circumstances. The banks' failure to meet their commitment to improve the awareness and operation of IBAAs (14 March 2003) was confirmed by OFT research in 2007 which found only 25% awareness amongst those who might benefit. See attached chronology.

Neutral Shared Branching

Basic counter and related services, to agreed operating standards, delivered by a third party provider(s) on behalf of participating banks through a variety of delivery channels—retail/social enterprise franchises, mobile vehicles, community banks and banking centres—as appropriate to each community and locality. The model, which uses existing common technology, can replace existing branches and make it cost-effective to establish an "open to all" banking presence in new communities.

3. A step further would be the introduction of neutral shared branching in secondary and tertiary locations, although it could be argued that transactional activity and cash handling has become a commodity service in the eyes of the banks in which case the CCBS model has the capability to be extended. Regrettably the banks continue to oppose any proposals for experimentation of this model which has been academically validated in the UK as "operationally feasible and financially viable" and is successfully operated in a retail banking context in 45 US States. Full details in "Bank Closure Problems—One Solution Fits All" available in the REPORTS section of the CCBS website www.communitybanking.org.uk

4. To aid competition further the UK should consider following the example of other European countries and recognise the existence of local markets for banking competition. As recently as 21 December 2007 the Competition Commission confirmed its view that in the UK retail banking is a national market.

> *Example*
>
> In 2006 the merger of Banca Intesa with SaoPaoloIMI in northern Italy resulted in the Italian competition authorities enforcing the sale of 193 Intesa branches (plus two savings bank subsidiaries) to preserve local competiton. The branches were acquired by Credit Agricole of France to enlarge its presence in Italy.130 branches of Banca Monte dei Paschi di Siena are currently being negotiated for sale to a foreign bank to satisfy anti trust concerns arising from its purchase of another northern bank, Antonveneta.

5. In the USA the Community Reinvestment Act imposes, inter alia, service obligations on licenced banks which lead to the retention of local bank branches; a poor CRA record can block bank mergers and acquisitions requiring State/Federal approval. The UK possesses no legislative teeth to ensure banks continue to service communities adequately.

6. It is of concern that Cabinet Office Minister Nick Hurd MP is reported (Regeneration & Renewal interview 12 July 2010) as having no plans to introduce CRA type legislation and CCBS urges government to reconsider this urgently as legislation of this type would provide a suitable vehicle to impose social obligations on banks.

August 2010

Further written evidence submitted by the Campaign for Community Banking Services

Since the August evidence submitted by CCBS, and acknowledged by the Committee Secretariat on 25 August, details of further branch closures and announced closures by HSBC have been received.

For 2010, ie since the data submitted, a further 55 (following 75 in 2009) will be closed of which 20 are "last bank in town"' and a further 14 leave another bank in that situation.

Of the 780 remaining communities in England and Wales which have only one bank, HSBC has more than halved its share since 2003 to 9% leaving Barclays 29%, Lloyds 25%, NatWest 31%. The HSBC closures have not reduced the number of communities having only two banks although that bank necessarily now features less in the composition of the approx 500 communities in that category.

The fear is that, without the network and competition protections referred to in our submission, other banks will follow the HSBC example in short order. The Issues Requiring Attention section of our submission assumes greater urgency in the light of this later information.

September 2010

Written evidence submitted by Unite the Union

This response is submitted by Unite the Union. Unite is the UK's largest trade union with 1.5 million members across the private and public sectors. The union's members work in a range of industries including financial services, manufacturing, print, media, construction, transport, local government, education, health and not for profit sectors.

Unite is the largest trade union in the finance sector representing some 150,000 workers in all grades and all occupations, not only in the major English and Scottish banks, but also in investment banks, the Bank of England, insurance companies, building societies, finance houses and business services companies.

Executive Summary

— Unite does not believe that the Coalition Government is doing enough to promote diversity in the sector.

— Unite believes that takeover and mergers must be fully investigated by the Competition Commission to ensure that such business decisions are in the best interests of all stakeholders including consumers, shareholders and the workforce.

— Unite would argue that companies operating in an increasingly regulated market should be more aware of their social obligation and give greater consideration to whether they are "socially useful".

— Unite believes that a re-evaluation of the banking business model which incorporates a moral and ethical dimension to the business is required.

— Unite is calling for guarantees to be put in place in takeover situations which will protect the terms and conditions of the workforce including pensions and a commitment to no compulsory redundancies or site closures for a negotiated period.

Introduction

1. Unite welcomes the opportunity to respond to this inquiry and is keen to work with employers to ensure that the financial services sector remains competitive, profitable and sustainable with customers treated fairly and the workforce valued and rewarded appropriately.

2. Unite supports the Coalition Governments intentions to "promote mutuals and create a more competitive banking industry, increasing competition and encouraging diversity".

3. Unite stated in a previous submission[1] that the UK needs a diverse finance sector, which includes retail banks, building societies, mutuals, cooperatives and credit unions, providing different products and services, relationships and experiences. A diverse finance sector is better placed to serve the needs of a diverse population including those who presently find accessing financial services difficult.

4. However, Unite does not believe that the Coalition Government is doing enough to promote diversity in the sector. Indeed it would appear that recent announcements within the sector show an increase in consolidation and amalgamation rather than diversification or increased competition.

5. All the evidence points to existing players in the market buying up other existing organisations which Unite would argue reduce choice and creates a homogenous banking sector. This is evident with Lloyds TSB taking over HBOS; Abbey, Alliance and Leicester, Bradford and Bingley and RBS branches bought by Santander Group and Nationwide adding Derby and Cheshire Building Societies to their portfolio.

6. Unite believes that takeover and mergers must be fully investigated by the Competition Commission to ensure that such business decisions are in the best interests of all stakeholders including consumers, shareholders and the workforce. Workers representatives and consumer groups should be consulted to ensure the interests of stakeholders are included in any consultation process prior to the final decision being made.

7. The Government has set up the Independent Commission on Banking[2] to carry out a review on reforming banking and promoting competition and has set one of its objectives as:

> Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.

8. However, while Unite welcomes this review, the date given for reporting of September 2011 would appear to be too far in the future to influence the outcome of the sale of those banks that are wholly or part owned by the state as buyers are likely to become apparent before this date.

Sales versus Services

9. While Unite welcomes increased competition which would bring opportunities for employment, we would not wish to see increased competition at any price; where customers and employees feel unfairly treated and unable to challenge the might of the large banks. Indeed Unite would argue that new entrants as well as existing

[1] Unite response to HM Treasury discussion paper on building society capital and related issues.

[2] http://www.hm-treasury.gov.uk/d/banking_commission_terms_of_reference.pdf

companies operating in an increasingly regulated market should be more aware of their social obligation and give greater consideration to whether they are "socially useful".[3]

10. Unite has evidence of dysfunctional selling where products and services were sold to customers which were deemed inappropriate for their needs and the workforce then faced with the prospect of disciplinary action if they failed to reach targets on sales. This does not create an environment for delivering fair treatment to consumers or employees.[4]

Business and Banking

11. The UK needs a competitive banking sector which takes account of the needs of customers, including business customers, by providing the ability to access funding in order to grow and expand which is an important part of creating a sustainable and successful economy.

12. There are over 4.5 million small and medium sized businesses in the UK requiring banking services. However, it could be argued that not all businesses have been served well in recent times by the existing players in the market. A lack of access to affordable finance and a shortage of working capital, coupled with late payments, are making the situation difficult for many SMEs.

13. The Federation of Small Business Annual Survey 2009 found that "in the absence of fair lending from the banks and with only 13% of members who have borrowed new finance in the last year seeing interest rates decrease (in line with the Bank of England base rate), businesses have resorted to using bank overdrafts (28%) and their own savings (24%) to stay afloat."[5] The FSB is seeking to restore the trust that has been lost between small businesses and banks by ensuring banks "lend more finance more fairly".

Encouraging Diversity

14. The sector has much to do to re-engage consumers and despite the negative experiences many people have, they remained relatively loyal to their bank. The lack of transparency in the charging structures together with a perception of the difficulties associated with switching banks has meant that in 2009 only 1.2 million of the 60 million current account holders in the UK switched banks.[6] This is despite the biggest financial crisis in modern times and the apparent disaffection many consumers had with their bank.

15. In view of this, new players may find it difficult to penetrate the dominance of existing high street brands or will be required to provide a different banking experience that will capture the market.

16. Metro Bank has made an attempt to break in to the UK high street banking market by opening a branch in central London with a business model aimed at "service not price" and calling on customers to "love your bank at last". The branch opened on Sunday 1 August and it is too early to see whether the focus towards better customer service will entice consumers away from existing banks.

17. Unite will however pay close attention to Metro Bank as an employer as it may be that this approach will come at a price as the bank advertises the fact that it is opening longer and later than other banks which may impact on the workers employed at the bank.[7]

Consolidation not Diversification

18. The recent announcement that Santander is to buy 318 RBS branches appears to contradict EU rules on competition as well as the Coalition Governments own Coalition Agreement statement on encouraging diversity.

19. Santander has more bank branches than any other bank in the world[8] and through its purchase of other UK high street brands such as Abbey National, Alliance and Leicester and the savings arm of Bradford and Bingley, has captured a significant proportion of the banking market in the UK.

20. With Northern Rock likely to be sold off in the near future and LBG also being forced into selling off branches due to EU competition rules, Unite would wish to ensure any sale of Northern Rock, LTSB or Cheltenham and Gloucester branches are sold to a competitor which increases competition and choice in the market but also by provides the workforce with a degree of job security.

21. Unite is calling for guarantees to be put in place in takeover situations which will protect the terms and conditions of the workforce including pensions and a commitment to no compulsory redundancies or site closures for a negotiated period. These practices should be recognised as good corporate governance and provide employees with some degree of protection as significant stakeholders in a business. Those at the top of a company often have comfort in contractual protections in takeovers and the workforce should be able to have this level of protection also.

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[3] Adair Turner FSA Chairman described some of the work of banks as socially useless.

[4] Unite survey on Sales versus Service.

[5] FSC-ICM Voice of Small Business Annual Survey 2009.

[6] *Guardian* 1 August 2010.

[7] Unite has written to Metro Bank on two occasions to set up a meeting however has not yet received a response.

[8] About Santander www.santander.co.uk

22. Unite has expanded on its views regarding the conduct of takeovers in its submission to the Takeover Panel Codes Committee and this can be viewed on the undernoted weblink.[9]

23. Unite believes that a re-evaluation of the banking business model which incorporates a moral and ethical dimension to the business is required; one which regards good customer service as equal to good sales techniques; one which gives regard to fairness in employee relations as well as treating customers fairly. This should be a prerequisite in expanding competition and choice in the UK banking sector and should be enforced.

September 2010

Written evidence submitted by David Johnston

RE: LLOYDS GROUP AND SANTANDER CONVEYANCING PANELS

I write to draw your attention to a concerted attempt by the above two banks to use their dominant market position to drive small conveyancing firms out of the mortgage market and therefore to restrict consumer choice; presumably for their own financial advantage. Given Lloyds in particular is 41% owned by the taxpayer, is this Government Policy?

I am a solicitor with 30 years post qualification experience. In 1984, I set up my own firm Clifford Johnson and Co in south Manchester. I no longer own the firm but continue to work fir it as a consultant. I believe that the firm has a good reputation and has served its clients well over the past 26 years.

In particular, over this time, I have carried out conveyancing mortgage work for the above two organisation. The firm has been on panels for both organisations for 26 years. I am not aware of any complaints or concerns from either organisation over this period.

I was therefore surprised to receive letters from both organisations recently removing the firm for which I work from their conveyancing panels with immediate effect on the grounds of "low volume" of work. The decision is being appealed but, if confirmed, will have a serious effect on the firm's ability to carryout conveyancing business in the future and if other lenders follow a similar course may threaten the future viability of the firm itself. Lloyds also threaten to carry out a further cull in the not too distant future.

According to the Law Society, the rationale behind the decision is to reduce both organisations exposure to fraud and negligence. I would strongly questions this for two reasons. Firstly, I believe that small, tightly controlled, well run firms such as the form for which I work stand comparison with the large "conveyancing factories" on grounds of customer satisfaction; negligence; fraud prevention and complaints. Indeed, my personal experience of such large organisations over the years is that their services ranges from poor at best to appalling at worst. Such organisations pay large referral fees to, for example, mortgage brokers to get volume conveyancing business.

Secondly, I believe that the real reason for this decisions is to reshape the conveyancing market by driving out small providers to maximise the referral fee income which large conveyancing providers are prepared to pay for volume conveyancing business. This restricts consumer choice and, in my view, compromises the ability to provide truly independent advice. I have always been opposed to paying referral fees and I do not believe you can give properly independent advice if you receive them.

Lloyds action is particularly troubling as when they were created the then Government waived competition requirements to allow their creation do to the parlous state of HBOS. They now seek to use their dominant market position to reshape the conveyancing market to their long term financial advantage.

They are also 41% owned by the taxpayer. Is there decision in line with Government policy to promote small businesses?

I am also concerned that these letters have appeared at roughly the same time. Is this coincidence? Or has there been collusion between these organisations to attempt to shape the conveyancing market to their advantage?

In short, I believe this development will be bad for consumers as it will restrict consumer choice; compromise consumers ability to receive truly independent advice, and coupled with the other threats faced, hasten the closure of small, locally based high street firms, thereby restricting access to legal services.

I would be most grateful if you would consider these concerns and respond appropriately. If you need any more information please do not hesitate to contact me.

August 2010

[9] Unite response to Takeover Panel consultation.

Written evidence submitted by Mr and Mrs Ralph

REVIEW OF RETAIL BANKING COMPETITION

We read that you are seeking comments from organisations and individuals regarding banking competition as part of the newly commissioned review. We further understand that in advance of that review, you support the break-up of partly owned banks such as Lloyds and RBS—we find this extremely disappointing.

Could we ask that you bear in mind the plight of several million small shareholders, including ourselves, who've lost a substantial part of their savings as a result of the Lloyds/HBOS merger. To enforce a demerger beyond that required by the EU would be devastating to share value. Lloyds did the previous government, and by implication, the present coalition, a huge favour by taking over HBOS at the height of the credit crisis. We believe it has managed the integration process well but it is surely not right to destroy value to its shareholders (including the taxpayer) by further government intervention beyond that required by the EU state and roles.

In our view, there is adequate competition on the High Street and the banks which survived the crisis without direct government assistance will, in any event, but stronger entities and therefore control the market. Lloyds and RBS are weakened and will need many years to recover, but further demands on them could well destroy them only for foreign banks to take over.

We would be grateful for these comments to be taken into account in your deliberations.

July 2010

Written evidence submitted by Ian Kerry

As with trying to work out which utility company is the cheapest, it is very complex to work out whether one bank is cheaper that the rest. And then once you have made a decision it is hugely complex to change banks. Opening new accounts (mainly I assume for terrorism and laundering on money issues) is very long winded. When I changed my business accounts from Abbey to Co-op 18 months ago, I regretted doing so on several occasions.

Could there be a set number of fees and charges that all banks had to produce so that the poor consumer could see at a glance how competitive each account/bank was? Mind you they seem to change the fees etc fairly often. Perhaps they should be allowed to anytime they want but hold them the same for a 24 month period.

This probably has nothing to do with the enquiry but the situation of when you do an online transfer and get one digit wrong on the sort code. At the moment the bank KEEPS this money (even if the account doesn't exist). They don't return it (even though the name on the account and the account code differ). They don't let you know that there has been an error. So after five months from me paying £10k corporation tax, thinking the government has been paid, I receive a letter from HMRC saying why hasn't it been paid? It seems one digit was wrong, the bank keeps the money, gets the interest, tells no-one, takes a further two months (and counting) to get the money back. AND ALL THIS IS LEGAL!!!!

I will put aside all my anger at the bonuses bankers are still receiving when the rest of the country are losing their jobs or suffering cutbacks. Either you guys can't do anything about it or you find it acceptable, either way it makes the whole country angry!

September 2010

Written evidence submitted by VocaLink

SUMMARY

— VocaLink processes automated payments in the UK, including all Direct Debits, Direct Credits and Faster Payments; this accounts for approximately half a billion payments a month. It also operates LINK, the world's busiest ATM network of over 63,000 cash machines.

— Bacs services (Direct Debits and Direct Credits) have been available for many years, work well and are readily accessible by market participants.

— The UK Faster Payments Service has been available since 2008, delivering real innovation to consumers.

— We do not believe that access to systemically important payment systems represents a barrier to entry in the banking market.

— We believe the consumer inconvenience in switching banks has been largely removed by the ToDDaSO service, although there is potential for further innovation in this area.

— We believe that there is considerable scope for better delivery and further innovation in mobile payments offerings to consumers.

1. VocaLink welcomes the opportunity to contribute a submission to the HM Treasury Committee's Inquiry into competition and choice in the banking market.

2. VocaLink is a specialist provider of transaction services. We process automated payments in the UK including Bacs Direct Debits and Direct Credits, the method by which 95% of salaries and 98% of state benefits in the UK are paid. It is estimated that over 70% of household bills are paid by Direct Debit, and the total value of payments flowing through the Bacs system in 2009 was £3.8 trillion.

3. We provide the real-time central infrastructure for the UK Faster Payments Service—which enables payments, including state benefits, to be made between accounts within seconds. Our services operate in highly secure data centres on "never fail" technology which ensures total reliability and availability, 24 hours a day.

4. The specific purpose of this submission is to demonstrate that access to payment systems does not, in our opinion, represent a significant barrier to entry in the banking market.

5. The Bacs service has been in existence since 1968, and in 2004 following the Cruickshank Report it was divided into a scheme company (Bacs Payment Schemes Limited) and an infrastructure company (originally called Voca, now VocaLink following the merger between Voca and LINK in 2007). The separation of scheme and infrastructure provides a level of separation between the customers and the owners of the service. This model has been followed for the Faster Payments Service, launched in 2008, and has been widely copied in Europe and elsewhere. The Faster Payments scheme is managed by CHAPSCo and the infrastructure is provided by VocaLink.

6. The Bacs service (Credit Transfers and Direct Debits) has been running for over 40 years and its potential market is approaching saturation, although there are ongoing efforts by Bacs and the industry to encourage even higher levels of adoption of Direct Debits by consumers. The Faster Payments scheme was launched in May 2008 and banks are currently completing the migration of Standing Orders and remote banking transactions to this service away from Bacs. The Faster Payments Service has the potential to attract other types of payment, including lower-value CHAPS transactions and support new payment methods such as mobile payments and on-line payments (as an alternative to cards). There has been wide interest in the concept of Faster Payments from other countries seeking to learn from our experiences.

7. We do not perceive access to the Bacs and Faster Payments services as a barrier to entry or expansion in UK banking. The agency bank model works well for Bacs although it should be noted that after two years operation there are still no agency banks providing access to Faster Payments services directly. This may be due in part to the technical complexity of building or purchasing a gateway and then integrating this to the bank's back office systems. We have recognised the demand for a managed service offering in this area and have developed a Faster Payments Managed Service to offer an easier channel for agency banks and other potential FPS users.

8. The provision of the ToDDaSO service (Transfer of Direct Debit and Standing Orders) has largely removed the customer inconvenience of cancelling Direct Debits and Standing Orders with one bank and then having to re-establish them at the new bank. This service has worked well for a number of years and has removed the major obstacle to account switching.

9. Further enhancement to ToDDaSO to provide linked electronic transfer of associated funds, the extension of the service to investment accounts such as ISAs and the migration of the service to real-time operation would significantly enhance the benefits to the consumer.

10. The near universal use of mobile phones and the sharp growth in availability of smart phones provides a compelling base for innovation in delivering mobile banking, and in particular mobile payments. The launch and widespread take-up of mobile banking services from major banks in the past two years shows that there is significant consumer demand for further innovation in delivering mobile payments. The key driver for future demand is likely to be the ability to clear funds between accounts within a few seconds,[10] utilising existing services such as Faster Payments and LINK. We believe that there is a compelling case for industry collaboration to facilitate full account reach and widespread take up of such services. Mobile payments will deliver credible alternatives to cheque and cash usage, and allow consumers greater control of their finances.

September 2010

[10] VocaLink consumer research August 2010; available on request.

Written evidence submitted by the Building Societies Association

Executive Summary

- Mutual lenders and deposit takers benefit the operation of the banking sector by nature of their ownership structure, which delivers diversity, lower risk, competition, democracy, high levels of service and trust, and a long-term perspective to the market.
- Although mutuals have been affected by the financial crisis and recession, they have generally performed better than their plc competitors, and, in comparison, have drawn on very little support from the Government. However, current market conditions remain challenging for all financial firms, especially deposit takers.
- In response to the events of recent years, mutuals have adapted their operations significantly, both by innovating and by reaffirming their core strengths. These have included controlling costs, continued focus on high-quality lending funded from retail sources, exploring shared services and continuing to improve corporate governance. Some mutuals have merged to create stronger institutions that are better placed to deal with the current market conditions and to grow in the future.
- Regulatory changes should not discriminate against mutual institutions. It is essential that the Government ensure that amendments to the Capital Requirements Directive enable mutuals to raise external capital that is consistent with mutual ownership.
- The Government should consider restricting the activities of banks that it owns so that markets are not distorted. The long-term payback from remutualising Northern Rock also merits consideration.
- Substantial barriers to entry to banking exist. These include increasing regulatory requirements, networks of systems, branches and staff and, vitally, the need for trust.
- Further changes to the banking sector need to be carefully evaluated so as not to cause unintended consequences, such as excluding groups of customers from the market or reducing stability.

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. This submission sets out the positive contribution that mutuals make to the banking sector in the UK in terms of competition and stability. Mutual lenders and deposit takers have not been immune to the financial crisis and recession of the last three years, and the effects of the financial crisis on mutuals are examined, and the sector's responses to these challenges are set out. The Government's role in banking is then addressed, before other aspects of the Committee's inquiry are covered, including barriers to entry, free banking and competition from foreign banks.

Mutuals' Contribution to the Banking Sector

3. There are a number of inter-related features of mutual financial service providers that enhance both competition and financial stability in the banking sector. These all follow from the organisations being owned by their customers.

4. Firstly, **mutuals add to the diversity of the sector**. While publicly quoted banks might be expected to try to maximise returns to shareholders, mutuals pursue alternative strategies that are a consequence of the customer being the primary stakeholder. In a speech in 2009, Andrew Haldane, Executive Director for Financial Stability at the Bank of England, highlighted the increased homogeneity of business strategies in the run up to the crisis, which reduced the resilience of the system as a whole[11]. A strong mutual sector with different incentives to plcs can potentially reduce herd effects.

5. **Mutuals also tend to take less risk than quoted banks**. This is partly because it is difficult for mutuals to raise new capital (apart from via retained profits), but also because the majority of their members are savers, who are risk averse because they would not benefit from any upside, but could be subject to any downside from risky strategies. Mutuals have been less reliant on wholesale funding than plc banks, with more stable retail funds accounting for 70% or more of total funding. And the proportion of mortgage loans that is in arrears is typically much lower at mutuals than across the market as a whole.

6. **Competition in banking and mortgage markets is enhanced by the presence of mutual lenders and deposit takers**. As they do not have to pay dividends to shareholders, mutuals can offer more competitive rates of interest on savings and mortgages than can banks. For example, Moneyfacts found that 73% of

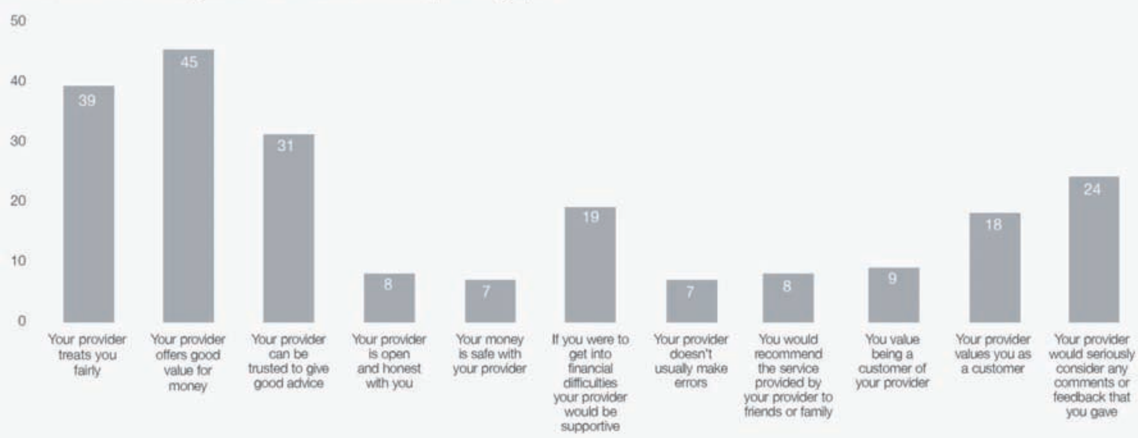
[11] "Credit is Trust" Haldane, A, Bank of England, http://www.bankofengland.co.uk/publications/speeches/2009/speech400.pdf

consistently high-paying savings accounts were offered by building societies[12]. Mutuals therefore impose a competitive constraint on the pricing activities of their bank rivals.

7. **Mutuals are accountable to their owners**, their customers. Members of building societies can vote to appoint directors to the Board, so directing the strategy of the organisation. Furthermore, at mutuals customer feedback may command more direct attention than at quoted banks as it does not compete with the needs of external shareholders. Mutuals have made considerable improvements to their corporate governance in recent years, with greater disclosure of information (including the voluntary disclosure of directors' remuneration, which on average is approved by over 90% of members who cast their vote), increased proportions of members voting at Annual General Meetings, and deeper and more consequential direct contact between members and directors[13].

8. Research has consistently shown that **mutually-owned financial firms deliver higher levels of satisfaction and trust** than plc banks. Research conducted this year showed that mutuals outperformed plc banks across eleven aspects of customer service (see chart)[14]. This is because the interests of customers are paramount at mutuals, and not in conflict with those of shareholders, as is potentially the case at other banks. Staff at mutuals are aware that they are dealing with an owner of the business, so the customer relationship is quite different from that at plc banks.

Mutuals score better in all aspects of service compared to banks
Difference between net agreements at mutuals and banks, percentage points



Source: GfK NOP survey of 1,968 adults, 11–16 March 2010

9. Finally, the economist John Kay has noted that "the special value of mutuality rests in its capacity to establish and maintain relational contract structures" which are well suited to the long-term nature of mortgage lending[15]. The trusted relationships necessary in mortgage and savings markets can only be built up over a protracted period. **Mutuals are not subject to the same short-term pressures that might apply to banks** that must maximise returns to shareholders.

The Effects of the Financial Crisis on Mutuals

10. Mutual lenders and deposit takers have obviously not been immune from the financial crisis and recession. At the height of the crisis, mutuals were the recipients of substantial deposit inflows from worried customers of banks. In the last year or so some of these deposits have since moved elsewhere as the banks (including those failed banks now supported by the taxpayer) have competed aggressively for retail funds due to the closure of wholesale markets and the need to roll-over many hundreds of billions of maturing wholesale funding over the next few years. Households are struggling to save, and the low interest rate environment causes them to seek higher returns from riskier investments. As a result deposits from households grew by just 2% in 2009. Mortgage lending has also fallen substantially across the market. In 2009 outstanding mortgage balances grew by just 1%. The low interest environment continues to put considerable pressure on profit margins at all retail banks, mutuals included. These pressures are added to by regulatory changes, including increased capital and liquidity requirements, and the levies of the Financial Services Compensation Scheme, which fall disproportionately on retail-funded mutuals.

11. However, mutuals have generally been less affected by the financial crisis than publicly quoted banks. The FSA has observed that "*although building societies, like banks, have been weakened by adverse economic and financial market conditions, the extent of that weakening has to date been less than that experienced by*

[12] Moneyfacts press release, 19 January 2010 http://www.moneyfactsgroup.co.uk/press/pressreleases/displaypressrelease.asp?id=727

[13] "Conversations with Members", BSA, 2010: http://www.bsa.org.uk/docs/publications/conversations_with_members.pdf

[14] "Customer service at mutuals is better than at banks", BSA, 2010: http://www.bsa.org.uk/docs/consumerpdfs/customerservice.pdf

[15] Kay, J, 1991, "The economics of mutuality" Annals of Public and Co-operative Economics, 62, 3

the banks mainly because of the lower exposure to wholesale funding and complex financial instruments"[16]. It is noteworthy that of the former building societies that demutualised, none remains today as an independent entity.

12. Although the Dunfermline Building Society did require resolution under the Banking Act, the sector overall has called on very little direct assistance from the authorities during the crisis[17]. Instead, the sector has addressed any problems that have arisen itself, including a number of mergers between mutuals (though not all of these have occurred out of distress). There remain 49 separate building societies, and the brands of many merged societies also continue to be present on high streets, and there are several mutual lenders and deposit takers, including the combined business of Co-operative Bank and Britannia. Consolidation has helped to ameliorate some of the immediate issues facing certain societies, resulting in stable and secure institutions, such that the mutual sector continues to provide meaningful diversity and competition in banking markets.

Responses by the Mutual Sector

13. Mutuals have responded in a number of ways to the challenges of the financial crisis. As has already been mentioned, several mergers have occurred and there will doubtless be other societies that decide to merge in the future, but this is by no means a certainty for all mutuals, and there are likely to be limits to the benefits from increased size and scope in financial service providers[18]. Very many building societies, small and large, have performed well over the last few, challenging, years.

14. This has been achieved by a number of approaches. Ongoing efforts to manage costs have intensified, with several societies taking difficult decisions to scale back activities in geographical or market segments that are not core to their operations. However, measures continue to be taken to ensure the high levels of service and trust that distinguish the mutual sector are preserved. Mutuals have reduced their use of wholesale funding, which peaked at 30% of funding, much lower than most banks. As stood them in generally good stead going into the crisis, mutual lenders are focussing on high quality assets and are pricing cautiously for risk.

15. Mutuals are also exploring ways to work together to share services or to develop methods of pooled funding. Steps to improve corporate governance at mutuals continue to be made, with a working group chaired by the Financial Reporting Council investigating this issue. The BSA has also helped to share ideas and best practice in engaging members effectively.

The Role of Government

16. The Coalition stated in its Programme for Government that "we will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry."[19] The previous Government also stated its strong support for the mutual sector[20].

17. The BSA would like to see this support translated into action in the European Commission's consultations on capital. One drawback of the mutual model is that it is difficult for mutuals to raise additional capital, particularly when market conditions are stressed. An extremely important consequence of this is that current consultations at a European level on what constitutes core capital must give due consideration to alternative organisational forms to the plc. The definition of core capital needs to be consistent with mutual ownership (and be marketable to investors) if it is not to disadvantage mutual firms. The BSA and its members have urged the UK authorities to take the initiative in the consultations in Europe to ensure diversity and competition are promoted[21].

18. Banks that received direct State-backing during the crisis have subsequently distorted the operation of the UK's mortgage and savings markets, and now dominate these markets. The direct Government support gives deposits held with these banks an implicit guarantee. Conditions should be applied to these institutions' activities to limit unfair distortions to competition, at least, and we welcome the review by the Independent Commission on Banking into the future structure of the industry.

19. If a long-term view is taken in relation to divesting the State's ownership of Northern Rock, converting the failed bank back to a mutual becomes a viable option. This could be achieved by arranging for Northern Rock to pay returns to the taxpayer over a number of years to repay the injection of capital[22]. Remutualisation would help to foster diversity and promote mutuals, and deserves serious consideration by the Government.

[16] Specialist Sourcebook For Building Societies, FSA, http://www.fsa.gov.uk/pubs/cp/cp09_17.pdf

[17] No building society received any public money under the Bank Recapitalisation Programme nor took part in the Asset Protection Scheme. Use of the Credit Guarantee Scheme and the Special Liquidity Scheme by building societies was relatively modest.

[18] "The $100 billion question" Haldane, A, Bank of England: http://www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf

[19] Coalition Programme for Government: http://programmeforgovernment.hmg.gov.uk/files/2010/05/coalition-programme.pdf

[20] "Reforming financial markets" HM Treasury, http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

[21] The BSA's submissions relating to capital can be found via these links:
HM Treasury: http://www.bsa.org.uk/policy/response/capital_related_issues_response.htm
CRD4: http://www.bsa.org.uk/docs/policy/prudentialandfinreg/CRD_4.pdf
Basel: http://www.bsa.org.uk/docs/policy/prudentialandfinreg/basel_164_and165.pdf

[22] "Converting failed financial institutions into mutual organisations", BSA, 2009, http://www.bsa.org.uk/docs/presspdfs/remutualisation.pdf

Barriers to Entering the Market

20. There are significant barriers to entry and expansion in retail banking, and the BSA welcomes the OFT's review, to which we made a detailed submission[23]. In that submission, we drew attention to the principal importance of consumers' trust in financial services, since banking is relational rather than transactional, and this has implications for how barriers to entry and exit are interpreted. Consumers, and the wider public interest, would not be served by a proliferation of fly-by-night deposit takers.

21. The establishment of trust and reliability are in addition to other substantial set-up costs relating to systems, branches and staff, and are more fundamental than simply investing in a new brand. Trust is built on consumer perceptions and moral judgements, which can be developed only over a prolonged period of time.

22. Therefore, while consumer inertia does exist, this may reflect the necessity of long-lasting trusted relationships as much as consumer confusion. There are now more ways than ever before for consumers to find out about products, and the wide range of options available often represent features tailored in response to demands from specific market segments rather than providers' desire to obfuscate.

23. Regulation is another significant and growing barrier. As well as increased capital and liquidity requirements, there is the Mortgage Market Review, changes to the Financial Services Compensation Scheme (FSCS), and just for building societies, a Specialist Sourcebook. It is not at all clear that the cumulative effects of all these regulatory changes have been assessed. Nor is it apparent that the potential trade-offs between competition, financial stability, distribution (reducing financial inclusion, for example) and supporting economic growth have been actively managed.

24. For example, new regulation to preserve stability has tended to favour large incumbent organisations, protecting them from competition, with additional prudential regulation typically representing a greater proportionate cost to small firms. As a result, in 2009 Lloyds Banking Group had a 24% share of new mortgage lending and 28% of the increase in deposits, and Santander, which combined Alliance & Leicester and the savings business of Bradford & Bingley banks with its Abbey brand, took an estimated 18% share of new lending and 23% of the increase in retail deposits in 2009. And some small societies are inclined to interpret the increased regulatory burden as being driven by a hidden agenda for the consolidation and marginalising of smaller institutions.

25. Another regulatory barrier is the FSCS. The BSA is extremely concerned about the requirements proposed by the European Commission to build up a deposit guarantee fund (equivalent to 1.5% of eligible deposits) at a rate that would be crippling for the entire existing retail banking sector, and would pose an additional barrier to potential entrants. The Government needs to ensure any changes to deposit protection can realistically be achieved.

26. The wider mutual sector incorporates credit unions, which can now offer basic banking services. Credit unions are not subject to the European banking directives and therefore it is much easier to establish a new credit union than, for instance, a new building society. It may be appropriate to increase the coverage of the Building Societies (Funding) and Mutual Societies (Transfers) Act to facilitate the transfer of engagements between credit unions and other types of mutual so that expansion is not constrained.

Free Banking

27. Account terms and conditions and charges should be reasonable and presented clearly to consumers, and the OFT has been working with current account providers to improve the transparency of charges, as well as the account switching process. Mutual financial service providers offer simple products, primarily through branches, with many savings accounts that can be opened with just one pound. And mutuals have tended to keep their branches open to a greater extent than banks.

28. However, when considering policy relating to the pricing of banking services, it is important to consider the potential distributional effects of any changes, as alternative fee structures may increase financial exclusion. It is likely to be especially helpful to those on low incomes if, by keeping their account in credit, they are able to operate a bank account for free.

Foreign-based Operators

29. Although several foreign-based lenders may have left the UK market following the credit crunch, it is not clear that foreign-based deposit takers have been so deterred. Many of the most competitive savings interest rates currently available are offered by institutions based in other countries, and often outside the EU. The role of foreign-based banks is complicated by potential issues such as instability if increased competition from abroad results in a greater amount of entry and exit from the market, and also the risk that foreign-owned banks enter to attract the most profitable customers, with the possibility that less profitable customers are excluded. It is also pertinent to question whether foreign-based deposit takers that compete for UK savings then play their part in providing credit to UK households or businesses, or whether the money is deployed overseas, possibly at greater risk (as the Icelandic banks episode demonstrated).

[23] BSA submission to OFT review into barriers to entry: http://www.bsa.org.uk/docs/policy/OFT_B2Ebanking.pdf

Conclusion

30. The mutual sector provides a valuable alternative to the large plc banks, and mutuals have responded to the economic challenges to ensure that they continue to do so in the future.

31. We welcome the Coalition Government's support for mutual financial service firms, but this needs to be translated into action. This is most pressing in the need for the definition of core capital consistent with the mutual model. And in policy making mutuals should not be considered merely as an afterthought to the hegemony of shareholder (and Government) owned banks.

September 2010

Written evidence submitted by Kensington Mortgage Company

Executive Summary

- The landscape of the UK mortgage market has changed dramatically over the past three years. The majority of UK mortgage lenders, as a response to the financial crisis and market downturn, have restricted their lending to consumers, while other providers have pulled out of the market altogether.
- In addition, much of the consolidation within the market has resulted in a lack of diversity of mortgage products and providers, which has, in turn, restricted mortgage provision to a select number of customers (*eg* those with an exceptional credit rating or with a significant level of deposit).
- With a lower number of first-time buyers in the market in England and Wales than at any time in the last 35 years[24], we believe it is more important than ever that mortgage lenders do their utmost to help people fulfil their aspirations of homeownership consistent, of course, with their ability to fund those loans sustainably.
- We believe that the best way to do this is to ensure a competitive, diverse market, which is able to meet a range of customers needs in different circumstances and which is not just reliant on a small number of super-dominant lenders.
- We believe it is important for the Government and regulators to support a level playing-field between lenders of every kind—whether large and small, monoline and full service, private sector and part-nationalised—to maximise the level of competition in the mortgage market and make sure that every lender is, like us, playing their full part.

1. Introduction

1.1 Kensington Mortgage Company ("Kensington") welcomes the opportunity to contribute to the Treasury Select Committee's important and timely inquiry into competition and choice in the banking sector.

1.2 Kensington is a leading intermediary only mortgage lender with approximately 47,000 customers and a mortgage book of £4.54 billion. It offers mortgage products—through a controlled distribution of intermediaries—aimed at customers who are overlooked by the high street and its products are tailored to meet a range of different circumstances[25]. With the support of its parent, Investec, a leading specialist bank and asset manager, Kensington became the first lender driven out of the market by the credit crunch to return to lending.

1.3 As an intermediary lender, Kensington plays a key role in ensuring greater diversity and competition for mortgage customers and potential homeowners, as part of ensuring a sustainable recovery in the UK mortgage market—particularly, at a time when there have been mixed signals about the direction in which the housing market is heading. In a sector which has been subject to significant levels of state support through the nationalisation and part-nationalisation of some of the big banks and mortgage lenders, we believe that the promotion of greater competition and diversity is of paramount importance for the benefit of consumers.

1.4 Kensington are committed to running a responsible, sustainable business. We make sensible considered lending decisions based on the information provided us from a variety of verifiable sources. We check robustly a customer's ability to afford a mortgage taking into consideration the specific characteristics of the customer's financial situation and we further stress test this to allow for the potential of further interest rates increases.

2. The Impact of the Financial Crisis on Competition and Choice

2.1 The landscape of the UK mortgage market has changed dramatically over the past three years. The majority of UK mortgage lenders, as a response to the financial crisis and market downturn, have restricted their lending to consumers, while other providers have pulled out of the market altogether.

[24] Statistics supplied by Home Builders Federation, 5 August, 2010

[25] These include self-employed workers, people whose income includes salary plus bonus or commission, people with more than one income source (eg from two part-time jobs), customers who have missed one or two of unsecured payments in the past but are now back on their feet financially and people without personal information on record to fit a standard credit score.

2.2 The market in mortgages saw a reduction of products from 28,413 in June 2007 to just 2,177 in July 2009 according to Money Supermarket. That figure had risen slightly to 2,990 by August 2010.

2.3 With a lower number of first-time buyers in the market in England and Wales than at any time in the last 35 years[26], we believe it is more important than ever that mortgage lenders do their utmost to help people fulfil their aspirations of homeownership consistent, of course, with their ability to fund those loans sustainably. We believe that the best way to do this is to ensure a competitive, diverse market, which is able to meet a range of customers' needs in different circumstances and which is not just reliant on a small number of super-dominant lenders.

3. The Impact of Widespread Consolidation among Banks and Mutuals

3.1 There has been significant consolidation in the UK mortgage market over the past three years. In addition, much of government support has focused almost exclusively on larger deposit-takers, reinforcing the lack of overall competitiveness in the mortgage market for first time buyers and those facing negative equity.

3.2 Much of the consolidation within the market has resulted in a lack of diversity of mortgage products and providers, which has, in turn, restricted mortgage provision to a select number of customers (*eg* those with an exceptional credit rating or with a significant level of deposit). Many credit-worthy consumers—including those, for example, who are self employed—are still being denied the opportunity to buy their own homes and are unable to enjoy the clear benefits associated with home ownership. A diverse and responsible mortgage market that supports the recovering in the housing market would, in turn, give a much needed fillip to the broader national recovery.

4. The Key Barriers to Entry Inhibiting Increased Competition—Including Regulation

4.1 It is crucial for the Government, regulators and the industry to ensure the necessary conditions for a return to a diverse and vibrant market in which there are more kinds of lenders—both small and large—with different funding models.

4.2 Following the financial crisis, there have been a number of new or proposed regulatory requirements affecting the mortgage market including the FSA's Mortgage Market Review and the Bank of England's proposed market measures on monetary policy[27]. While the intention to further stabilise the system is entirely welcome, there needs to be greater recognition and understanding of the cumulative effects of all these regulatory changes on market competition and scope for product innovation. There is a danger that these new and proposed regulations will tend to favour large incumbent organisations, protect them from competition (in some cases with taxpayers' money), with additional prudential regulation typically representing a greater proportionate cost to small firms.

5. Whether Competition is Inhibited by Difficulties Faced by Customers in Accessing Information about Products

5.1 Kensington believes that there is currently a lack of transparency in the market, with many of the products promoted by the mainstream providers being restricted to only a very small number of borrowers. Credit scoring systems are used to cherry pick customers for the best rates. The criteria behind these scores are undisclosed and many customers can be denied access to products promoted as best buys without knowing why.

5.2 In addition, Kensington believes that it is important to promote greater understanding in financial services, with more emphasis put on the value of product transparency and professional independent financial advice. We support the work of Independent Financial Advisers (IFAs) and Mortgage Intermediaries as the fairest financial services institutions inspiring trust and consumer confidence as well as continuing the roll out of free impartial generic financial advice.

6. Explore the Government and Competition Authorities' Strategy to Increase Competition in Banking, Including the Likelihood that New Entrants will Successfully Enter the Market

6.1 We believe it is important for the Government and regulators to support a level playing-field between lenders of every kind—whether large and small, monoline and full service, private sector and part-nationalised—to maximise the level of competition in the mortgage market and make sure that every lender is, like us, playing their full part.

6.2 Kensington is determined to play its role to support the continuance of a sustainable, responsible recovery in the UK mortgage market though helping homeowners and potential homeowners.

[26] Statistics supplied by Home Builders Federation, 5 August, 2010
[27] Monetary Policy After the Fall—Paper by Charles Bean, 28 August 2010

7. Conclusion

7.1 Kensington has been delighted to offer these thoughts to the Committee which it trusts the Committee will find helpful. We would be delighted to discuss these important issues with you in further detail.

September 2010

Written evidence submitted by Intellect

Executive Summary

Intellect believes that the current regulatory focus on the banking sector in the UK must be supplemented by a greater understanding amongst policy-makers and regulators of the critical role that technology plays in the functioning of this critical industry.

Technology and financial services are inextricably linked. A durable and effective regulatory programme that tackles the issues of competition, transparency, systemic risk, and lack of capital for SMEs (amongst other issues) must reflect what technology can facilitate today and, crucially, what it will enable in the future.

Intellect believes that there are a number of competition challenges that need to be dealt with by Government and industry together if issues such as lack of choice for consumers are to be rectified. These include:

- Customer inertia—how can competition be increased (and new entrants be encouraged to participate in the market) when customers are not inclined to change banks?
- Poor flows of financial risk information on SMEs—an untapped market that banks do not currently want to tap.
- Costs of complying with regulation and high capital requirements.
- High cost of establishing a branch network—how can this be overcome by new entrants?
- Banks that are unable/unwilling to exit unprofitable markets.

Intellect believes that there are a number of ways that competition and choice within the retail banking market could be improved. These include:

- Individual bank account numbers that can be taken from bank to bank—to facilitate easier switching.
- Offer innovative, convenient, technology-facilitated banking products for customers that do not necessarily have to rely on a branch network.
- Use of innovative back-office IT to reduce up-front capital expenditure and counter-balance other high entry costs.
- Increase the quantity and accuracy of financial risk information (especially on SMEs) that is collated and flows between banks.
- Engagement with industry, via a continuing dialogue, to maximise the opportunity for innovative technologies to improve the process—be it in payments, online access, or, fundamental for all services, flows of information.

1. Intellect Financial Services Programme

1.1 Intellect is the UK trade association for the IT, telecoms and electronics industries. Our members account for over 80% of these markets and include blue-chip multinationals as well as early stage technology companies, and play a crucial role in virtually every aspect of our lives. In the UK these industries together generate around 10% of GDP and 15% of trade, directly employing over one million people.

1.2 We are a trusted partner for Government, both in terms of policy development and policy implementation across numerous sectors. We look to ensure that all relevant engagement of policymakers and regulators with industry is both easy and as valuable as possible in order that the technology industry may play the fundamental role it merits in the success of UK plc.

1.3 Intellect's Financial Services Programme brings together over 150 suppliers of information systems, services and consultancy to the financial services sector. Global IT service providers sit alongside many specialised smaller companies and all play an active role in imparting their expertise and experience to better inform the development of financial services policy at a cross roads in the industry's development.

1.4 Many of Intellect's members are heavily involved in providing the fundamentally important technology platforms upon which the UK's financial services industry is built. For example, these members help facilitate the 5.7 billion automated payments that are made through the banking system on an annual basis. Indeed, through Intellect our members are working with the Payments Council to develop the future technology that will afford consumers and businesses alike more convenient, secure and efficient ways to conduct their transactions. Similarly, the 40 million online bank accounts that are registered in the UK would not function without the technological capability that our members design and supply.

1.5 The relationship between the financial services industry and the technology sector is one of fundamental importance. Technology not only plays a critical role in the functioning of the financial services industry, it is a hugely important factor in ensuring that these institutions can operate more responsibly and remain competitive in the global marketplace.

1.6 Consequently, if the UK's banking sector is to be reformed to meet the challenges posed in recent years and provide the backdrop to economic recovery, policy not only needs to reflect what technology can facilitate today, but what it will enable in the future. Regulation will only be effective and durable if it takes into account how it will be implemented and how the application of technology can be complementary. For an industry like financial services that relies so heavily upon technology, it is essential that policy is developed at all stages with a full understanding of it.

2. Intellect Response to the Inquiry's Terms of Reference

2.1 *Please note: Intellect has not responded to all the issues set out in the Inquiry's Terms of Reference. Answers that are given to questions below are based upon Intellect's Members' expertise in the field of financial services.*

2.2 *Given the word limit for this response, Intellect is unable to cover the wide spectrum of issues in great detail. However, more detail on issues of interest to the Select Committee is available upon request.*

3. Financial Services Reform & Technology—Inextricably Linked

3.1 Intellect welcomes the focus that the Government, Independent Banking Commission and other authorities are taking on competition within the banking sector. However it is clear that there needs to be a shift in attitude amongst policy-makers and regulators about the role that technology has in this particular industry. Whether it is because of the dominance of the "traditional" stakeholders in this industry, or a prevailing misconception that technology is merely a means to implement legislation and is treated as an afterthought, to date there has been insufficient attention paid by the Government to how technology can offer solutions to many of the challenges the financial services industry currently faces.

3.2 Technology has played a significant role in the development of the banking market in recent years. The banking system as we know it would not function without the fundamental technology platforms that underpins all activity, both customer-facing and back office. This will continue to be the case as consumer technology converges and organisations (not necessarily just retail banks) develop a variety of technologies to provide banking services to an increasingly digitally-native market. In the future, how technology is applied will be a key differentiator between operators in a market that is in a state of flux. Those willing and able to embrace new technologies (both front-end and in terms of infrastructure and back-office) will be able to adapt to accommodate changing consumer demands and expectations. **Not only can technology reduce systemic risk and increase flows of capital to SMEs, it can increase competition and provide a platform for new entrants to expand within the retail banking industry**.

3.3 As the UK's financial services sector is reformed to meet the challenges posed by the recent banking crisis and provide the backdrop to economic recovery, the development of policy must reflect an understanding of how technology continues to be the driver of change in the financial services industry. Understandably there may be an inclination in some quarters to move from principles-based regulation to a rules-based approach. Whilst not offering arguments in favour of either, **Intellect believes that before committing to any changes to the regulatory system, the possibilities that technology offers for increasing competition (and increasing transparency, stability and consumer protection) should be examined in detail by policy-makers and the financial services industry alike**.

3.4 Currently the level of understanding amongst policy-makers and regulators about the technology systems that provide the fundamental platforms for nearly every transaction across the financial services industry, is poor. **It is common sense that if policy-makers and regulators are to ensure that regulation is effective, but not unnecessarily restrictive, they need to have an understanding how banks operate. It is now impossible to do this without appreciating the technology that not only underpins existing institutions in this sector, but will also underpin new entrants to the market as well and is constantly evolving.** Intellect provides an ideal source of neutral expertise for policy makers and regulators to tap into, representing the aggregated expertise of the companies that provide the platforms which underpin much of the financial services industry.

4. Barriers to Entry and Technology Solutions

4.1 As outlined above, the application of technology will afford new entrants the opportunity to build up a foot print within the retail banking market. This increase in competition will have resulting benefits for customers (both individuals and SMEs) and will have the effect of diversifying the risk that is posed to an economy that has been overly reliant upon a small number of large banks.

4.2 Intellect believes that there are a number of competition challenges that policy-makers will have to deal with over the coming months. However, more often than not there is a technology solution that can complement or even reduce the need for regulatory activity. Some of these challenges and solutions are set out below:

Customer inertia

4.3 Both the Office of Fair Trading and HM Treasury have identified customer inertia as a key barrier to competition within the retail banking industry. As noted in HM Treasury's Reforming Financial Markets consultation paper of 2009, both the reality and the perception of the difficulty of switching bank accounts increase customer inertia. Nearly two-thirds of people have held their current account for more than 10 years and 60% of people are still using the first current account that they ever opened (HM Treasury).

4.3.1 In the banking sector especially, customer inertia represents a significant challenge not only to potential new entrants, but to any provider of financial services that is looking to expand their customer base. If banking providers are aware that customers are more inclined to stay with them than leave, then there is less motivation to ensure that its customers are its number one priority. However, there are a number of technology-based means to reduce customer inertia:

Individual, portable bank account numbers

4.3.2 Intellect believes that by creating a bank account number that is specific to the individual rather than the bank and that could also be transferred from one bank to another, market stagnation that results from customer inertia will be alleviated to a significant degree and competition within the banking sector will be enhanced (with knock on benefits for the availability of capital for SMEs and individuals—through greater choice). There has been significant regulatory focus in recent years on the porting of individual phone numbers as a means to increase competition in the mobile phone industry and from April 2011, mobile phone customers will be able to transfer their existing number to a new provider in just one working day rather than the current two days. That switching of bank accounts takes a matter of weeks, not days and is a significant barrier to competition suggests that this should be a priority issue for Government.

"3 Cs" technology-facilitated products

4.3.3 By using technology to provide banking products and services of convenience to their customers, such as mobile payments, online banking and use of social media, financial services providers will challenge customer inertia in some sectors of the market where "digitally native" consumers look for banking services that encompass the "3 Cs"—Customer Focused; Convenient and Converged. The development of these products will ideally be demand-led. Those banking providers that are able to accurately anaylse customer sentiment and quickly develop technology-enabled products that cater for a relevant market sector will find that they are in a good position to increase their market share. The challenge for established banks (as outlined below) is that their legacy IT systems, which are comprised of layer upon layer of IT platforms that have been built upon over many years, do not easily allow new systems for new products to be easily added without significant disruption to existing services. New entrants will find that because of their "technological blank slate" they are more agile when it comes to rolling out innovative technology-led services for their customers.

Flexible and efficient payment systems

4.3.4 The main objectives for new entrants into the banking sector will be simplification, quality of service and lowering costs. It is anticipated that new entrants, because of their technological blank slate, will drive towards integrated systems that can handle payments from any channel, whether consumer or corporate, from start to finish—with no redundancy of technology or duplication of processes and labour. This type of integration will enable financial institutions to manage transactions quickly and effectively, with less need for manual intervention and costly interfaces between different systems. Crucially, it will allow these new entrants to consider all payment forms—from smart phone applications to contactless payments—based on customer demand. This will be tied in with the likelihood that new entrants will turn away from large traditional back office IT departments which require an initial high outlay of capital, to outsourced IT operations that can expand as the new entrant expands. Increased use of Software as a Service (SaaS) and cloud computing, provided by IT outsourcers directly to new lenders, will mean that their services are scalable, easily updatable and importantly, new entrants will only pay for what they use. In the short to medium term this will represent significant cost savings as new entrants will be able to "rent" the services they require without any upfront capital costs.

Costs of compliance and capital requirements

4.4 With such a wide ranging raft of regulation on the horizon, all of which requiring changes of varying cost to individual financial services providers' internal systems, coupled with the huge cost that capital reforms (Basel III) will have across the industry, the drain on resources is going to be acute over the coming months and years. Such high costs, in addition to the costs of setting up a bank, will act as a deterrent to entry to potential new entrants to the retail banking market.

4.4.1 It is therefore critical that if new entrants are to be encouraged to participate in the retail banking market, that they are not over burdened with compliance costs for regulation whose objectives could be achieved through other means. Lessons can be learned from recent regulation which, in some cases, is still being implemented. The estimated costs of changes to the IT infrastructure of deposit takers to implement the Financial Services Compensation Scheme's Single Customer View (SCV) initiative—circa £1 billion—is huge.

Although Intellect welcomes technology investment by financial institutions, there is a question whether the requirements of the FSCS's SCV could have been met by the commercially focused SCV that many banks were already working towards, with a reduction in associated compliance costs. New entrants, if they are to comply with this specific legislation and develop a means to better identify their individual customers, will therefore have to pay to implement two versions of a Single Customer View.

4.4.2 Whilst Intellect fully supports regulatory efforts to improve the stability, transparency and performance of the financial services industry, we believe **there is a responsibility for regulators and industry to take a broader view of how proposed policy/regulation is going to be implemented in reality—especially with regard to likely impact that changes will have upon financial service providers' IT systems**. This should be undertaken at an early stage to avoid unnecessarily expensive or time-consuming changes that could further add to the start-up costs for potential new entrants, and indeed reduce disruption to existing institutions, the market and customers. A means to achieve this could be through an adaption of Intellect's Government-supported Concept Viability scheme.

Inability of established banks to exit specific markets

4.5 One of the major obstacles to competition in the banking sector stems from a specific barrier to exit—large incumbent banks offering products and services that are loss leaders, but whom are unable/unwilling to exit the market for these products and consequently allow other actors to enter and expand.

4.5.1 As banks on the most part do not employ detailed analytics that can offer information on product profitability they are, in many cases, unable to determine which products to discontinue and which to actively promote. Amongst other reasons, products may be failing because they do not reflect the needs of customers or that they may not be targeted at the right sectors of the market. However, the real issue is that a market awash with similar products combined with a public that is, generally speaking, more inclined to take up products from their incumbent banking provider than shop around (regardless of whether or not these products are the best fit for them), makes it hard for new entrants to compete on a level playing field and gain a foothold in the banking market. If banks can be encouraged to identify their unprofitable products, it would be better for them, the wider market and the consumer.

4.5.2 Where products have been removed from a market, there has not been enough importance attached to learning how and why these projects failed. By establishing what could be done better, there is an opportunity to ensure that new entrants to the retail banking market can offer technology-facilitated banking products and services with a reduced chance of them failing. Product failure at an early stage of a new entrants' existence could also have significant negative consequences on its reputation, its resources and its ability to gain a foothold in the retail banking market.

4.5.3 Intellect believes that there could be a role for regulators to ask banking providers for their views on why particular projects did not succeed so that the wider market, and indeed the consumer, can benefit from this hindsight. Similarly, for the sake of greater competition and efficiency, Intellect believes that **retail banks should be encouraged to actively evaluate the performance of their products in this sector. State-owned retail banks should, in the interests of reducing costs, be compelled to do so**. In both instances, a short term investment in appropriate analytics software would be required, but the longer term savings made from leaving unprofitable markets and greater insight on how to target more profitable products would justify this expenditure many times over.

Legacy systems

4.6 In the instance that an unprofitable product is identified, it is often difficult for banks to remove them from the market because of the effect that doing so would have upon their interdependent legacy IT systems. These legacy systems, the multiple layers of IT platforms within banks that have been built upon over many years, are at the heart of established financial service providers' operations. They are business critical, intertwined with other elements of a bank's IT infrastructure and are often running 24 hours a day. Adding new elements or removing them from these legacy systems (ie to remove IT systems that facilitate specific banking products or services) is a very complex and expensive process that will impact upon a multitude of different aspects of the bank's operations. In many cases it is not in the broader interests of a bank to remove a product from the market because of the costs and the disturbance to core systems that unwinding these un-needed systems would incur.

4.6.1 A lack of information about the performance of specific products can be addressed more easily than the issue of IT legacy systems. For this very reason Intellect believes that **regulators should do more to understand the impact that legacy systems have upon banks' abilities to provide high standards of customer service and remove loss-making products from the market.** Incentives, such as capital tax breaks, could be made for banks to replace their ageing legacy systems and allow them to become more efficient and customer friendly. For state-owned banks, a reduction in the repayment of public debt could be made in the immediate term so that investment could be made in banks' IT systems. This would allow a quicker repayment of public money in the medium term as the banks become more efficient and more commercially viable.

4.6.2 However, as outlined above, where legacy IT systems reduce established banks' abilities to innovate, their existence does provide a significant opportunity for new entrants to the retail banking market to establish a foothold. Every year, banks invest hundreds of millions of pounds in new technology, yet it can take years before a new product reaches the consumer. New entrants without these legacy systems hold a distinct advantage as they are able to adapt quickly to changing customer demands or the availability of new technology.

FSA licensing regime—auditing of ICT suppliers

4.7 Intellect fully supports the "litmus-testing" of organisations wanting to enter or expand their provision of banking services and the protection of the customer (and of the wider economy) is of paramount importance.

4.7.1 However, Intellect does believe that there should be a balance between transparent and appropriate auditing of suppliers to potential entrants in the retail banking market, and unnecessary and costly oversight that prolongs the licensing process (extending "go to market" time for the entrant) and which ultimately will itself act as a barrier to entry. The role that the Financial Services Authority (FSA) currently plays, whilst necessary, should be evaluated and refined where appropriate (especially if this role is passed on to a new prudential regulator within the Bank of England) to ensure that it does not suffer from "mission-creep". A specific issue is the FSA's "adopted" role of scrutinising the contractual relationships between the market entrant and its service suppliers—especially ICT suppliers that supply its systems and infrastructure. This could potentially cause a barrier to entry as the FSA does not have the necessary level of technical expertise to adjudge what ICT technology is appropriate, what represents a satisfactory level of risk and what is in the consumers' best interests with regards to ICT provision. A solution to this would be the **development within the FSA (and its successor) of a greater level of technology-based knowledge amongst relevant staff.** Intellect provides an ideal source of neutral expertise for policy makers and regulators to tap into, representing the aggregated expertise of the companies that provide the platforms which underpin much of the financial services industry.

4.7.2 This prolonged time frame, as a result of increased FSA scrutiny, could also have the effect of discouraging smaller ICT providers from forming commercial relationships with prospective and new entrants to the retail banking sector. It is simply not as profitable for smaller ICT providers to be involved in such projects as it would be for them to be involved in other, less scrutinised markets. If it is taken that innovative IT-enabled customer services and infrastructure are important to new entrants' entry and expansion in order to differentiate themselves from incumbents a reduced field of suppliers to choose from will harm this ability. The public sector has, in recent years, seen a similar problem where smaller, innovative suppliers were discouraged from tendering for government contracts because of the costs of embarking on a time consuming and administration-heavy process. There is a danger that through increased regulatory scrutiny of ICT suppliers, the financial services industry could be sleep-walking into a similar situation.

5. The Acquisition of SME Customers—An Untapped Market for New Entrants?

5.1 Intellect acknowledges that the limited availability of capital for SMEs from banks is a separate (but related), ongoing concern for Government at the current time. However, it is also the case that by addressing this issue, a side benefit could be an increase of competition within the banking sector.

5.2 Financial services organisations generally have a good track record on information sharing. For example, the advent of increasing customer applications for credit, have heightened the industry's interest in information sharing. Furthermore, collaborative events to tackle financial crime have increased the speed in which information sharing can take place. However, these incidences typically relate to data sharing on individuals, a similar flow of information between institutions on potential SME customers is not nearly as developed. Generally,) larger incumbent banks have been guilty of viewing SMEs as one large group (or groups by sector & size), all posing the same level of risk regardless of their own specific business models, financial health etc. This has led to a reduction in the availability and cost of credit to SMEs—a lack of detailed information sharing on SMEs has led to risk-averse banks becoming even less likely to lend to SMEs, and the conditions that are attached to the loans that they are willing to make are often so high that they do not represent realistic options for SMEs.

5.3 Now, more than ever, it is critical that access to financial risk information is available to all operators in the financial services market. On a general level, higher levels of data interoperability can facilitate better credit flows between banks, ensure greater accuracy of data and consequently more informed decisions on lending can be made. **Technology has a crucial role in facilitating the flow of credit to individuals and SMEs in the UK, but has to be accompanied by a change in mindset within the banking community**—ie that SME's are an important source of business for the retail banking industry, and that the availability of credit will beget more business for banks that are willing (and able) to lend to them.

5.4 The challenge for smaller and new entrants to the retail banking sector is to expand their information base to gain as comprehensive a picture of their potential SME customers as possible. If the range and quality of information that can be gleaned can be increased, not just from potential customers but also from other financial institutions, smaller and newly established banks will be able to make more informed decisions about who they lend money to in the SME sector and, in theory, acquire more SME customers. In order to achieve this, data interoperability standards across the financial services ecosystem need to improve significantly.

5.5 Additionally, the issue of data accuracy is also applicable here. However effective the ability to share information might become, it can only be as useful as the accuracy of the information being shared. The greater the ability to make an accurate assessment of the credit worthiness of individual SMEs, the greater the ability of new or less-established entrants to attract more commercially-viable business from SMEs. This will lead to greater competition and choice in the banking sector, with a beneficial effect on the UK economy in the longer term.

Lack of a Single Customer View (SCV)

5.6 Competition in the retail banking sector will be restricted if new entrants are unable to form a SCV of their individual SME customers. As outlined above, a SCV is a longstanding commercial aim of the retail banking industry and will allow lenders to not only build up a detailed view of a customer's individual credit risk, but also to identify other services and products that can be sold to the customer. It is equally important to have a similar SCV of SME customers if a new entrant is seeking to grow its business. Generally, in the experience of Intellect's members, new entrants in the retail banking field do not have a common facility management system in place that can facilitate a single point of access to information about a specific SME customer. Consequently they are not as adept as more established operators at spotting risk, increasing processing efficiencies and generally providing customers with a more tailored customer service. This has a knock on effect on customer retention and growth of existing customer business.

5.6.1 The simple solution to this is that a common loan origination system should be in place for all new entrants to the retail banking sector. If better flows of information between banks on SMEs can be supplemented by better use of information within individual banks, it will have benefits for the banks themselves, SMEs and ultimately the economy.

6. Conclusions

6.1 Intellect believes that three is currently an opportunity to ensure that efforts to safeguard the future safety of the wider financial services sector also act as a catalyst for greater competition and benefit for consumers. As Intellect has looked to demonstrate in this submission, **technology must be the foundation upon which competition is enabled—as it is the foundation upon which the banking sector is already built and upon which it will continue to be developed.**

6.2 The aim for all parties must be to facilitate a retail banking market that encourages participation from new entrants, has unhindered opportunities for expansion and does not artificially block retirement from specific markets for banks or products that are commercially unsustainable.

6.3 Intellect would urge the Treasury Select Committee to recommend that the Government thinks laterally in its approach to competition in the banking sector (as new entrants to the retail banking market will be doing). It should consider:

— A greater focus on the fundamental technology platforms that the banking system is built upon, as a means to increase competition. The appropriate application of technology within the banking sector will go a long way to increasing competition and it should be considered alongside and, potentially, instead of some legislative remedies.

— A greater focus on increasing the quality of the analysis and flows of information, both within and between banks.

— Ensuring that financial services regulators and policy makers have a greater understanding of how technology impacts upon the functioning of the banking sector.

6.4 Those banking providers that are able to harness convenient, demand-led banking products, greater analysis/information and cost efficiencies that the application of technology can bring, will give themselves a greater chance of establishing themselves in this market. This is to the benefit of the consumer, the shareholder and, of course, UK plc.

September 2010

Written evidence submitted by the Consumer Financial Education Body

About CFEB

The Consumer Financial Education Body (CFEB) is an independent body, created in April 2010 as a result of the Financial Services Act 2010. Our mandate is to develop consumer financial education in the UK, as well as to enhance the public's understanding and knowledge of financial matters and their ability to manage their finances.

CFEB welcomes the opportunity to submit written evidence.

Summary of our Response

— The main point of interest in this inquiry for CFEB is "whether competition is inhibited by difficulties faced by customers in accessing information about products".

— There are barriers to accessing information and also barriers to acting on that information.

Barriers to accessing information

- — Product disclosure has limitations. CFEB is happy to work with industry and regulators to identify what works in adequately informing consumers of risks and benefits.
- — Transparency is important and desired by consumers. We welcome the Government's announcement around simple products.
- — Packaged accounts and different systems of overdraft charging create barriers to comparability and transparency of accounts.
- — Some consumers have very limited choice—such as undischarged bankrupts and people without conventional proof of identity.
- — Our impartial information and advice can help competition. Evidence from the Money Guidance Pathfinder shows people using the service to compare products and taking action afterwards.

Barriers to acting on information

- — There are several reasons why information and advice do not have a stronger influence in the market.
- — There are clear differences between types of consumer, not least in terms of their financial capability. People are less financially capable when they are going through major life events, such as unemployment and divorce.
- — Financial capability will have less impact in markets where consumers do not feel powerful and where competition is limited.
- — Evidence from Centre for Competition Policy and from the FSA provides some explanation for why switching of bank accounts is low, including confidence and the perceived time needed.
- — But the difference between banking and other markets is not fully explained. Behavioural science may have some explanations—we welcome research and ideas from firms and others about changing financial behaviour.
- — Remedies are needed on the demand and supply side, and at their interface. CFEB has a role on the demand side and we are exploring interventions, such as a Financial Health Check, at key financial decisions.

1. Introduction

1.1 This is a response to the Treasury Committee's call for evidence to inform its inquiry into competition and choice in the banking sector. A number of the issues the Committee is addressing in this inquiry can ultimately impact on consumers' ability to manage money, and it is clear that the financial crisis has affected competition and choice in retail and wholesale markets. For example, there is less scope and arguably less incentive to switch in a highly consolidated market. But the main point of interest in this inquiry for CFEB is "**whether competition is inhibited by difficulties faced by customers in accessing information about products**".

1.2 Our expertise is important to this inquiry because the way consumers use information about products is central to our statutory function. We were set up to enhance: public understanding and knowledge of financial matters; and the ability of members of the public to manage their own financial affairs. We consider that there are barriers to accessing information and also barriers to acting on that information. This submission considers each of those issues in turn.

2. Our Response

Barriers to accessing information

2.1 CFEB considers that there are barriers to accessing information, which can partly be addressed by a better process of providing information, and ensuring transparency.

2.2 The report by the Commission on the Future of Banking, as well as research by the FSA and others, note the limitations of product disclosure—both in its volume and the extent to which consumers engage with it, remember it accurately or recall seeing it at all.[28] Previous Treasury Select Committee inquiries have also made very helpful contributions to this debate. CFEB is happy to work with the Government, industry and regulators to discover what works best in terms of adequately informing consumers of the risks and benefits of a particular product or service.

2.3 Central to the purpose and effectiveness of disclosure is product transparency: the consumer should know what they are buying. Research for the Treasury's Retail Financial Services Forum found that transparent products with clearer labelling were desired by consumers.[29] The Government has announced its intention to

[28] For example, Future of Banking Commission, 2010 [commission.bnbb.org]; Disclosure in the Prime Mortgage Market, FSA 2009 [www.fsa.gov.uk/pubs/consumer-research/crpr82.pdf]; Warning: Too much information can harm, Better Regulation Executive and National Consumer Council 2007 [www.bis.gov.uk/files/file44588.pdf]

[29] "Simple transparent products" research paper, HM Treasury 2010 [www.hm-treasury.gov.uk/fin_retail_finservices_forum.htm]

consult on a new range of simple products, into which CFEB will seek to input. The sales process should also be transparent—one of the problems identified with the Payment Protection Insurance market was that many consumers did not know it was optional.[30]

2.4 Developments in the personal current account market have meant that products are not necessarily transparent, readily comparable or understandable. Firstly, increasingly available packaged accounts and other products tied to current accounts compete, by their nature, on a variety of features as well as price. The FSA has flagged that this may not be of benefit to all who use them.[31] Consumers should be encouraged to consider whether the extra features offered provide good value for money and, where insurance products are included, the cover they need. Secondly, it is well documented that overdraft charges are not consistently applied from firm to firm, which limits transparency and comparability.[32] Regardless of any developments in the market and regulation of overdrawn bank accounts, it is important that efforts are made to ensure consumers are able to understand and compare the costs they may face when borrowing in this way, and better able to compare the overall cost of different forms of credit.

2.5 The Committee should also give consideration to the limited choice available for some consumers. Current accounts increasingly have conditions attached, such as a minimum monthly deposit. The features of basic bank accounts vary significantly and, as highlighted by Citizens Advice in their recent report, *Called to Account*,[33] the choice available to groups such as undischarged bankrupts is very limited and not always clear. Those without conventional forms of proof of identity, such as homeless people and recent migrants, may also struggle to access a bank account and information about it. The outcome is that many people remain unbanked, with the individual and social costs that entails. Rural consumers may have little meaningful choice if they wish to use face-to-face banking—and the OFT found that branch location was the main reason for choosing a bank account.[34] An increasing number of accounts are only available online, which restricts choice for those without internet access.

Barriers to acting on information

2.6 As we have noted above, consumers do face difficulties in accessing clear information about products; but perhaps more important is their ability and motivation to act on that information.

2.7 Financially capable consumers can drive competition. Our definition of financial capability is made up of five domains: making ends meet, keeping track, planning ahead, choosing financial products and staying informed. Choosing products is clearly crucial, and the other domains are all relevant, to a consumer's ability to exercise choice and encourage competition.

2.8 We believe CFEB's impartial information and advice can help competition—shopping around for the best deal and comparing products are among the main activities we help people do. In the Money Guidance Pathfinder,[35] users were helped to gather information on and compare products in 30% of face-to-face and 47% of telephone sessions. Evaluation found that 21% of users had applied for, bought or changed a product within two months of a session. The Moneymadeclear website contains information on bank accounts, including packaged accounts, and our comparison tables can be used as a tool to inform switching.[36] In future, CFEB aims to make it easier for users to make informed decisions about products.

2.9 However, there are several reasons why information and advice do not currently have a stronger influence on consumer behaviour in the market. It is worth acknowledging that consumers are not one homogenous group. There are clear differences between types of consumer, not least in terms of their financial capability. Our research shows that people are less financially capable when they are going through major life events, such as unemployment and divorce, both of which tend to increase in an economic downturn.[37] This is likely to impact on their ability and inclination to exercise choice.

2.10 In markets where consumers do not feel powerful, the impact of financial capability will be limited. In sectors that are not competitive, due to consolidation for example, even active consumers may benefit less from switching and are therefore less likely to be able to drive competition.

2.11 Research by the Centre for Competition Policy shows that active consumers are more likely to switch bank accounts: the best predictor of whether someone will switch is whether they have switched in another market. A person's confidence in predicting gains and costs was a better predictor than what they estimated

[30] See, for example, The sale of PPI—results of thematic follow-up work, FSA 2006 [www.fsa.gov.uk/pubs/other/ppi_thematic.pdf]

[31] Financial Risk Outlook, FSA 2010 [www.fsa.gov.uk/Pages/Library/corporate/Outlook/fro_2010.shtml]

[32] See, for example, Personal Current Accounts in the UK—an OFT market study, OFT 2008 [www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf]; Which? magazine September 2010

[33] Called to Account, Citizens Advice 2010 [www.citizensadvice.org.uk/called_to_account]

[34] OFT ibid.

[35] The Money Guidance Pathfinder provided information and guidance by telephone, face-to-face and online. Money Guidance Pathfinder evaluation, CFEB 2010 [www.cfebuk.org.uk/pdfs/20100709_pathfinder.pdf]

[36] See www.moneymadeclear.org.uk.

[37] The impact of life events on financial capability: evidence from the BHPS [www.fsa.gov.uk/pubs/consumer-research/crpr79.pdf]

those gains or costs to be. Consumers thought it would take much longer to search and to switch bank accounts than other contracts. But even allowing for consumer characteristics, experience and expectations, there was an effect that meant that switching was lower in the current account market[38]. This warrants further research and the CCP are following up this study. This suggests that increasing knowledge and confidence is an appropriate remedy but will not be the whole solution.

2.12 An omnibus survey of 2,000 adults in Britain conducted on behalf of the FSA in January 2010 found that people with only a bank account were less likely to have switched or considered switching in the last year. Across all product holdings, most consumers who considered switching in the past year did actually switch; and the reasons given by those who switched were very closely matched to the reasons given by those who only considered switching. These reasons were predominantly financial: dissatisfaction was not the main driver of switching.[39] More research would be welcome into the reasons people do not shop around when they are dissatisfied.

2.13 Behavioural science has some theories to explain the low levels of switching in the current account market.[40] We welcome the Government's commitment to make use of behavioural economics and agree it is relevant to financial services. CFEB recently published *Transforming financial behaviour*, which identifies drivers for changing consumer behaviour and ways these could be harnessed to improve financial capability.[41] The report seeks the views and experiences of others in using behavioural strategies and we would welcome the contribution of retail firms and others to help inform our work.

2.14 To increase the number of financially capable consumers who are able to exercise choice effectively, a range of remedies will be needed on the demand and supply sides and at their interface. On the demand side, CFEB is striving to enhance the public's understanding and their ability to manage money. We are exploring interventions such as the Financial Health Check at key financial decisions.

September 2010

Written evidence submitted by the Payments Council

1. Introduction

1.1 The Payments Council is pleased to have the opportunity to submit written evidence to the Treasury Committee's inquiry into *Competition and Choice in the Banking Sector*. We recognise the importance of payments in access to retail banking and so have focussed our response on this aspect of the banking sector.

1.2 The Payments Council is the organisation that sets strategy for UK payments. It was established in March 2007 to ensure that UK payment systems and services meet the needs of users, payment services providers and the wider economy. Whilst the Council is funded by its membership, which consists of banks and other bodies that provide payment services, the Board does have an Independent Chair and four Independent Directors who represent consumer and business interests. These Independent Directors, whilst in a numerical minority, can collectively veto any decision of the Board. The Council also operates several User Forums to enable better understanding of user requirements of the payment system over a wide range of subjects.

1.3 The Payments Council has three core objectives:

- to have a strategic vision for payments and lead the future development of cooperative payment services in the UK;
- to ensure that the payment system is open, accountable and transparent; and
- to ensure the operational efficiency, effectiveness and integrity of payment services in the UK.

1.4 The Payments Council works closely with its contracted schemes, for the benefit of the UK payments industry. These include:

- Bacs Payment Schemes Limited;
- CHAPS Clearing Company (covering two schemes: the CHAPS Sterling and Faster Payments);
- LINK ATM Scheme;
- Cheque & Credit Clearing Company Limited;
- Belfast Bankers' Clearing Company Limited; and
- UK Domestic Cheque Guarantee Card Scheme.

38 Pain or gain: Does consumer activity reflect utility maximisation, Centre for Competition Policy, University of East Anglia 2008 [www.uea.ac.uk/polopoly_fs/1.104668!ccp08–15.pdf]

39 Consumer awareness of the FSA and financial regulation, FSA, to be published September 2010, copies available from the FSA on request.

40 The psychology of personal current accounts, OFT 2008 [http://www.oft.gov.uk/shared_oft/reports/financial_products/oft1005e.pdf]

41 Transforming Financial behaviour, CFEB 2010 [www.cfebuk.org.uk/pdfs/20100713_transforming_financial_behaviour.pdf]

The clearing schemes are run by their respective Boards which are responsible for setting the work of the schemes and their entry criteria. This response covers the contracted schemes, with the exception of the UK Domestic Cheque Guarantee Card Scheme as it has been agreed this scheme will close on 30 June 2011.

2. Access To Payment Systems

2.1 We believe that the entry criteria set by the clearing schemes are reasonable and proportionate. It is a vital balance to get right, given their economic importance, between enabling sufficient access to schemes to create competition amongst players and ensuring that the criteria are robust and can withstand changing economic environments. As systemically important infrastructure, it is critical that payment systems are not made unstable by the failure (financial or technical) of a scheme member. Therefore, any criteria that restrict or inhibit access to the clearing schemes are only in place to the extent that is necessary to protect the systems against specific risks, or to protect the financial and operational stability of the system. As a case in point, it is important to note that the payment systems worked very well during the extreme market convulsions in late 2008.

2.2 The Payments Council has seen no evidence to suggest that the entry criteria for the clearing schemes impede competition and it is in fact the policy of both the Council and the schemes themselves to encourage new Members. The schemes aim to be as transparent as possible and ensure that information regarding membership is available in the public domain on their websites and that firms are encouraged to make enquiries about potential membership.

2.3 The schemes do not cover agency bank relationships with clearing Members but we have no reason to consider that these are causing problems. The ratio of agency arrangements to scheme Membership suggests that the agency market is competitive and thriving. If there were issues, we would expect to be made aware of any problems via applications to become direct Members, complaints about the rules of scheme Membership and wider market comment.

2.4 Over the last five years there have been 12 applications for membership across the schemes, all of which have been successful. Two of these new Members are expected on stream during the later part of 2010. Additionally, Faster Payments has received two applications for Direct Agency status, which are currently under consideration. When the technical specifications for the Faster Payments Service were drawn up, a variety of ways of accessing the service were designed so that payment institutions and others which did not want to become full members could still use the service by different routes such as direct agency access.

3. Raising Consumer Awareness About Choice

3.1 The Payments Council pushes an agenda of transparency so that customers have the necessary information to make an informed choice about their providers. With the roll-out of the Faster Payments Service, we have published information on our website concerning Member status on the scheme—including which banks are operating in the scheme and what their individual limits are for single immediate payments and for standing orders. We believe it is important that consumers have the ability to chose their provider if speed of payments is important to them.

3.2 As part of our transparency agenda, we also operate a sort code checker on the UK Payments website that allows consumers to check whether their account (or an account they are sending money to) can receive various payment types or be eligible for having a Direct Debit instruction set up on it.

3.3 Whilst this work is important for informing consumers, we also see it as having a vital function in pushing our members to offer the best choice and service to their customers.

September 2010

Written evidence submitted by the Yorkshire Building Society

Executive Summary

- Building societies make a crucial contribution to the competition, diversity and strength of the UK's retail financial services sector. Yorkshire Building Society (YBS), as a mutual, is able to offer competitive rates on savings and mortgages because it does not have to maximise returns to shareholders. YBS believes that, provided they are able to compete on fair and level terms, building societies can further enhance the level of competition in the financial services market.
- YBS believes that, in investigating competition and choice in the banking sector, the Treasury Committee may wish to scrutinise (a) the distortions that injecting public funding into plcs has created in the market, and (b) how current and proposed regulation of financial services is a significant and growing barrier to fostering competition, choice and innovation in the sector.

— YBS has welcomed the Government's stated intention to "foster diversity in financial services, promote mutuals and create a more competitive banking industry"[42] and is encouraged by the Chancellor's recent statement that "building societies and mutuals have an important role to play in the future". YBS looks forward to seeing how this stated intention to promote mutuals is translated into action.

— One of the biggest priorities for YBS is to ensure that current and future regulatory requirements appropriately reflect the mutual model. A number of new and proposed regulatory requirements have been created or implemented. These new and proposed regulations have tended to favour large legacy institutions, with additional prudential regulation typically representing a disproportionate cost to small firms. In addition, we believe that little account has been taken of organisational entity in terms of regulating the financial services industry.

— YBS therefore believes that the Government should commit to alter the terms and approach of regulatory and supervisory authorities, including the FSA and its successor bodies. This would include appropriate and proportionate treatment of mutuals in respect of capital and liquidity requirements, and other key regulatory issues such as the funding model for the Financial Services Compensation Scheme. In particular, the financial mutual sector needs access to a mutual capital instrument.

1. Introduction

1.1 Yorkshire Building Society (YBS) welcomes the opportunity to contribute to the Committee's important and timely inquiry into competition and choice in the banking sector. YBS, which also incorporates the Chelsea and Barnsley building societies, is the second largest building society in the UK, with a strong belief in, and commitment to, the mutual ethos. With total assets of £30 billion, the Society holds £23 billion in residential mortgages and £23 billion in members' savings from 2.8 million members, and employs approximately 3,000 staff in a network of 178 branches and 77 agencies located across the UK.

1.2 The Yorkshire's geographical reach creates a business that is big enough to compete, yet small enough to care. Its commitment to the communities it serves is reflected in its retention of branches in areas where many other lenders have withdrawn. Over the last few years YBS has experienced a growing high street presence, at a time when many others have been reducing theirs. Our approach to mergers (see also paragraph 2.5 and 3.1) is predicated on the creation of a strong organisational centre balanced by the retention of local names, brands, character and presence in and understanding of the local communities from which we derive our strength and sense of identity and purpose.

1.3 YBS views its approach to financial stability and strength as being a direct consequence of its mutuality and the governance arrangements this entails. Strong capital and liquidity positions ensure the Society and its constituent brands are well funded. Although not untouched by the financial crisis, YBS's financial resilience enabled it to emerge from this period of instability in much better shape than many quoted banks, without having recourse to taxpayer support. Moreover, the mutual sector as a whole, through consolidation, has largely protected the sector's own strength and, in turn, enhanced the stability, vigour and diversity of the wider UK retail financial services market and supported its recovery.

1.4 YBS continues to work hard to maximise opportunities for its members to contribute to the effective running of the Society and in order to develop and sustain over time a robust mutual governance model. This accountability structure is a key differentiator between the mutual model and that of the plc. Member forums, a members panel and member "question time" meetings also play their part, as part of a coherent and self-iterating programme of member engagement, in ensuring that the Society's leadership team remain continuously accountable (with votes on key issues, for example, remuneration), take decisions for the longer-term, and act with the interest of members at heart. The long-term, sustainable approach to lending that YBS has maintained in the past decade and more has allowed the Society to retain a strong financial position during and after the financial crisis.

1.5 This submission seeks to address important issues in relation to competition and choice in the banking sector, including:

— The distortions that injecting public funding into plcs has created in the market for competitors which do not have the benefit of the implicit guarantee that State support entails.

— Throughout the period of financial crisis and following it, building societies retained a higher level of consumer confidence than plcs. This is reflected in regularly measured levels of customer satisfaction[43].

— How current and proposed regulation of financial services is a significant and growing barrier to competition to the sector. How regulation disadvantages building societies by failing to take into account comparative organisational structures on issues such as capital and liquidity requirements.

[42] The Coalition: our programme for government, page 9
[43] see Building Societies Association report "*Customer service at mutuals is better than at banks*" (March 2010)

— Specific proposals on how to ensure the future stability and growth of the mutual sector in a way which creates a level playing field with the banking sector, something which YBS does not believe currently exists.

2. The Impact of the Financial Crisis on Competition and Choice

2.1 An immediate consequence of the financial crisis of 2008 was, for mutuals and quoted banks alike, a substantial tightening in credit available to consumers. YBS, in common with other building societies, was less badly affected than the retail banks—most notably the nationalised and part nationalised banks—and has been able to continue to offer a wide and well balanced range of competitively priced products which continue to top "best buy" product league tables[44].

2.2 But, whereas the retail banks benefited handsomely from taxpayer support (variously including the Bank Recapitalisation Programme, the Asset Protection Scheme (APS) and the Credit Guarantee Scheme), these initiatives, although ostensibly accessible on fair and level terms by the building society sector, were largely unavailable to most mutuals to draw down upon.

2.3 YBS was in a position to utilise the Credit Guarantee Scheme (CGS), which was for it a potentially suitable vehicle. Although in principle the scheme was the perfect vehicle to strengthen depositors' and broader market confidence in the mutual sector, in practice, it was much less accessible to the mutual sector than to banks, when the need arose, because many building societies were too small to issue debt securities which this initiative sought to underwrite with State support.

2.4 Although YBS did not require the type of support that other, more short-term, shareholder-focused financial entities did, counter-intuitively, those retail deposit taking institutions that took State aid came to be seen by many as enjoying a special status as "too big to fail" which enhanced the perception of their attractiveness in the eyes of actual and prospective depositors. Consumer inertia to switching means this remains a legacy of the period of instability. YBS believes that this situation could be exacerbated as the Special Liquidity Scheme is withdrawn.

2.5 Nonetheless, the building society sector in general, and YBS in particular, has played its part in reinforcing the stability of the mutual sector, and the continuance of a diverse and more robust financial services sector, through a process of defensive consolidations: YBS merged with the business of the Barnsley Building Society in December 2008 and merged with the Chelsea Building Society in April 2010. It is important to note that this strengthening of the building society sector was achieved at nil cost to the taxpayer.

2.6 So far as consumers were concerned, the market in mortgages saw a reduction of products from 27,105 in April 2007 to just 2,516 products in January 2010, according to Money Supermarket. Today, although lending criteria remain strict, that figure has risen to 2,990, and among the best mortgage products are to be sourced from the building society sector.

3. The Impact of Widespread Consolidation among Banks and Mutuals

3.1 In the course of the past two years, YBS has merged with other building societies (see paragraph 2.5 above). The circumstances and rationale for each transaction were different, but both building societies share YBS's commitment to mutuality and the values which go with this.

3.2 The financial services market has changed fundamentally in recent years, and scale is increasingly important for the efficient operation of building societies and access to funding markets. However, while remaining big enough to compete, YBS is small enough to care about its customers and the communities it serves. In addition, YBS strongly believes that its retention of the three separate brands of "Yorkshire", "Barnsley" and "Chelsea", with their own high street presence and product sets, competing with each other and other providers in the sector, sustains strong competition, while helping to ensure the longer-term strength of the mutual sector in the utility retail financial services.

3.3 In YBS's view, the system protects and in fact entrenches incumbency; militates against dynamic competition in the marketplace; and, most crucially, denies consumers real choice; and, structurally and behaviourally, obviates the switching between brands and products that, in a truly competitive banking sector, this would predicate.

3.4 New regulation to support financial stability, as well as enhanced capital and liquidity requirements, have collectively had the perverse effect of further entrenching the position of the large quoted banks, a number of which are supported by substantial taxpayer support. This has further protected their positions and, in inverse proportions, enhanced the disparity between the competitive positioning of banks and mutuals to high street consumers. As the BSA has noted, in 2009, the Lloyds Banking Group had a 24% share of new mortgage lending and 28% of the increase in deposits; Santander took about an 18% share of new lending and 23% of the increase in retails deposits.

3.5 Existing regulators can easily give the impression that they find it easiest to deal with large deposit-taking institutions, based on a plc model. This has the effect of further legitimising the plc model in preference

[44] In 2009, YBS received 1,130 best buy mentions. 2010 (between January and July) YBS has received 1,351 best buy mentions (this excludes Chelsea Building Society between January and March 2010)

to the mutual one, in spite of the fact that, as we explain elsewhere in this memorandum, and as the coalition Government has made clear, mutuality has a key role to play in delivering choice, competition, value, innovation and, therefore, enhanced financial stability. Mutuals, which stick to utility banking, have played their part in ensuring the continuance of diversity and vigour in the mutual sector. YBS has, through its merger with the Barnsley and Chelsea, strengthened all these businesses, as well as provided reassurance to their depositors, members and staff.

3.6 It is worth remembering none of the building societies which went down the path of demutualisation have succeeded in remaining independent entities.

4. The Key Barriers to Entry Inhibiting Increased Competition—Including Regulation

4.1 Building societies make a crucial contribution to the competition and diversity of the retail financial services market. YBS is, as a mutual, able to offer competitive rates on savings and mortgages as it does not pay dividends to shareholders. YBS believes that, provided they are given a level playing field, building societies can further enhance the level of competition in the sector, in the interests of consumers.

4.2 YBS believes that regulation is a significant and growing barrier to competition in the sector. A number of new and proposed regulatory requirements (such as capital and liquidity requirements, the Mortgage Market Review, changes to the Financial Services Compensation Scheme) have been created or implemented. While the intention to further stabilise the system is welcome, there needs to be greater recognition and understanding of the cumulative effects of all these regulatory changes on market competition.

4.3 These new and proposed regulations have tended to favour large incumbent organisations, protecting them from competition, with additional prudential regulation typically representing a greater proportionate cost to small firms. In addition, we believe that little account has been taken of organisational structure in term of regulating the financial services industry.

5. Explore the Government and Competition Authorities' Strategy to Increase Competition in Banking, Including the Likelihood that New Entrants will Successfully Enter the Market

5.1 YBS has welcomed the Government's stated intention in the Coalition Agreement to "bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry"[45]. YBS has also been encouraged by a recent statement from the Chancellor that "building societies and mutuals have an important role to play in the future" and the Government wants to "strengthen them and support those who want to create mutuals".[46] YBS looks forward to seeing how this stated intention to promote mutuals is translated into action, and believes that the mutual sector could benefit from and support new entry.

5.2 But YBS believes that more emphasis should be placed on strengthening existing financial mutuals to ensure that they compete vigorously, sustainably and effectively with plcs. That provides the shortest route to enhancing the competitive dynamic in the retail financial services market. That means providing mutuals with a non-publicly funded vehicle that enables them to draw down upon fresh capital, recognising that their organisational structure inhibits their ability to inject capital from the markets in the same way as quoted banks. In YBS's view, the only credible way to achieve this highly desirable public policy outcome is to provide mutuals with a capital instrument to capacity build within the existing mutual sector and, in this way, drive choice and competition in the interests of consumers, rather than shareholders (see also paragraph 5.5 below).

5.3 One of the biggest priorities for YBS is to ensure that current and future regulatory requirements appropriately reflect the mutual model. We believe, for example, that the Financial Services Authority (FSA) has not, to date, taken organisational structure into account when regulating the financial services industry and has failed to cater adequately for building societies both in its regulation of the UK market and in its European and international negotiations. We believe that the mutual sector should be treated as a sector in its own right and not be treated in the same way as plcs.

5.4 YBS therefore believes that the Government should commit to alter the terms and approach of regulatory and supervisory authorities, including the FSA and its successor bodies. YBS proposes the following:

— An appropriate treatment of mutuals with regards to the Capital Requirements Directive in order to ensure a capital instrument consistent with mutuality. The definition of core capital needs to be consistent with mutual ownership if it is not to disadvantage mutual firms.

[45] The Coalition: our programme for government, page 9
[46] Hansard, 16 June 2010

— A review of the current funding model for the Financial Services Compensation Scheme (FSCS), where allocation does not reflect risk and the burden falls disproportionately on building societies. New arrangements are needed that more accurately reflect the relative risks faced by banks and building societies. In particular, the way in which building society regulation has developed over time has created an anomalous position in which the FSCS—and, therefore, the depositor protection threshold of £50,000—applies to the consolidated group of businesses within a mutual, whereas for a plc with banking licences per brand, the consumer protection is multiplied by the number of banking licences it possesses. This could sustain an existing behavioural incentive for understandably risk-averse depositors to see banks rather than mutuals as the best home for their savings.

— The European Commission has proposed that deposit protection cover should increase to EUR 100,000 per individual from 31 December 2010. At this time coverage will also be limited to each deposit taker and the temporary arrangement for dual cover for merged building societies will end. As building society legislation makes it far more difficult for the operating of subsidiaries, this potentially places building societies at a disadvantage to plcs, which do not operate under such restrictions and can therefore continue to benefit from dual protection. We fully accept that if dual protection received a dual levy that would be appropriate and fair.

5.5 These changes can be implemented without cost to the taxpayer.

6. Conclusion

6.1 YBS has been pleased to offer these thoughts to the Committee which it trusts the Committee will find helpful. YBS would be delighted to have the opportunity to expand on its views and ideas, in oral evidence, if the Committee would find this useful.

September 2010

Written evidence submitted by the Paragon Group of Companies

Introduction

1. The Paragon Group of Companies welcomes the opportunity to submit evidence to the Treasury Select Committee's current inquiry into competition and choice in the banking sector.

2. We are the UK's leading specialist provider of residential mortgages to professional and investor landlords. We launched our first specifically targeted private rented sector mortgages in 1995 and have increasingly specialised in this market over the last 15 years.

3. The company has been publicly-listed for the last 25 years and is currently the UK's third largest lender of privately rented residential property finance. We have approximately 40,000 landlord customers and manage £10 billion of loan assets. Our buy-to-let arrears, at 0.97%, currently stand at less than half of those typically achieved in the owner-occupier market.

4. As a non-deposit taking lender, Paragon has extensive experience in the securitisation markets. We were the first to undertake a securitisation in the UK almost 25 years ago and we have successfully completed more transactions than any other market participant, all of which have been straightforward, transparent and low-risk.

Executive Summary

5. The key points of our submission are as follows:

— Non-deposit taking lenders utilising securitisation were the mainstay of many of the more specialised parts of the UK mortgage market prior to the credit crunch, providing vital competition to the major banks and an important source of choice for consumers.

— Securitisation played a vital role in the UK mortgage market more generally, accounting for 80% of the net funding needs of the mortgage industry in the 12 months before the credit crunch.

— Fundamental problems in the US housing market—not the securitisation model itself—contaminated the global wholesale funding process and caused the liquidity issues that still persist today.

— Non-deposit taking institutions, such as Paragon, that draw primarily on securitisations to fund new lending have been impacted negatively by the impairment of credit markets. Despite remaining profitable, our ability to make new advances has been severely constrained.

— Government and Bank of England support packages have to date been skewed in favour of the mainstream banking sector. Non-deposit takers have been excluded, placing them at a significant competitive disadvantage.

— Competition in some lending markets has been eradicated by the lack of wholesale funding availability, with many of the major banks not engaging in sectors traditionally served by non-deposit takers.

— In the case of the buy-to-let market this has serious social consequences—a shortage of funding for private rented homes is emerging at a time when people are increasingly unwilling or unable to enter the owner-occupier market and the social housing sector is already at full capacity.

— Ensuring that credit flows are sustained and that competition in lending markets is increased will be crucial to the recovery of the British economy and, within the housing sector, to a stable and growing private rented sector. Reinvigorating securitisation markets lies at the heart of this.

— We welcome the Government's focus on reviving securitisation and would urge HM Treasury and BIS to look at ways of improving non-banks' access to warehouse funding—a key element of securitisation that remains highly challenging and is limiting the recovery of wholesale-based lending

The Importance of Securitisation to Competition

6. The main business model utilised by non-deposit taking lenders involves the aggregation of mortgages into a warehouse facility, with funding provided by banks until public securitisation allows debt to be raised through the issuance of bonds. Lenders whose business is based on this model rely on securitisation for long term funding and have been the mainstay of many of the more specialised parts of the UK mortgage market. Securitisation has therefore played a vital role in the UK mortgage market. In the twelve months prior to the credit crunch, 80% of the net funding needs of the UK mortgage industry were provided by the capital markets through securitisation.

7. As a result, the non-deposit taking sector, funded in the main by the securitisation markets, provided a vital source of competition for mainstream banks in the mortgage market in advance of the credit crunch. This helped to drive product innovation and a diversity of finance for consumers in a stable way, and without any of the risk associated with many mainstream banking practices in recent years. It has been more fundamental problems in the US housing market that have contaminated the global wholesale funding process and resulted in the liquidity issues that still persist today.

8. The example of Paragon demonstrates how securitisation has been—and can in the future be—used responsibly. We pioneered the use of Asset-Backed Securities in the UK and have securitised £19.5 billion of first mortgages and consumer loans through 53 public transactions. All continue to perform well and we have no exposure to any toxic assets, having neither originated nor acquired such assets.

The Continuing Impact of the Credit Crunch

9. The impact of the credit crunch was particularly severe on the availability of funding from the capital markets for non-deposit taking institutions and as a result, such lenders have been unable to compete in the mortgage market since 2007. As a result, we are unable to secure the necessary warehouse funds on economic terms to originate new mortgages to private landlords. The wider non-deposit taking sector is in a similar position.

10. There have been some signs in recent months that the market for Residential Mortgage Backed Securities (RMBS) is improving. Investor appetite has increased across the credit spectrum and recent deals have attracted a large number and greater range of investors. However, the market remains fragile and requires nurturing and support.

The Current State of Competition

11. Competition in some lending markets has been eradicated by the lack of wholesale funding availability, with many of the major banks not engaging in sectors traditionally served by non-deposit takers. Bank of England figures show that specialist mortgage lenders accounted for just 3.7% of new mortgage lending in 2009 compared to 21% in 2007. Specialist lenders provide an important source of competition for mainstream lenders, ensuring product innovation and consumer choice.

12. The buy-to-let market is an example of a specialist lending sector that has been adversely impacted by the closure of the wholesale funding markets. The availability of buy-to-let mortgage products for landlords has declined by over 90% since 2007 due to the forced withdrawal of non-deposit taking lenders the focus of high street lenders on their mainstream residential mortgage businesses. The buy-to-let market is now dominated by just two lenders, Lloyds and Nationwide, which together account for approximately 80% of the UK's buy-to-let business and face little competition in this important part of the market.

13. The decimation of product availability in this particular market is not due to a lack of demand from investors or concerns about the credit quality of the product. Buy-to-let lending, when underwritten appropriately, is high-performing and reliable and arrears in the buy-to-let market have outperformed the wider market for 34 of the past 38 quarters. Paragon's arrears levels remain significantly below those of the wider mortgage industry and industry peers. We are also experiencing robust demand for new loans from our customers, but we are unable to satisfy this demand due to funding constraints.

14. Due to the dysfunction in capital markets, non-deposit taking institutions such as Paragon, which were core providers of finance for investment in the private rented sector before the credit crunch, have been unable

to extend loans to new landlord customers. This has potentially very serious social consequences that should not be overlooked, such as increased levels of homelessness.

15. Demand for private rented sector accommodation has expanded significantly in recent years due to a combination of short-term economic factors and longer-term structural changes, such as a growing population, increasing numbers of single person households, expanding numbers of students and economic migrants and the general housing shortage. Proposed changes to the financial regulator environment are also likely to reduce the availability of residential mortgages as the Financial Services Authority clamps down on interest-only and self-certified loans. There is increasing evidence of a shortage of properties and there will be upwards pressure on rents without new investment by private landlords. The Royal Institution of Chartered Surveyors reported in August that the proportion of surveyors reporting rent increases rather than falls was growing.

16. Market domination by two lenders—as is the case in the buy-to-let market at present—is both non-competitive and of detriment to private landlords and private tenants at a time of rising tenant demand. There continues to be little competition and choice for borrowers in this market.

Barriers to Entry Persist

17. Ensuring that credit flows reach consumers and businesses continues to be key to the recovery of the British economy. The securitisation market lies at the heart of this and its continued fragility is being felt on the wider market in the form of poor competition and choice for consumers.

18. Both the coalition government and the previous administration have recognised the importance of securitisation markets to the future of mortgage finance. The previous administration's Guarantee Scheme for Mortgage-Backed Securities provided some lending support, but excluded non-deposit takers, skewing the market in favour of mainstream banks and placing non-deposit taking lenders such as Paragon at a competitive disadvantage. Furthermore, the expiry of this facility has exacerbated the funding gap that currently exists in the market, which will get considerably larger as the Treasury and Bank of England's liquidity support schemes also expire over the next two years. The Council of Mortgage Lenders estimates that there will be a £300 billion mortgage funding shortfall over the next five years due to lenders having to repay Government support schemes.

19. We are encouraged by the acknowledgement of HM Treasury and the Department of Business, Innovation and Skills that securitisation is important as a funding source for banks and non-bank lenders alike in their recent joint consultation on "*Financing a private sector recovery*". Reinvigoration of the securitisation market is essential to future recovery as retail deposits alone were insufficient to support lending before the credit crunch and will not be sufficient to support sustained mortgage availability moving forward.

20. In particular we would urge the Government to explore ways of improving non-banks' access to warehouse funding—vital to the revival of the securitisation market—on more acceptable terms. We will be submitting our views to Government on this issue as part of its consultation.

Conclusion

21. It is important that Government supports the financial community to address dysfunction in the wholesale funding markets, especially as both securitisation markets and the wider economy remain fragile. We urge HM Treasury to form a securitisation forum to facilitate a full and frank discussion with RMBS market participants about the measures needed to restore a sensible, prudent and transparent securitisation market, needed to increase competition and ensure a stable flow of mortgage finance.

22. Paragon is separately working on public-private solutions that would help generate meaningful competition and choice across all sections of the mortgage market.

September 2010

Written evidence submitted by Toynbee Hall

Toynbee Hall welcomes the opportunity to respond to the Treasury Select Committee's enquiry into Competition and Choice in the Banking Sector.

Summary

- The financial crisis has hit the most vulnerable the worst. It is these groups who see the strongly the negative impacts of financial instability.
- Choice and competition in the banking sector is about promoting a fairer market. A tightening of affordable lending will have an ongoing negative effect on creating a banking system that is fair for all.
- Creating the conditions for new entrants into the banking sector will have a positive effect on the market by introducing new suppliers; however the committee needs also to consider demand side policies.
- Hidden bank charges are a problem for those who are already at the margins of the banking sector.

— Moving away from free banking will hit those already in poverty worst, and will provide a disincentive for people opening bank accounts even when it is in their best interest.

1. Introduction

1.1 Toynbee Hall is a charity based in Tower Hamlets that produces practical innovative programmes to meet the needs of local people, improve conditions and enable communities to fulfill their potential. Toynbee Hall works with over 6,000 members of the community each year to support them to meet the challenges that they face and to encourage them to take control of their lives.

1.2 Toynbee Hall has been a pioneer of financial inclusion work in the UK third sector for some years, and continues to develop services and projects to help improve the lives of people facing financial exclusion. Current projects include:

— **SAFE (Services Against Financial Exclusion)** provides preventative financial capability training for organisations and their service users and problem-solving financial inclusion support for individuals.

— **Evaluation and Measurement** develops methodologies and tools for measuring and evaluating levels of financial capability and inclusion and the impact of interventions designed to improve them.

— The **Illegal Money Lending** Team provides supports to victims of loan sharks across London, through helping them to identify their financial/well-being priorities and supporting them to achieve them.

— The London Strategic **Financial Inclusion Champion** is based at Toynbee Hall. The Financial Inclusion Champions are a national team of network-builders who support organisations to make links, share best practice and close gaps in provision around Financial Inclusion.

— **Transact**, the national forum for financial inclusion, a network of over 1,000 organisations committed to practicing and promoting financial inclusion.

1.3 Our comments in response to the consultation are therefore focused on the impact of the proposals on financial inclusion, and have chosen to respond to those questions that we believe have a financial inclusion element.

1.4 The recent financial crisis will have an adverse effect on the everyday lives of the most vulnerable in society[47]. Those most vulnerable in society often do not have access to mainstream financial services and therefore suffer further from a poverty premium, when poorer households pay more for goods and services. Without a bank account, for example, a household will not be able to take advantage of the lower costs of their utility bills by paying through a direct debit[48]. If Britain is to be able to exit the recession in an effective way that will not cause further detriment to the vulnerable people in society, then it is important that there is a banking sector which caters for all in society in a fair and equal way. This will have a further positive effect on financial stability, by increasing consumer confidence in the banking sector lowering the chances of another run on a British bank[49].

1.5 Toynbee Hall welcomes the committee's interest in competition and choice in the retail banking sector. Effective competition in the banking sector permits consumers to actively engage in the market by switching to better offers. This drives firms to deliver lower prices and higher quality due to the risk of losing customers. Whilst on one hand effective competition is driven by the business model of banks, we would ask the committee to consider the other side of things: the relative weakness of consumers. This is especially the case when thinking about those who are understood as being "financially excluded"[50], that is those who currently do not participate in mainstream financial services. We would ask the committee to consider what effects choice and competition have on these more vulnerable groups to ensure that fair retail banking markets are created for all. This includes a consideration of the effects of changes in free banking for these groups.

2. The Financial Crisis

2.1 The financial crisis has had a detrimental effect on consumer participation in the retail banking sector. This translates into having a negative effect on choice within the market. As a result of the financial crisis, banks have tightened the purse strings and lending to individuals has decreased[51]. This increases the chances of an individual of becoming financially excluded, because the high street will no longer lend to them. These individuals are forced to turn to door-stop lenders or loan sharks. Loan sharks target the most vulnerable and have been found to charge up to 825% APR on loans[52].

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47 http://www.esrc.ac.uk/ESRCInfoCentre/about/CI/CP/Our_Society_Today/economists/RecessionBritainPublication.aspx
48 http://www.savethechildren.org.uk/en/docs/poverty_briefing.pdf
49 http://news.bbc.co.uk/1/hi/business/6996136.stm
50 http://www.fsa.gov.uk/pubs/consumer-research/crpr03.pdf
51 http://www.guardian.co.uk/money/2010/aug/31/mortgage-lending-plunge-july
52 http://www.guardian.co.uk/money/2010/jan/15/loan-sharks-poorest-households

2.2 The threat on financial stability caused by the financial crisis also rests on the ability that markets have for working fairly for all consumers. Toynbee Hall would therefore welcome the committee giving attention to current campaigns that are seeing to address bank lending to individuals[53].

3. Demand Side Policies are Needed for Effective Markets

3.1 New entrants into the retail banking sector will be beneficial to mainstream consumers in that it will have a positive effect on choice and competition[54]. Toynbee Hall would like to the committee to consider consumers who are for whatever reason excluded from mainstream financial services.

3.2 The availability of choice in the retail banking market can be offset by the strong presence of consumer inertia. Evidence shows that consumers tend not to shop around for competitive deals on their bank accounts. In addition, consumers have concerns that the switch might be problematic. In 2008, the number of consumers found to have switched bank accounts in the previous 12 months was 6%; the lowest in Europe[55].

3.3 The other barriers to switching are not simply that the consumer does not want to switch, the problem is more that they are not able to switch. Evidence shows that a majority of low income consumers feel they do not have the knowledge to be able to switch bank accounts[56]. Or at least switching is sufficiently difficult enough for it to act as a disincentive.

3.4 Toynbee Hall considers inertia and the lack of financial capability to be significant barriers to creating a successful competitive market. Any policies around the development of fairer markets for banking therefore should consider demand side policies as well as supply side policies.

4. Free Banking

4.1 Toynbee Hall welcomes the need for more transparency from banks when it comes to charges. There is a need to deal more effectively with unfair bank charges. Incurring bank charges acts as a disincentive to opening an account for many people on low incomes[57].

4.2 Consumers who are financially excluded are more like to feel the adverse effects of hidden bank charges. Through a combination of lower financial capability as well as not having the savings to recover from being overdrawn, these consumers are more likely to incur them.

4.3 Furthermore, these charges often outweigh the benefits for many people in holding a bank account.

4.4 Toynbee Hall are concerned, however, that if customers are charged for holding a current account, this will provide a disincentive for the financially excluded to enter into mainstream financial services; therefore making those who are not included into mainstream financial services, more vulnerable to the pitfalls of financial exclusion

Recommendations

- A retail banking sector needs to be set up in which they create the condition for a fair service to all consumers. For those who cannot access mainstream affordable credit, there should be viable options for these people to turn to. We would therefore recommend the continuing support of CDFIs in order to ensure the existence of viable alternatives.
- We recommend the consideration of how demand side policies can have a positive effect on creating a fairer banking sector. Improved financial education, targeted at those who need it the most, should be provided to increase the knowledge and skills needed for all consumers.
- We recommend that further research be conducted to look into the effect of banking charges on low-income groups.

September 2010

Written evidence submitted by the Association of British Credit Unions Limited (ABCUL)

1. Executive Summary

1.1 Credit unions are financial co-operatives owned and controlled by their members on a "one-member-one-vote" basis. They offer safe savings products and affordable loans and an increasing range of other services.

1.2 Credit unions are legally constituted under the Credit Unions Act 1979. They are regulated deposit takers with the same protections and safeguards as those afforded to banks and building societies.

1.3 Credit unions provide inclusive services to the whole of their communities rather than simply the better-off.

[53] http://betterbanking.org.uk/ and http://www.londoncitizens.org.uk/pages/pdfs/Press%20Release.docx
[54] http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf, pp24–54
[55] Ibid, p85
[56] Ibid, p106
[57] http://www.jrf.org.uk/sites/files/jrf/2222-financial-exclusion-policy.pdf, p26

1.4 Over the past decade savings, loans and assets held by credit unions have grown four-fold and membership has tripled.

1.5 Impending reforms of the Credit Unions Act, which has been described by the World Council of Credit Unions (WOCCU)[58] as *amongst the most restrictive in the world*, will see credit unions able to reach out to new groups and develop new services.

1.6 At present, the Legislative Reform Order (LRO) which will bring in these vital reforms is still making its way through Parliament. We are keen for this process to be completed as quickly as is possible, so that credit unions and consumers can start to benefit from the reforms

1.7 "The Coalition: our programme for government" states a commitment to "bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry". We believe that the continued development of credit unions is vital to this process as the only true, local alternative to the mainstream banking system.

1.8 Internationally, there is a proven model for credit union development which—following professional development, strengthened governance and the flexible and proportionate application of regulatory and legislative frameworks—rests on the development of centralised shared services to enable credit unions to benefit from economies of scale whilst retaining their localised nature and autonomy.

1.9 With a back-office system in place, all credit union services could be made available through the Post Office network. This would greatly increase the accessibility and visibility of credit union services whilst providing a new source of revenue to the Post Office network and boosting its sustainability.

1.10 The development of the back-office system and Post Office partnership would cost somewhere in the region of a one-off £10-£15 million. Given its potential to address several key areas of government policy, this represents significant value for money. The system would increase diversity and competition in banking, improve the sustainability of the Post Office network and address the present lack of universal financial services provision.

2. Introduction

2.1 We welcome the opportunity to respond to this inquiry. ABCUL is the main trade association for credit unions in England, Scotland and Wales, and our members serve around 85% of Britain's credit union membership. Credit unions are not-for-profit, financial co-operatives owned and controlled by their members providing safe-savings and affordable loans facilities. Increasingly credit unions offer more sophisticated products such as current accounts, ISAs, Child Trust Funds and mortgages.

2.2 At the end of March 2010, credit unions in Great Britain were providing financial services to 761,708 adult members and held almost £600 million in deposits with around £475 million out on loan to members. An additional 107,077 young people were saving with credit unions. [59]

2.3 At 30 September 2009, the 325 credit unions belonging to ABCUL were managing around £568 million of members' savings on behalf of over 470,000 adult members.

2.4 The Credit Unions Act 1979 sets down in statute the objects of a credit union; these are four-fold:

- The promotion of thrift among members;
- The creation of sources of credit for the benefit of members at a fair and reasonable rate of interest;
- The use and control of their members' savings for their mutual benefit; and
- The training and education of members' in the wise use of money and in the management of their financial affairs.

2.5 Credit unions in Britain are small, co-operative financial institutions often extending financial services to those unfairly excluded from the financial services the majority take for granted. They are owned and controlled by a restricted membership and are operated for the sole benefit of this membership. The Credit Union Act 1979 sets down these operating principles in law. The central, local and devolved governments of the UK have consistently supported credit union expansion and development in recognition of the benefit that they provide.

2.6 The Coalition Government, since coming to office, has committed to bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.[60] At a meeting of the All-Party Parliamentary Group on Credit Unions on 30 June 2010, the Financial Secretary to the Treasury, Mark Hoban MP, explicitly identified credit unions as part of this drive to support mutuals in financial services saying:

> "We are determined to help credit unions grow and expand into the future. But growth and expansion must be established on the basis of credibility—credibility that can only come as credit unions build

[58] See www.woccu.org
[59] Figures from unaudited quarterly returns provided to the Financial Services Authority
[60] The Coalition: our programme for Government: http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf

> sustainability. And it is in the interests of credit unions, the members of credit unions and the movement as a whole that sustainability is built."
>
> "This Government believes that strong credit unions will greatly enrich British society, so it is in our interest to do whatever we can to help the credit union movement to prosper."[61]

2.7 Internationally, credit unions are a successful alternative to mainstream financial services providers—the chart below compares international market penetration.[62]

Country	*Market Penetration*	*Total Assets (USD)*	*Average Assets (USD)*
Ireland	75.4%	20,052,172,916	39,865,154
Canada	47%	229,693,740,409	243,062,159
USA	44.3%	896,823,977,926	116,349,763
Australia	24%	42,172,247,180	379,530,154
Great Britain	2%	1,072,321,685	2,220,127

2.8 Credit union in Britain have not yet achieved their full, internationally proven potential—although there are pockets which exemplify what is possible with the right support, such as Glasgow where one in five people is a credit union member.

2.9 Measures taken to develop the credit union sector have built a strong base from which to expand into the future. With radical legislative reforms in train and a decade's foundation building behind the sector, the right support over the next few years has the potential to push British credit unions into a comparable position with their international counterparts nationally—injecting a strong element of diversity, choice and extra competition into British financial services and providing a better deal for consumers of all incomes and a more stable financial services system overall.

3. Credit Union Development So Far

3.1 In the decade since the turn of the century, credit unions in Britain have undergone a fundamental shift in their developmental philosophy and have earned significant recognition and support as a result.

3.2 Beginning with a seminal research project published in 1999 by Paul A Jones of Liverpool John Moores University, *Towards Sustainable Development*,[63] British credit unions—led by ABCUL—began to implement a new model of development based around a recognition that credit unions needed to be professionally-run, financial businesses before they could be socially effective ethical financial services. Credit unions would need to have a broad membership, operate from high-street premises and provide a quality of service comparable with that of the mainstream financial services.

3.3 Developments that have contributed to this transformation include:

3.3.1 Increasingly credit unions began to employ trained staff, implement sound governance and provide services to a wider range of people—requiring a greater level of sophistication of product offering including: ISAs, Child Trust Funds, insurance and mortgages.

3.3.2 In 2002, credit union regulation became the responsibility of the Financial Services Authority which meant, for the first time, credit unions were prudentially regulated and supervised. Furthermore, savings were guaranteed by the Financial Services Compensation Scheme and complainants had recourse to the Financial Ombudsman Service.

3.3.3 ABCUL successfully lobbied for various regulatory and legislative changes which have allowed for, amongst other things, an increase in the upper-rate of loan interest, greater flexibility around common bonds and a package of legislative reforms ongoing which will put British credit union legislation on a par with any other movement in the world. It is imperative that these final legislative changes are passed as soon as possible to promote the unrestricted, natural growth of British credit unions.

3.3.4 A new era of financial support was begun—epitomised by the DWP Growth Fund—which tied funding to contractual growth targets and developmental goals. The Growth Fund to April 2010 has provided 260,000 loans totalling £113 million and saving recipients in the region of £86 million compared with the leading doorstep lender, Provident Financial. Furthermore, according to DWP's interim evaluations of the scheme's effectiveness, participant credit unions have grown significantly in organisational strength and asset size compared with their non-Growth Fund counterparts. Average loan-processing costs have been reduced by 60% to £66 per loan.[64]

3.3.5 A major training and development project—DELTA—was undertaken by ABCUL to support the continued development of credit union staff and volunteers and to ensure the institutional soundness of the credit union movement.

[61] See: http://www.hm-treasury.gov.uk/speech_fst_300610.htm for full speech

[62] Figures taken from the World Council of Credit Unions' Statistical Report, 2009. See: http://www.woccu.org/publications/statreport

[63] See: http://s.coop/towardssustainabledevelopment

[64] See: S Collard & L Day, *Evaluation of the DWP Growth Fund—Interim Report*, PFRC / Ecotec, May 2010

3.3.6 The Credit Union Code of Governance was developed to ensure strong standards of internal governance were standardised across the credit union movement as an essential prerequisite to positive growth.[65]

3.3.7 ABCUL and some our leading members—with infrastructure support from the Co-operative Bank—developed the Credit Union Current Account (CUCA) which brought a full current account facility with debit card functionality to the British credit union movement for the first time.

3.4 As a result of these and other initiatives the credit union sector has built over the past decade to a position of strong fundamental foundations. The decade to 2007 saw savings, loans and assets all grow by more than four-fold and membership almost treble.[66]

3.5 Below we set out how a further package of one-off support will enable the British credit union movement to emulate our international counterparts through developing a strong infrastructure which will afford credit unions the same economies of scale enjoyed by much larger institutions whilst retaining the local, ethical ethos which sets credit unions apart from their financial services counterparts.

4. A Credit Union Back-office

4.1 Credit unions in Britain, whilst currently being a small feature of the financial landscape, have taken great developmental strides in the past decade.

4.2 The imminent introduction of the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order (LRO), having undergone an extended period of review and consultation begun in 2006, will cement the significant legislative and regulatory recognition already secured with a modern, proportionate and flexible framework on a par with the best in the world and removing significant barriers to growth.

4.3 It is vital that the LRO is passed as soon as protocol allows; many credit unions and potential partners are keen to use the new legislation to bring benefits to consumers.

4.4 The missing piece in the developmental jigsaw, based on international best-practice, is the development of a centralised, back-office system which would provide the economies of scale necessary to bring great efficiencies and consistency of service to the credit union sector building capacity and resulting in a step-change in credit union development.

4.5 Those services which the back-office might provide include:

4.5.1 A common accounting platform for credit unions enabling central treasury and liquidity management.

4.5.2 Central loan processing, credit control and marketing resource.

4.5.3 Human resources, legal and compliance services provided centrally.

4.5.4 Significant cost reductions in providing more sophisticated products, including CUCA, pre-paid debit cards, insurance, ISAs and mortgages.

4.5.5 Potential for centrally managed internet and telephone banking.

4.5.6 A conduit through which full collaboration with the Post Office could be achieved in that, through the common platform, all credit union accounts and services can be accessed at all Post Office branches earning a transaction fee for the Post Office and greatly increasing the accessibility and visibility of credit unions.

4.6 The implementation of a back-office for credit unions would result in a significant step-change in the sector's development leading to a fast growth in scale and reach and introducing the sector as a significant new player in the financial services market.

5. The Potential Effects of a Credit Union Back-office

5.1 Even on conservative estimates, the potential for credit union growth with a back-office system in place is enormous. We anticipate credit union membership to grow from 750,000 to two million in five years—potentially by much more.

5.2 This would have the effect of increasing the diversity, choice and competition in financial services as per the Coalition's commitment in its programme for government.

5.3 It would also have the effect of bolstering the credit union business model and creating a much more sustainable credit union sector. This was outlined as the Government's vision for the movement in the Financial Secretary to the Treasury Mark Hoban's recent speech to the All-Party Parliamentary Group on Credit Unions, and this was a vision similarly articulated and supported by the previous Government.

5.4 A collaboration with the Post Office could also meet the government's commitment to ensuring that the Post Office network is freed to develop its range of services and increase revenue and sustainability. This

[65] See: www.credituniongovernance.coop

[66] See P A Jones, *Breaking Through to the Future*, Liverpool John Moores University, 2008: http://s.coop/breakingthroughtothefuture

would improve the situation further by making inclusive, ethical financial services available through the network which is already the leading provider of financial services to those most in need of access to fair financial support through the Post Office Card Account (POCA). Pensioners, benefits claimants and small businesses are the main users of the Post Office's services and credit unions have a strong role to play in serving these groups.

5.5 The Government has also committed to altering the prevailing culture of borrowing to one of savings and investment. A greatly strengthened credit union sector would boost this effort. Under the Credit Unions Act, credit unions have as part their statutory objects both *the promotion of thrift amongst members* and *the training and education of members in the wise use of money and the management of their financial affairs.* There are several key ways in which credit unions do this most notably through payroll deduction which, drawing on the insights of *Behavioural Economics* and Richard Thaler's *Nudge theory*, deducts savings at source before an individual has had seen the money and greatly increases the likelihood that they will stick to their saving plans.

5.6 The on-going consultation jointly conducted between HM Treasury and the Department for Business, Innovation and Skills, *Financing a Private Sector Recovery*, is seeking views on ways in which private finance can be utilised to finance a growth in private enterprise and credit unions have a role to play in this. The upcoming LRO will enable credit unions to serve bodies corporate as well as individuals and therefore funding small enterprises will be an area in which credit unions could potentially play an important role following its passage—particularly should their capacity be strengthened by the back-office.

5.7 The Government's "Big Society" policy has received much attention and is another area where a stronger credit union movement can have an important role to play. The Big Society Bank could be used to support the activities of credit unions, both in themselves as social enterprises, but also, pending legislative reforms, as conduits for finance to small social enterprises in their communities. Similarly, an expanded and strengthened credit union sector will have more capacity to support social enterprise through its own resource.

6. Other Areas for Support

6.1 Credit unions, under their co-operative structure, are directed by an elected board of volunteer directors. We feel there is a potential role that large banking groups could play—jointly with ABCUL—in creating a volunteer hub which would match skilled banking employees with eligible credit unions to strengthen credit union governance.

6.2 Currently, credit unions are restricted from accessing capital markets. A liquid secondary capital market for credit unions would assist greatly in increasing their scale. Potential avenues for this are greater emphasis on Subordinated Debt, the imminent introduction of Deferred Shares—as per the Building Society sector—and Social Investment Bonds.

6.3 Another feature of the credit union sector internationally is the appearance of Stabilisation Funds which work to intervene where credit unions are in difficulty through various means. ABCUL have recently commissioned a research project into the viability of such an initiative in Britain and we feel there is great potential for supporting credit union strengthening in such a scheme.

7. Conclusion

7.1 Credit unions in Britain operate on an internationally proven model which has great potential to increase diversity and competition in financial markets.

7.2 In the past decade, credit unions have undergone a reassessment of their development model leading to a great strengthening of the sector due to various initiatives involving reform of the regulatory and legislative framework, strengthening governance and management, increasing the sector's capacity and securing appropriate investment.

7.3 A credit union back-office—as well as several other strengthening initiatives—and a full partnership with the Post Office network has the potential to transform the credit union movement and build upon the strong foundations laid over the past decade. This would assist in various areas of government policy and as such, any investment represents excellent value for money.

September 2010

Written evidence submitted by David T Llewellyn, Professor of Money & Banking, Centre for Financial Markets and Institutions, Loughborough University

COMPETITION, CONTESTABILITY AND EFFECTIVE COMPETITION IN BRITISH BANKING

Executive Summary

When considering the nature and structure of competition in banking and retail financial services, three alternative concepts are to be identified: *competition*, *contestability* and *effective competition*. A market may appear to be highly competitive but competition may nevertheless not be effective in the market place. Even though there may be many competitors in a market, competition is only effective in practice if consumers are able: to make rational and informed choices between competitors, and to exercise choice at low transactions costs. Both may act to limit effective competition. Even if consumers are able to make rational choices, the transactions costs of exercising this choice may be high. Information is the major constraint to making rational choices, and transactions costs to executing them. Combined, they can have the effect of limiting the effectiveness of competition even in a market place which is contestable or which has many competitors.

Banking is not a homogeneous business but a conglomeration of different businesses. For this reason, the focus needs to be on sub-markets. Banks are involved with different customers, markets, and products in each market. Competition takes place in sub-markets rather than generically between firms. It is necessary, therefore, to focus on the collection of narrowly-defined markets if the true nature of competitive conditions in the banking industry are to be understood.

Competition can be especially powerful when it develops from outside the traditional industry rather than developing endogenously within the industry. For this reason, competition would develop to consumer advantage if entry barriers were to be lowered, and if diversity in the banking system were to be fostered. In particular, enhancing the role of the mutual sector in retail financial services as is allegedly the government's aim) would be beneficial.

The degree of contestability in some banking and financial markets has increased. Many of the traditional entry barriers have been lowered partly because of the impact of technology. It is evidently the case that the degree of contestability varies considerably between sub markets. The impact of new entrants is not measured by the market share they secure which may be quite limited. The biggest potential impact is in terms of how they force incumbents to behave differently. Although entry barriers have declined in some banking markets, and as a result contestability has increased, this is evidently not the case in all banking markets. Entry barriers may be powerful in some banking markets which means that excess returns can be sustained for incumbents, and anti-competitive practices can be sustained.

Nature of Competition

1. When considering the nature and structure of competition in banking and retail financial services, three alternative concepts are to be identified: *competition*, *contestability* and *effective competition*. The first-mentioned focuses on the traditional way of considering competition in an industry and considers factors such as the number of suppliers, the market share of the dominant players (as, for instance, measured by Herfindahl indices) etc. This dimension also considers the type of competition in an industry: perfectly competitive, monopoly, complex monopoly, monopolistic, oligopolistic, etc.

2. In some industries (and in some banking markets) the traditional way of measuring competitive conditions has become less appropriate because of increased *contestability*. A market is said to be contestable if entry and exit barriers are low: ie it is easy for new firms to enter the industry at low cost, but equally easy (and at low cost) to exit (Baumol, 1982). In this case, incumbent firms are restrained in exercising monopoly power (such as through high costs, prices, and profits) because, if they were to do so, new firms would enter the market. In the extreme case of perfect contestability, even a monopolist would be forced to behave as if it faced many competitors because of the threat of entry by others. It is the credible threat of entry that deters anti-competitive behaviour by incumbents, irrespective of the number of firms actually in the market at a given point in time. In a contestable market the number of actual competitors is largely irrelevant in determining competitive conditions in the market. A later section argues that contestability has increased in some, but certainly not all, banking markets in the UK.

3. The main purpose of this memorandum is to consider *effective competition*. A market may appear to be highly competitive (as measured in standard ways) but competition may nevertheless not be effective in the market place. Even though there may be many competitors in a market, competition is only effective in practice if consumers are able:

(1) to make rational and informed choices between competitors, and

(2) to exercise choice at low transactions costs.

Both may act to limit effective competition.

4. There are many reasons why in some markets consumers are unable to make rational choices. If consumers do not have sufficient information to make comparisons and rational choices, competition between suppliers may not be effective in practice. For instance, some years ago independent research commissioned by Abbey

National revealed that more than half of bank account holders were unaware that they could obtain higher interest rates if they switched banks. We also find a wide range of prices and interest rates for almost identical products offered by different banks. There are also cases where the true price and costs of a financial product are difficult to discern (and hence for comparisons to be made) because of its complexity and the occasional practice of obfuscatory pricing. To alleviate some of these problems the Financial Services Authority introduced a "Treating Customers Fairly" requirement on financial firms.

5. Even if consumers are able to make rational choices, the transactions costs of exercising this choice may be high. Clearly, consumers will incur the costs of "shopping around" only to the extent that the expected benefits exceed the costs and there are sometimes impediments in making this calculation in financial services (Llewellyn, 2005). In an empirical study of the current account market in the UK, Gondat-Lerralde and Nier (2004) find that switching costs are a key determinant of competition in the market. The bundling of products and services may mean that the purchase of one service may be dependent on the purchase of other services from the bank. For instance, loans to SMEs are often dependent on the individual firm having many other services (payments, etc) supplied by the same bank. The Competition Commission (CC) focused heavily on the issue of bundling (which it defined as "the supply of a product is made conditional on the take-up of another product or obtaining services at a reduced price when taking out another service") in its 2002 enquiry. There may be considerable inconvenience attached to buying a particular product from the "best" bank if, because of bundling, many other services need to be switched. Switching costs may be high. The CC found that "there is only a very limited degree of switching of main bank accounts by SMEs. This is one of the most important characteristics of banking services to SMEs". Furthermore, consumer inertia may inhibit switching and the search for the "best" deal, and in some cases redemption penalties may be high especially when long-term contracts are involved. There may also be costs in disturbing an existing relationship with a bank because of the information advantages gained though a long-term association. This relationship can work to the advantage of both the bank and the customer.

6. Research by the Consumer Panel of the Financial Services Authority found that, contrary to the evidence, 39% of consumers believe there are no differences in costs and charges between banks because there is competition between them (Consumer Panel, 2001). Clearly, if this expectation exists the cost-benefit calculations of shopping around are adverse. In fact, the evidence is that there are significant differences between almost identical products offered by different banks and even by the same bank. Research undertaken by the FSA suggests that this is most especially the case with short-term products (Cook, et. al., 2002). In an attempt to enhance consumer awareness in financial markets, the FSA now publishes tables of comparative information.

7. Information is the major constraint to making rational choices, and transactions costs to executing them. Combined, they can have the effect of limiting the effectiveness of competition even in a market place which is contestable or which has many competitors.

Methodology: Markets v. Institutions

8. A central methodological issue when considering the degree of competition in the banking industry is whether the focus should be on the total market or on individual banking sub-markets. In the latter case the issue arises as to how to define (and with what degree of fineness) the relevant markets. The general conclusion here is that banking is not a homogeneous business but a conglomeration of different businesses. For this reason, the focus needs to be on sub-markets. Banks are involved with different customers, markets, and products in each market. The emphasis on sub-markets is considered in Bikker and Groeneveld (2000) and in Bikker and Haaf (2002b) where they define a market as "all suppliers of a good who are actual or potential competitors".

9. A central, though difficult, research area in banking is how to measure and define competitive conditions in banking markets and how to make comparisons between countries. Several alternative methodologies (eg Structure Conduct Performance, Panzar and Rosse Model, et. al.) have been applied in an extensive literature. A theme here is that these conventional approaches have become less appropriate because they are too aggregative. Evidence from the UK, and the work of the Competition Commission, suggests that the focus needs to be on micro banking markets and that these markets might need to be defined very narrowly. Competition takes place in sub-markets rather than generically between firms. Unfortunately for research purposes, there is often a paucity of data regarding sub-markets and the profitability of banking business in these disaggregated markets. However, some research has been conducted applying this approach. For instance, Courvoisier and Gropp (2002) in a 10-country study found significant correlations between margins and product-specific measures of industry concentration. Similarly, Bikker and Haaf (2002) found that when focussing on a national scale, the degree of market concentration of the largest banks is often modest and they have only limited market power. On the other hand, when the analysis is conducted on a disaggregated basis large banks often do have market power.

10. There are several reasons why different sub-markets need to be distinguished: competitive conditions vary between sub-markets, consumer behaviour is different in each market (eg with respect to the extent that a product is regarded as commoditised, ie purchased mainly on the basis of price), the profitability of different sub-markets varies, there are cross-subsidies between different markets (where prices in some markets are set high relative to cost and risk while in others they are set low), and the way banks compete differs between

sub-markets. In an empirical study, Corvoissier and Gropp (2002) find that different banking products are affected differently by competition and concentration: increased concentration leads to less competitive pricing in loan and deposit markets but not in savings and time deposit markets.

11. Analysis of competition in the banking industry therefore needs to focus on sub-markets rather than regard banking as a homogeneous business. As banks operate in sub-markets, profits are generated in such markets and the overall ROE is based on the sum or profits in sub-markets. This was the focus of two Competition Commission enquiries where the conclusion was that competitive pressures vary greatly between different sub-markets, eg between, for instance, loans to SMEs and savings deposits for personal customers. This analysis was applied in the adjudication of the proposed merger between two banks. The CC rejected the bid by LloydsTSB for Abbey National not on the grounds that it would have serious negative impacts on competition overall, but because it would have significantly diminished competition in two sub-markets: SME banking and personal current accounts. And yet, in the wake of the banking crisis, the government allowed a merger between LloydsTSB and HBOS which would create equal, if not more, competition concerns in the same areas as identified by the CC in the earlier case.

12. It is necessary, therefore, to focus on the collection of narrowly-defined markets if the true nature of competitive conditions in the banking industry are to be understood. This also means that profitability may vary between banks within the same country (and also on average between countries) because of the particular business mix of individual banks, and also because there may be substantial differences in competitive conditions between sub-markets with such differences themselves varying between countries. It also means that aggregate concentration figures (eg Herfindahl indices) may give a distorted and misleading indication of market power. Thus, for instance, aggregate concentration in the UK banking sector is comparatively low but is high in some sub-markets such as SME banking products and services.

Entry Barriers and Contestability

13. The nature of contestability was briefly outlined above. While competition (as, for instance, measured by the number of competitors) may be low overall, competitive conditions may be strong in particular markets if they are contestable. The key (though not the only) characteristic of contestability is that entry and exit barriers are low. In practice, there are many entry barriers into some banking markets (Llewellyn, 1999).

14. The degree of contestability in some banking and financial markets has increased. Many of the traditional entry barriers have been lowered partly because of the impact of technology (Llewellyn, 2002). The process of *deconstruction* (whereby component parts of banking products are supplied on an outsourcing basis) also has the effect of lowering scale barriers, delivery barriers, set-up costs, skill requirements, and the barrier of integrated processes. In particular, the process of deconstruction and outsourcing means that a new entrant is no longer required to supply all the components within the value chain of a product and, therefore, is able to concentrate on that part of the value chain in which it has a potential competitive advantage. To the extent that consumers have become more prepared and able to unbundle, this potential entry barrier has also weakened. Equally, the development and increasing sophistication of credit-scoring models has made it easier for new entrants to enter some lending markets. The development of technology has also lowered some traditional information barriers to entry to the extent that it has increased the supply, and lowered the cost, of some information needed to provide some financial products and services.

15. More generally, the development of the Internet, and its application to banking, has had the effect of lowering entry barriers into some sub-markets in the banking industry. In particular, it has lowered the marginal cost of transactions, has made distance and location increasingly less significant, has lowered consumer search costs, has increased the availability of information, and has lowered the cost of price discovery. It has also raised transparency which has lowered search costs for consumers and raised the potential for consumers to make rational choices between alternative offerings by different banks.

16. It is evidently the case that the degree of contestability varies between sub-markets. While in new entrants have entered some banking sub-markets, other markets have been untouched. The CC noted that there are few suppliers, and high entry barriers, in the markets of general-purpose business loans for SMEs. It also observed only limited entry by suppliers into the provision of liquidity management services, and in particular current accounts with overdrafts and bank loans. In fact, some past new entrants have withdrawn from these markets. On the other hand, there is a large number of suppliers of some other banking services to SMEs. There have been several new suppliers of Time Deposit accounts and asset-related loans that have entered these markets. As noted by the CC: "this shows the relative ease of entry into these activities on a niche basis". There has also been some entry into the supply of current accounts without overdrafts. Equally, in some personal banking markets (notably savings accounts) there have been several new entrants including Supermarket Banks.

17. The degree of contestability therefore varies considerably between sub-markets in banking. This can be represented in a Contestability Matrix (Figure 1) where sub-markets are defined in terms of customer groups and products. There is no scientific basis to the precise numbers indicated in each cell (i.e. each sub-market) which are impressionistic and given for illustrative purposes only. Nevertheless, they may be a reasonable reflection of the relative contestability of each market.

New Entrants into Banking Markets

18. Competition can be especially powerful when it develops from outside the traditional industry rather than developing endogenously within the industry. There are several reasons for this: new entrants have different cost structures than incumbents, they are more prepared to challenge traditional ways of conducting business, the basic economics of the firm are different, alternative business models are applied, they apply a different business strategy and business mix of products and services, and the incumbents often do not understand the business models of the new entrants and hence may find it difficult to develop competitive strategies against them.

19. In various countries new entrants into some banking sub-markets have included supermarkets, motor car manufacturers, DIY furniture stores, the Post Office, utility companies, insurance companies, and even well-known football clubs! They tend to have certain common characteristics: entry barriers are low in the relevant sub-markets, new forms of delivery are utilised, and only a limited range of products is offered rather than the full range of products and services offered by conventional banks. In addition, they are focussed within the value chain by outsourcing a large proportion of processing, and have low fixed costs (partly because they do not need to cover the substantial costs of establishing a processing infrastructure), low costs overall, and no legacy costs through dated IT systems and infrastructure. Furthermore, they often enter the market in partnership with an incumbent bank.

20. The impact of new entrants is not measured by the market share they secure which may be quite limited. The biggest potential impact is in terms of how they force incumbents to behave differently. For instance, faced with competition from some new entrants, at one time Lloyds TSB offered a Current Account paying interest of 3.5% against its norm of around 0.5%.

21. Although entry barriers have declined in some banking markets, and as a result contestability has increased, this is evidently not the case in all banking markets. Entry barriers may be powerful in some banking markets which means that excess returns can be sustained for incumbents, and anti-competitive practices can be sustained. There are entry problems in four main areas: (1) deterrence to entry, (2) cost and pricing asymmetries facing new entrants, (3) the advantages possessed by incumbents, and (4) the difficulty for new entrants to induce customers away from long-standing incumbents with whom they may have had a long relationship.

22. The context of the CC study on SME banking was that around 85% of SME traditional banking business was at the time in the hands of only six banks and the bulk was in the hands of only four. The CC considered in detail how entry barriers might operate in the SME banking market. In the process, they identified several barriers of varying degrees of intensity: information problems for new entrants about the credit-standing of SMEs; free banking provided by incumbents to start-up firms creating pressure on new entrants to offer it to the majority of their customers whereas incumbents offered it to less than 20% of their customers, and the scope by incumbents to negotiate with customers who are considering switching. In addition, potential new entrants often lack access to relevant skills such as credit assessment and relationship management. An incumbent may also have economies of scope in the provision of a range of services: in particular, the "first-port-of-call" advantage.

Assessment

23. Our central theme has been that different concepts of competition need to be applied to banking with special attention given to "effective competition". It has also been argued that competition can be particularly powerful when it develops from outside the traditional industry. For this reason, competition would develop to consumer advantage if entry barriers can be lowered, and if diversity in the banking system is fostered. In particular, enhancing the role of the mutual sector in retail financial services (as is allegedly the government's aim) would be beneficial This is argued further in Richie (2010).

FIGURE 1

CONTESTABILITY MATRIX

PRODUCTS/SERVICES	CUSTOMER GROUPS: Individuals	Large firms	Small firms
Payments	2	5	2
Loans	8	10	2
Deposits	10	10	8
Advice	7	10	3
etc.			
etc.			

SCORE: 10 IS HIGH CONTESTABILITY
1 IS LOW CONTESTABILITY

The scores are arbitrary and illustrative only, and no scientific basis has been applied.

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Written evidence from nef (the new economics foundation)

PROMOTING A DIVERSE AND RESILIENT BANKING SYSTEM

1. Executive Summary

1.1 Banking is unlike any other industry sector. It has unique properties that require an approach that goes beyond competition and choice to examine its broader social, economic and environmental impacts. We argue that effective reform needs to take as its starting point a re-statement of the function of banking, and while acknowledging that there is a strong case for reforms of the investment banking industry, we focus here on retail banking.

1.2 The most important privilege of the banking sector is the ability to create credit. This effectively hands complete control over the allocation of credit and significant control over the money supply, the means of exchange that underpins the economy, to private banks. Closely connected to this is the problem of moral hazard arising from the implicit and explicit government guarantees of banks' solvency.

1.3 These features of banking make it more analogous to public utilities, natural monopolies or merit goods[1] such as health and education, than to ordinary free market industry sectors. The incoherence caused by the privatisation and deregulation of a public good creates inherent instability in the banking system.

1.4 Apart from these unusual features, the banking market does not approach anywhere near conditions of perfect competition. Therefore a laissez-faire deregulatory approach paradoxically leads to less competition and choice. Other observed market failures include:

— the demise of relationship banking;

— distorted incentives and short-termism;

— patchy access to finance and poor customer service;

— withdrawal of support from local economies, and;

— increasing risks from increasing scale.

1.5 We argue that among the plethora of useful reform initiatives, the watchword for transforming banking for the better is "diversity"—of function, scale and location, and ownership.

1.6 We further argue that to truly get at the roots of systemic instability, the committee should consider convening a separate inquiry into the case for and against monetary reform.

2. The Function of Banking

The banking system is, by its very nature, not subject to the normal laws of market competition. Although competition and choice merit careful examination, the Committee is well advised to take a broad approach to reform. We believe it is necessary and desirable to start any review of banking with the question "What is the function of banking?" and we offer the following definition:[2]

> *"To facilitate the allocation and deployment of economic resources, both spatially and temporally, to ecological sustainable activities that maximise long-term financial and social returns under conditions of uncertainty"*

We argue that a fundamental redesign of existing market structures is required for banking to fulfil this function.

3. Banking is Special

3.1 Banking is unlike any other industry; this has been made abundantly clear in the current crisis. Banks enjoy certain privileges that normal commercial businesses do not have. The most important of these is the privilege of "credit creation", and closely connected is the problem of moral hazard arising from the implicit and explicit government guarantees of their solvency.

Credit Creation

3.2 In modern economies, through fractional reserve banking, banks play a key macro-economic role in the creation and allocation of virtually the entire money supply as credit. This is accepted by the Federal Reserve and the European Central Bank and by most monetary economists, although it does not feature in most general equilibrium models of the economy used by orthodox economists.[3] Private-sector commercial banks can thus be seen to provide a key public utility function as the originators and allocators of the money supply.

Moral Hazard

3.3 This leads inevitably to the second privilege, that risks are effectively underwritten by the taxpayer. This happens in two ways: in order to prevent the sudden loss of confidence that can lead to a run on the banks they are provided with a highly valuable deposit guarantee scheme funded at taxpayers' expense. This is compounded by the problem of institutions that are too systemically important to fail. One estimate of the value of this implicit guarantee in the UK, in terms of allowing banks access to cheaper capital, is over £50 billion a year.[4] This figure has swollen following the banking bailout, as these banks would have faced significantly higher funding costs without the government interventions, but the pre-crisis figure for 2007 was still £11 billion. Significantly, this value accrues almost entirely to the largest five banks.

An Incoherent System: Public Money, Private Banks

3.4 The government, via the Bank of England, has a monopoly on the creation of legal tender. The means of exchange that forms an essential building block of any modern economic system is therefore limited to a single currency that allows no legally enforceable competitors. There are alternatives to a monopoly fiat currency, but discussion of these is outside the scope of this paper. What is relevant to the reform of the banking system is that the provision of a reliable and stable currency to fulfil the function of a means of exchange is a public good. But the advent of electronic banking and the demise of notes and coins (which now make up less than 3% of the money supply) have resulted in money now mostly existing in electronic form as credit created by private banks. This could never have been envisaged by the architects of the 1844 Bank of England Act that banned the private creation of money by conferring a monopoly of issuance of notes and coins on the central bank.

3.5 The means of money creation and its allocation have significant economic, social and environmental impacts. The Bank of England's attempts to control retail price inflation does influence credit creation indirectly through interest rates and, more recently, quantitative easing, but essentially the quantity and allocation of money in the economy is determined by private banks.

3.6 Thus an inherent contradiction exists: a stable monetary system is a public good, money is backed by a state guarantee in the public interest and in this respect nationalised, but its creation and allocation is controlled by private banks motivated only by profit. It should hardly come as a surprise when private banks are bailed out by the taxpayer when the system crashes.

3.7 These features of banking make it more analogous to public utilities, natural monopolies or merit goods such as health and education, than to ordinary free market industry sectors. Retail banking underpins economic activity and has a related impact on social inclusion. Access to basic transactional banking services is increasingly important for full participation in the economy and for social justice. The cost of not having a current account and access to mainstream credit, borne by the most financially disadvantaged, can reach £1,000 per year.[5] Forcing people into the arms of loan sharks and confining them to the cash economy provides fertile ground for criminal operations and tax evasion.

3.8 Although "public good" industries often incorporate market mechanisms and competition to great benefit, they are ultimately managed and regulated in the public interest and subject to democratic control. Broader economic, social and environmental goals take precedence over profit. We would argue for this reason alone that the structure of the banking market, the level of financial returns, the number of market participants and their scale and scope, are all appropriate and indeed essential subjects for regulation. There are further arguments for state intervention based on observed market failures which we examine next.

4. Laissez-faire Leads to Market Failure

4.1 The banking sector displays fundamental flaws in approximating to anything close to conditions of perfect competition. Indeed, the nature of banking as outlined above is such that a laissez-faire approach will lead to less competition, not more, and even improving competition cannot of itself address all forms of market failure.

Deregulation destroys competition

4.2 Policy on banking regulation has been largely based upon assumptions, derived from neo-classical economics, of perfect competition and information that have no basis in reality. A rigorous and objective review of competition in the banking sector must start without making such deductive assumptions about how economies and markets work based upon hypothetical models of general equilibrium. It should take a more inductive approach based upon empirical evidence of what is actually happening in the sector.

4.3 Over the last three decades, regulators became exceedingly relaxed about competition in the banking sector, relying on the UK sector's international standing as proof of its competitiveness. Policy permitted an ever more homogeneous and top-heavy sector to develop. Consolidation, takeovers and aggressive acquisitions left the UK economy with fewer banking institutions and the competitiveness of UK banks in terms of their product offering to UK citizens and businesses was neglected. They have been, to a greater or lesser extent, doing the same things and offering customers the same products.

4.4 The sheer profitability of the financial sector makes it clear that the system is not competitive in the usual meaning of the term. Competition is meant to ensure that the lure of high profits will attract new entrants who will offer products at a cheaper price. The fact that this has not occurred suggests that there are major barriers to entry and that incumbent institutions are operating in an oligopolistic[6] rather than in a competitive market. Over 85% of current accounts are now concentrated in the hands of the big five banks.[7] This destruction of diversity has had profound effects:

The demise of relationship banking

4.5 These few big banks operate at an ever-more profitable distance from their customers, thanks to new, automated techniques such as credit scoring. "Relationship-banking" has gone in to decline, as employees with direct knowledge of borrowers have been shed in favour of centralised IT systems able to deliver more "efficient" computer ratings. However, homogeneity in approach to credit scoring leaves some sections of society underserved while decreasing system resilience as a small number of institutions chase the same group of customers and assess them in the same way.

Distorted incentives and short-termism

4.6 The recent problems in the system have been compounded by the way in which traders are remunerated on a very short-term basis, creating incentives to maximise short-term returns. Similarly, the financial "engineers" creating new products for the derivatives market are often paid immediately for the returns forecast over the whole term of the product. This creates potentially destructive incentives to develop products with a long "tail" of risk.

4.7 Institutions have converged on those activities that offer the highest returns, particularly over the short time horizons against which performance is generally judged in listed companies.[8] There is little to be gained from accepting lower returns now to move into sustainable long-term sectors that may ultimately produce higher returns, if all your shareholders have left in the meantime for rivals posting better quarterly results.

Choice for whom? The lack of access to finance

4.8 As institutions stopped specialising, either geographically or by market sectors, less profitable activities—such as maintaining a branch network and providing financial services for low-income people[9]—became ever more marginalised. The spatial and social dynamics of branch closure are important. Academic research shows that branch reductions have generally been greatest in more deprived and ethnically diverse areas, and lowest in more affluent ones.[10] This means that where finance is available, it is often on exorbitant terms—a typical APR from the legal end of the home credit market, is 272%.[11]

4.9 According to the Campaign for Community Banking, the number of bank branches in the UK is now just 9,094—43% fewer than just 20 years ago.[12] The UK has 197 bank branches per million inhabitants (including building societies). This compares with over 500 and 1,010 branches per million inhabitants respectively in Germany and Spain.[13] Not only does Spain have more banks per head of population, they are also far better disbursed than they are in the UK. The UK has 162 banks[14] compared with France's 450 banks[15] and Germany's 2,000 banks.[16] Both countries have a variety of banking forms, such as savings banks, co-operative banks, private banks, municipal banks and post banks that are firmly anchored in local communities. This helps explain the superior performance of these economies is providing access to finance.[17]

4.10 And, when we find a branch that is still open, there are fewer people to deal with any queries we have. Figures from the British Bankers Association (BBA) show that in the five years from 2003, Abbey reduced its staff numbers by 12,897, Lloyds TSB cut 15,058 staff, and the Royal Bank of Scotland, 11,200. Since the BBA data was compiled, Lloyds TSB announced plans to make 11,000 more staff redundant and RBS announced plans for a similar number of cuts.[18]

Withdrawal of support from local economies

4.11 Nor is it just a question of access for individuals. Access to banking is vital to the survival of retail and other services in many medium-sized rural communities and in less well-off suburbs, estates, and inner cities. If active people and small businesses go to bank elsewhere, they are likely to spend elsewhere, too. Those that suffer most from the loss of local amenities are the most vulnerable: older and disabled people, those with mobility difficulties, and carers.

Economies vs diseconomies of scale: Increasing returns means increasing risks

4.12 While economies of scale are important, they also bring dangers. The concept of "too big to fail" is well-documented and tends to allow returns to be increased by increasing the risk to the taxpayer. Crucially, the theory of diversification of risk through universal banking has shown to not hold true when a small number of very large banks all converge on similar portfolios. Shareholders should have control over their own risk diversification and have a broad range of divergent institutions in which to invest.

4.13 As financial institutions grow they move further and further from their customers, and the knowledge of the products they are buying, selling or trading inevitably suffers. The fact that the crisis was sparked by an international market in subprime mortgages in the United States, about which very few had any real knowledge or great understanding, underlines this point.

5. Strength in Diversity

5.1 With others, **nef** has been advocating a series of reform proposals which are documented in previous publications,[19] and for brevity we do not reproduce them here. Instead we focus below on one key theme: **diversity**.

Diversity of function

5.2 We need financial institutions to focus on specific functions and to do a good job, not to chase the latest bandwagon. Retail banking is a very different business from investment banking, but universal institutions that devote large resources to speculative activity put at risk their ability to provide core functions for their customers—payments, settlements, savings and loans. Government must see through its commitment to the creation of a Post Bank, Green Investment Bank, and Big Society Bank, which we suggest should be based closely on the recommendations of the Social Investment Task Force for a Social Investment Bank.[20] However, we would also benefit from banks that focus on particular industries, customers and products.

Diversity of scale and location

5.3 Large banks, or rather banks that can service large customers, have their place in the ecology of finance, but we need many more smaller and medium sized banks that are not too big to fail. We need regional and local banks with the particular knowledge, experience and culture of the areas they serve. This notion is not fanciful as comparisons with competitor economies demonstrate. A vibrant Community Development Finance Institution sector should be encouraged by introducing a UK version of the US Community Reinvestment Act which would provide greater transparency over where banks deploy their capital—or more to the point where they choose not to.

Diversity of ownership

5.4 Britain has a long and proud heritage of mutually owned financial institutions. The sector was demolished in the 1990's to little good effect according to an All-Party Parliamentary Group inquiry.[21] The government should seriously consider re-mutualisation as part of any forced demergers or sales by large banking groups. They should also remove the harsh and artificial constraints on the credit union sector, which is puny compared with competitor nations. While only about 0.5% of the adult population in the UK is member of a credit union, the equivalent figures for Ireland, the US, Australia and Canada are 45%, 30%, 20% and 16%, respectively.[22]

Key benefits of diversity

5.5 Greater diversity in the banking sector would:

- help ensure that less profitable activities are not left behind;
- provide greater clarity to savers about the use of their deposits and the potential risks and returns associated with a bank;
- allow greater management focus at Board level on areas of banking that are considered overtly or covertly to be poor relations within large universal banks, and help reconnect senior management with high-street customers;
- allow more focussed micro-prudential oversight, and
- assist macro-prudential oversight and promote greater system resilience by creating "fire-walls" between different parts of the system.

We need a financial system that channels finance to ecologically sustainable activities that maximise long-term financial and social returns. We need to explicitly promote diversity and resilience as much as competition and choice, not least because the latter will be harder to achieve without the former.

6. Examining the Roots of Instability—An Inquiry into Monetary Reform

For the reasons outlined above, we believe that a system that allows private control over a public good creates incoherence and instability in the banking system. We recommend that the Select Committee convenes a separate inquiry on the case for and against monetary reform, including the nature and operation of credit creation under our existing current system of fractional reserve banking, and allowing a thorough review of all alternative variations on creation and control of the nation's money supply.

September 2010

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[1] Merit goods confer positive externalities on the economy and society as a whole that are not enjoyed directly by the customer. This leads to too few of such goods and services being supplied in a free market, hence they tend to be subsidised or provided directly by the state.

[2] Nissan S and Spratt S (2009) *The Ecology of Finance* (London: **nef**).

[3] "…the fractional reserve system… permits the banking system to create money." (Federal Reserve Bank of Kansas City, 2001, p 57.); "The actual process of money creation takes place primarily in banks." (Federal Reserve Bank of Chicago, 1961, p 3); "At the beginning of the 20th century almost the totality of retail payments were made in central bank money. Over time, this monopoly came to be shared with commercial banks, when deposits and their transfer via checks and giros became widely accepted." (ECB, 2000); Quoted in Werner, R, A, 2009, "Can Credit Unions Create Credit? An Analytical Evaluation of a Potential Obstacle to the Growth of Credit Unions", Centre for Banking, Finance and Sustainable Development, Discussion Paper Series, No 2/09, University of Southampton, School of Management.

[4] Haldane A (2010) *The $100 billion dollar question* (London: Bank of England).

[5] Thiel V (2009) *Doorstep Robbery* (London: **nef**).

[6] An oligopolistic market is one where a handful of firms have control or extensive influence, enabling them to impose worse services or higher prices on buyers. A well-known example of this is the OPEC cartel of petroleum exporters.

[7] Vickers et al (2010) *Issues Paper: Call for Evidence* (London: Independent Commission on Banking).

[8] Public limited companies whose shares are listed and traded on stock exchanges.

[9] Dymski G A (2009), *The global financial customer and the spatiality of exclusion after the end of geography*, Cambridge Journal of Regions, Economy and Society 2009, 2, 267–285; French S, Leyshon A and Signoretta P (2008) *All gone now: the material, discursive and political erasure of bank and building society branches in Britain*. Antipode, 40: 79–101.

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[11] Provident Financial Group—see up-to-date information on lending rates at www.providentpersonalcredit.com

[12] French D (2009) *Branch Network Reduction Report* (London: Campaign for Community Banking).

[13] *Ibid*.

[14] List of banks compiled by the FSA on 30 June 2010. Accessed at http://fsa.gov.uk/pubs/list_banks/june10.pdf

[15] Accessed at http://www.fbf.fr/Web/internet/content_fbf.nsf/(WebPageList)/les+chiffres+du+secteur+bancaire/$File/Chiffres_cles_des_banques_francaises_2007.pdf, p 10

[16] Accessed at http://www.german-banks.com/html/12_banks_in_facts_figures/sub_01_markt/ban_0501.asp

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[19] Simms A et al. (2010) *Better Banking* (London: **nef**). Simms A & Greenham T (2010) *Where did our money go?* (London: **nef**).

[20] Cohen R *et al* (2000) *Enterprising Communities: Wealth Beyond Welfare*, report to HM Treasury, October 2000 (London: Social Investment Task Force) and Cohen R *et al* (2010) *Social Investment: Ten Years On*, report to HM Treasury, April 2010 (London: Social Investment Task Force).

[21] Welch I (2006) *Windfalls or shortfalls: The true cost of Demutualisation* (London: ACCA).

[22] Werner R (2009) *Can Credit Unions Create Credit? An Analytical Evaluation of a Potential Obstacle to the Growth of Credit Unions*, Discussion Paper Series, No 2/09, Centre for Banking, Finance and Sustainable Development, Southampton University.

Written evidence submitted by the Competition Commission

This note provides an overview of the role of the Competition Commission ("CC") and a summary of the CC's inquiries relating to aspects of the banking and financial services sectors during the last 10 years.

Role of the CC

The CC is an independent public body which conducts in-depth inquiries into mergers, markets and the regulation of the major regulated industries. All of the CC's inquiries are undertaken following a reference made to it by another authority, most often the Office of Fair Trading (OFT) (which refers merger and market inquiries), or one of the sector regulators (which can refer markets within their sectoral jurisdictions or make regulatory references in relation to price controls or other licence modifications) or as a result of an appeal from a decision of one of those sector regulators.[67]

Under the Enterprise Act 2002 (the Act), the OFT can review mergers to investigate whether there is a realistic prospect that they will lead to a substantial lessening of competition (SLC). The OFT may seek undertakings from the merging parties to address any competition concerns. If that is not possible it may refer the merger to the CC for an in-depth investigation. The CC has wide ranging powers to remedy any competition concerns, including preventing a merger from going ahead or requiring a company to sell off part of its business. In exceptional circumstances where public interest issues are raised, the Secretary of State may intervene as provided for in the Act, and may prevent a merger from being referred to the CC or may make a merger reference himself.

The Act also enables the OFT (and the sector regulators) to investigate markets and, if they are concerned that there may be competition problems, to refer those markets to the CC for in-depth investigation. In market investigations the CC has to decide whether any feature or combination of features in the market prevents, restricts or distorts competition, thus constituting an adverse effect on competition (AEC). If the CC concludes that this is the case, then it must seek to remedy the problems that it identifies either by introducing remedies itself or by recommending action by others.

Undertakings or orders are the primary means by which remedies are given effect under the Act (and the Fair Trading Act 1973). The OFT has a statutory duty to keep these undertakings under review, and if it considers that due to a change of circumstances a set of undertakings or an order should be varied or terminated, then the OFT refers it for consideration by the CC. Responsibility for deciding on variation or termination of undertakings lies with the CC.

In relation to regulatory references, the CC's role is dictated by the relevant sector-specific legislation.

Size, Structure and Operation of the CC

The CC operates under a Chairman (Peter Freeman) and Chief Executive (David Saunders). CC governance is provided by the CC's Council comprising in addition the three Deputy Chairmen and three non-executive members.

The CC employs about 140 staff, the great majority of whom are professionals (primarily lawyers, economists, business advisors and inquiry staff).

The CC also employs about 35 part-time Members, who are experienced industry figures, professors of economics, competition lawyers, etc. Members are paid only for the inquiries on which they serve and, whilst appointed by the Secretary of State,[68] are completely independent of political control.

Inquiries are conducted by a small Group of CC Members (selected and appointed to the inquiry by the Chairman), normally led by the Chairman or one of the Deputy Chairmen. Decisions in individual cases are taken by consensus[69] by the Group (who are by statute sovereign) working closely with the expert staff team.

The CC is widely recognised for being highly transparent: inquiry Groups hold hearings with parties and publish evidence, working papers and provisional decisions to ensure that parties are appraised of the issues under consideration. The CC publishes an administrative timetable for each inquiry and is bound by a statutory time limit for determining competition cases.[70]

Whilst the CC's focus is primarily on competition, it necessarily takes other public policy issues into account, particularly when considering remedies.

The CC's work on mergers and markets is subject to judicial review by the Competition Appeal Tribunal (CAT), and on regulatory matters also by the general courts.

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67 The sectors include airports, air traffic services, electricity, gas, financial services, postal services, railways, telecommunications and water.

68 For an eight year term following open competition.

69 The CC would not normally expect to reach a decision from which more than one member dissented.

70 Two years for a market investigation; 24 weeks plus 8 weeks extension for a merger review.

The CC's Inquiries Relating to the Banking and Financial Services Sectors

The CC has completed six reports on topics within the banking and financial services sectors over the past 10 years. Four of them were under the 2002 Act:

- Payment Protection Insurance, January 2009 (followed by remittal November 2009–October 2010).
- Northern Irish Personal Banking, May 2007.
- Home Credit; November 2006.
- Store cards; March 2006.

Two earlier reports were made to the Secretary of State under the Monopoly and Merger provisions of the Fair Trading Act 1973:

- SME Banking—a monopoly inquiry—March 2002 (reviewed August 2007).
- Lloyds TSB/Abbey National—a merger inquiry—July 2001.

Details of these inquiries are set out in Annex A.

Annex A

SUMMARY OF THE CC'S INQUIRIES IN THE BANKING AND FINANCIAL SERVICES SECTORS

Payment Protection Insurance (February 2007–January 2009 followed by remittal November 2009–October 2010)

Terms of reference and status of the remittal

- The reference followed a super-complaint from Citizens Advice and covered the supply of all PPI services (except store card PPI services) to non-business customers in the UK. The CC reported on 29 January 2009, requiring a prohibition on selling PPI at the same time as credit—the point-of-sale prohibition (POSP), a ban on selling single-premium PPI policies (where a multi-year policy is paid for in one up-front fee, added to the cost of the loan; the FSA took action on this in parallel and there are now no single-premium personal loan PPI policies sold) and various remedies to increase and improve information flow and transparency.
- On 30 March 2009 Barclays challenged aspects of the CC's final report including inclusion of the POSP in the package of remedies. Lloyds and Shop Direct Group Financial Services Ltd (which sells retail PPI through brands such as Littlewoods) intervened in support of Barclays; the FSA intervened in support of the CC. In October 2009, the Tribunal upheld the CC's conclusions as to the competition problems in the market but ruled that the CC must consider further the inclusion of the POSP, taking account of the possible loss of convenience for consumers in no longer being able to buy PPI at the same time as credit.
- Following a remittal from the CAT in November 2009, the CC carried out a detailed analysis of the impact of the POSP on customers' convenience, including conducting a customer survey. In October 2010 the CC confirmed the POSP for all forms of PPI except retail PPI (a small part of the overall PPI market).

Product market

- PPI services are insurance services supplied to protect a borrower's ability to maintain credit repayments in the event that the borrower suffers an accident and/or sickness and/or unemployment and, under some policies, death. Short-term income protection (short term IP) sold alongside credit was found also to be PPI—whilst the sales focus is on a customer's income rather than outgoings, the policy typically insures the same events in the same way, with the same benefits. PPI is predominantly sold through three distribution channels: face to face contact in branches (over half), over the telephone, and over the internet.
- Most PPI policies are sold by credit arrangers (banks, building societies, mortgage intermediaries) at the point of sale of the credit being issued but there are a few providers of PPI policies that do not also supply the credit to be insured (ie stand-alone PPI).
- The CC found that PPI sold by an individual credit arranger is not in competition with other credit arrangers' products (though is in competition with the very small stand-alone PPI/short-term IP market), hence each credit arranger selling PPI is a virtual monopolist.
- Given the market definition, markets are essentially monopolies. In terms of share of supply, the newly-merged Lloyds Banking Group has 40–50% of gross written premiums.

Key issues

— The CC found there to be little competition among distributors and intermediaries in relation to the supply of any type of PPI policy sold at the point of sale. The CC found the following features of the market causing an AEC: the extent of competition between providers was limited (on both price and non price factors); there were barriers in terms of customer search for PPI policies (time consuming, limited information available, complexity of policies, misunderstandings in relation to PPI improving the credit application process, low level if stand-alone provision); barriers to switching (eg access to consumers' credit information); barriers to entry and expansion; and the point of sale advantage in selling PPI combined with a credit product (ie stand alone providers were at a competitive disadvantage); barriers to new entry (eg building scale and access to customers at point of sale).

— The consumer detriment included higher prices, less choice and less innovation. Total consumer detriment would be significantly more than £200 million per year (some elements of consumer detriment could not be quantified including the scale of the adverse selection problem).[71]

— The CC found that if a POSP were introduced there would be an overall benefit to consumers of all types of PPI (save retail PPI). Some customers would value an opportunity to reflect on their options away from the credit point-of-sale. In addition the package of remedies—including the point-of-sale prohibition—would introduce competition which is likely to bring substantial benefits to consumers in terms of lower prices, better products and more choice.

Remedies

— Remedies included prohibiting selling PPI at the credit point of sale and transparency measures for consumers (eg price comparison tables, the provision of annual statements), all PPI providers must provide comparative data to the FSA, a prohibition on the sale of single-premium PPI policies, a requirement to unbundle retail PPI from merchandise cover. The remedies will be implemented by means of an order.

STORE CARDS (March 2004–March 2006)

Terms of reference

— The OFT's reference specified the relevant market as the supply of (a) store card credit services and (b) consumer credit services through store cards. The CC requested a change to the terms of reference to include also insurance services (ie insurance purchased in association with provision and use of store cards). The geographic market was the UK.

Product market

— By taking out a store card, a cardholder enters into a direct contractual relationship with the provider, not the retailer. Providers often offer store card insurance (PPI) covering card repayments.

— The main sources of income for store card providers are interest income on balances not settled within the interest-free period; card related insurance income; income from fees levied for late payment of accounts; and other income including merchant fees from certain retailers.

— The store card market remains an important source of credit and associated insurance. There were more than 11 million store cardholders with outstanding balances of well over £2 billion.

— The distribution chain comprised department stores and clothing retailers, and store credit providers typically financed and administered the store cards on their behalf. At the time, six large lenders (five of which were quoted companies) accounted for around 90% of the market. A few retailers, notably Argos, financed and operated their store card programmes in house; however, most contracted their store card operation to a provider who managed it on their behalf. The two largest providers were General Electric Consumer Finance UK (GECF—largest provider having a share between 50–70%) and HSBC Group (HSBC—the second largest providing John Lewis and Marks and Spencer).

— There were found to be two relevant economic markets: an "upstream" market, where providers compete for retailers' store card contracts; and a "downstream" market for the supply of credit and insurance through store cards to retailers' customers.

Key issues

— There were no adverse findings in the upstream market and in particular no barriers to entry by financial institutions.

[71] High PPI prices are likely to have resulted in adverse selection in the markets for PPI, resulting in increased claims costs on PPI policies and increased impairment costs on credit sold to PPI customers, compared with the levels that would arise given the lower PPI price levels that we would expect in a well-functioning market. A further detriment to consumers as a result of high PPI prices is therefore the increased costs of supplying PPI at high PPI prices due to adverse selection: paragraph 77 of the CC's report, January 2009.

- In the downstream market, the CC found that there was little or no competitive pressure on setting APRs; there was little or no competitive pressure on the levels of late payment fees or on the pricing of insurance sold with store cards; and providers did not include sufficient information on their statements. Many store card programmes had APRs clustered around 30% and there was little competitive pressure to reduce them.
- Various features of the market had the effect of insulating from competitive pressures consumer credit and insurance services provided through or in association with store cards.
- Detrimental effects on consumers included higher prices, less choice, and lack of transparency. Over the period since 1999, consumer detriment was found to have amounted to at least £55 million a year and possibly significantly more.

Remedies

- Remedies related primarily to increasing consumer transparency and included full information on statements (key items of information to be prominently displayed on the front page of the store card statements eg the current APR and an estimate of interest payable next month); an APR warning on store card statements; and the provision and prominent display of a facility to pay by direct debit. Where store card providers offer a package of payment and price protection or payment and purchase[72] protection, they must offer payment protection alone as a separate item. All remedies were implemented by an order. The remedies are now under review following the implementation of the EU consumer credit directive.

HOME CREDIT (December 2004–November 2006)

Terms of reference

- The reference from the OFT followed a super-complaint from the National Consumer Council. The product market was defined as the provision of credit, typically in small sum cash loans, the repayments for which are collected in instalments (often weekly or fortnightly) by collectors who call for that purpose at the customer's home. The geographic market was the UK.

Product market

- The mean value of a home credit loan was around £300. APRs generally exceeded 100% and for loans of around 6 months often exceeded 300%.
- All parties investigated were legitimate licensed businesses (to be distinguished from illegal lenders ie loan sharks).

Key issues

- At a national level, this was a highly concentrated market and one in which the leading lender (Provident) had a very substantial market share. The CC found that Provident accounted for around 60% of the supply of home credit in the UK on most measures, and that the six largest lenders together accounted for over 90% of UK supply.
- Two features contributed to the weakness of competition creating an AEC: insensitivity of customers to prices and the failure of lenders to compete in any significant way on price. There were also incumbency advantages for established lenders (ie knowledge of customers' credit worthiness). Price insensitivity and incumbency advantages were preserved by the lack of data sharing, customers' requirement for an agent they can trust and the regulatory prohibition on door-to-door canvassing of loans.
- The CC found that customers generally paid higher prices than could be expected in a competitive market and on average £20 higher.

Remedies

- Four remedies were selected with the objective of increasing price transparency and decreasing information asymmetries between incumbent lenders and other lenders. These remedies were: increased data sharing on payment records through credit reference agencies; requirement for lenders to publish their prices for home credit loans; better information provision to customers on loan accounts; and early settlement rebates.

NORTHERN IRISH PERSONAL BANKING (May 2005–May 2007)

Terms of reference

- The reference from the OFT followed a super-complaint from *Which?* and the General Consumer Council for Northern Ireland (GCCNI). The terms of reference for the inquiry covered the supply of Personal Current Account (PCA) banking services in Northern Ireland.

[72] ie protection covering damaged, lost or stolen purchases.

Product market

- The product market covered all personal current accounts (PCAs) but not other types of personal financial products such as credit union accounts and offset/current account mortgages.
- The inquiry categorised the banks into "clearers" (eg Governor and Company of the Bank of Ireland, AIB Group—trading as First Trust Bank, Northern Bank and Ulster Bank) and "non clearers" including building societies (Abbey National, Alliance & Leicester, Halifax, Nationwide, Woolwich), banks based in Great Britain and banks providing a remote service.

Key issues

- The inquiry analysed branch networks including entry and expansion; bank conduct including charging structures and complexity for the consumer; customer conduct including levels of switching; unilateral and co-ordinated effects and financial performance.
- The features that restricted or distorted competition in the PCA market in Northern Ireland were (a) unduly complex charging structures and practices; (b) lack of transparency in banks' explanation of charging structures to consumers; (c) lack of consumer switching between PCAs and banks.

Remedies

- The CC's remedies aimed at increasing transparency of charges for consumers and covered clear language, explanations of the level of charges and interest rates, advance notice of charges and debit interest incurred and changes to the switching process. Remedies were implemented by means of an order.

SME Banking (2000–02 monopoly investigation, Fair Trading Act 1973)

Terms of reference

- On 20 March 2000, the CC was asked by Ministers to investigate the supply of banking services by clearing banks to small and medium-sized enterprises. The CC was required to determine whether a monopoly situation existed, whether firms exploited their monopoly position and what could remedy any exploitation.

Product market

- The CC defined SMEs as businesses with a turnover of up to £25million.
- The CC found the market for SME banking to be highly concentrated especially with regard to the four largest clearing groups (Barclays, HSBC, Lloyds TSB and Royal Bank of Scotland Group) that accounted for over 90% of liquidity management services in each geographic region.

Key issues

- For a number of reasons customers showed an unwillingness to switch.
- There was a similarity of pricing between the major banks; the use of selective negotiation to reduce prices for those considering switching; and high barriers to entry (including branch infrastructure and high sunk costs).
- The CC found that as a result of the consumer and competition issues identified, the four largest clearing banks were charging excessive prices and therefore earning excessive profits.

Remedies

- The Secretary of State asked the OFT to negotiate remedies to give effect to the CC's recommendations. As a result, a number of behavioural and transitional undertakings were given by the four largest banks. Behavioural undertakings were designed to: make switching easier and faster; limit bundling of services, and improve price information and transparency to SMEs. Transitional undertakings were also sought to strengthen competition in the short term. These required the banks to offer either current accounts paying interest (at BoE base rate minus 2.5%) or accounts free of core money transmission charges.

OFT and CC review of undertakings given by banks (August 2007)

- OFT found that the transitional undertakings had been successful in achieving increased levels of competition and that the four banks had complied with their requirements. The market had however become more competitive due to the impact of the behavioural undertakings and general market trends. The OFT therefore recommended the four banks be released from their transitional undertakings but that the behavioural undertakings remain in place to address their concerns over customer switching levels and customer awareness of costs.
- The CC largely agreed with the OFT's advice, and decided in December 2007 to lift the temporary price controls that had been imposed in 2003.

LLOYDS TSB/ABBEY NATIONAL (February–July 2001 merger inquiry, Fair Trading Act 1973)

Terms of reference

— Proposed merger between Lloyds TSB and Abbey National.

Product market

— Lloyds TSB was one of the four leading clearing banks (others were Barclays, HSBC and RBS/ National Westminster Bank). Lloyds and Abbey National were found to overlap in the following product markets: financial products sold to personal customers (current accounts, mortgages and savings accounts); markets for financial products sold to small and medium enterprises (SMEs); markets for financial products sold to larger firms and wholesale banking.

Key issues

— The proposed merger would reduce competition in the supply of banking services to SMEs as it would eliminate one of the very few players outside the big four. The merger would result in higher prices for personal current account (PCA) and SME banking services, and decrease innovation and consumer choice. Efficiency gains would result from the merger but the CC did not consider these would be passed on to consumers in the form of reduced prices.

Remedies

— The CC concluded that there were no possible remedies in relation to the PCA and SME markets short of prohibiting the merger that could adequately address the adverse effects. The Secretary of State accepted this recommendation and prohibited the merger.

4 November 2010

Written evidence submitted by Cut Loose

INTRODUCTION

1. Cut Loose welcomes this inquiry as an important further contribution to the debate on the future shape of the banking industry.

2. Cut Loose supports measures to increase prudential competition including the removal of barriers to entry and expansion of the market.

3. In this submission, Cut Loose addresses the issue of Direct Debit and Direct Credit transfers within the Account Switching process as a barrier to consumers changing their banking service provider.

ACCOUNT SWITCHING

4. The vast majority of accounts are switched without any problems for the customer.

5. However, for every customer who is inconvenienced there will be many who hear about the problems and decide not to switch.

6. The personal risk that bills won't be paid or salaries won't go to the correct account is at the heart of customer concern when switching. The inconvenience and embarrassment to the customer when payments going "wrong" is high and customers run the risk of such an error negatively impacting their credit reference score. Correcting these problems is time consuming and frustrating for the customer.

7. These potential issues undoubtedly contribute to the low level of account switching experienced in the UK, with customers preferring to open multiple current accounts or simply stay with their existing bank.

THE MECHANICS OF ACCOUNT SWITCHING

8. The industry has removed the need for customers to write a new Direct Debit mandate to each service provider with new bank account details. Instead, the new bank takes care of informing the customer's service providers of the new account details. This is a major improvement for the customer but they can still have a problem with a Direct Debit payment if:

(a) The new bank is slow to request the customers direct debit and standing order details from the original bank;

(b) The original bank is slow to send the information to the new bank; and

(c) The service providers are slow to update their records in a timely fashion to avoid charges being requested from the old account.

9. The customer is personally responsible for ensuring remittances to their bank account by Direct Credit (eg salary) are changed to their new account. This means they have to write a letter to remitters with the new bank details, BACS provides sample letters on their website.

(a) The customer is at risk of having a problem with a Direct Credit receipt if the remitter is slow to change their records. Since the remitter is frequently the customer's employer and primary source of income, the outcome is potentially a real problem for the customer who then has to both move the money to the new account and keep reminding the employer to change their information.

10. The process of account switching is complex, requiring timely information to be provided between:

(a) the customer,

(b) the original bank,

(c) the new bank,

(d) the customer's service providers who bill the customer using a direct debit, and

(e) the customer's remitters who transfer money to the customer using a direct credit. (eg employers).

(f) This is further complicated by the differing levels of back office automation in service provider and remitter organisations. Small organisations are likely to have manual processes to setup direct debits and credits while larger organisations are likely to be more automated.

11. The suggested timeline for the completion of the switching process is currently around three weeks.

Account Number Portability

12. In the evidence from Sir Donald Cruikshank the possibility of changing to portable bank account numbers was suggested as a possible solution, emulating his success in establishing portable fixed and mobile telephone numbers in the Telco sector.

13. Whilst undoubtedly possible in the banking sector, this would require a significant change to core processing systems across the sector at a huge investment cost and would not resolve the problem. All the banking systems in the world rely on a "Sort Code" to identify the Bank that transactions are sent to. The UK could not change this in isolation from the rest of the world.

Improving the Customer's Switching Experience

14. Cut Loose believes that further improvement to the Customer's Switching Experience is both desirable and possible in principle.

15. Cut Loose believes that the existing switching process, provided through BACS and free to the customer, is efficient and essential to ensure orderly transition from one bank account to another.

16. The legal, compliance and processing considerations that enable customers to benefit from the advantages of Direct Debit and Credit transfers are borne by the banks, service providers and remitters and must carry as much weight as the desire to make account switching painless for the customer.

therefore

17. The solution must provide legal and compliance protection for all the parties involved.

18. The solution must integrate with the current process and avoid adding any additional onerous processes for the customer, the original bank, the new bank and the service providers and remitters.

Automated Direct Debit and Credit Redirection

19. Cut Loose believes that in principal, BACS could be at the heart of a technical solution that would allow a customer to switch accounts without the potential for transactions to go wrong during the switching period.

(a) At the point of opening their new account the customer agrees to all of their existing Direct Debits and Credits being redirected to their new account.

(b) As part of the existing switching mechanism, banks submit a request via BACS to the original bank to send details of the customer's Direct Debits and Standing Orders. This request could be used by BACS to set up a cross-reference holding both the old and the new Sort Code and Account Number details.

(c) When BACS routes transactions, they check the cross-reference and if it holds a new Sort Code and Account Number the routing is done to the new bank.

(d) The new bank now receives all the customers Direct Debits and Credits automatically. In effect an instant Account Switch is achieved.

(e) The rest of the Account Switching process is completed as it is today to change all the information held at the service providers and remitters.

(f) The new bank can track when the service providers and remitters have made their changes and ultimately send BACS an instruction to remove the customers cross-reference when it is no longer needed.

Conclusion

20. Cut Loose understands that the technical development of the cross-reference by BACS is more complicated than the principles outlined above imply. Nonetheless, we believe this is achievable with a degree of effort appropriate to removing a key barrier to Account Switching and therefore enabling increased competition in the market.

About Us

Cut Loose is a niche consultancy advising potential new market entrants and helping existing banking organisations to expand their offering.

January 2011

Written evidence submitted by eBay

In November, eBay submitted a dossier of evidence to the Independent Banking Commission exposing the difficulties that Britain's small businesses are experiencing in securing access to finance. I am writing to ask you to take this evidence into consideration during the Treasury Select Committee's inquiry into competition and choice in the banking sector.

In a special report of eBay's Online Business Index, our regular barometer of the attitudes and performance of online firms, we investigated the relationship between SMEs and high street banks, naming and shaming the banks which were holding back finance. The report found that:

- A third (33%) of small businesses say they are unable to access new finance.
- A third (33%) say they are forced to rely on expensive overdraft facilities in order to borrow.
- Three fifths (60%) believe that banks are to blame for the difficulties experienced by SMEs in accessing finance.
- Half (48%) believe that greater competition in the banking sector is more important than maximising returns from the sale of public shareholdings in the banks.

Our report shows that access to finance remains an acute problem for a significant number of SMEs. Many SMEs believe that inadequate competition and choice in banking is making the problem worse.

In light of this evidence, we urge the committee to consider remedies which would address this problem—for example, by making the promotion of greater competition in the banking sector the Government's primary objective when drawing up proposals for the sale of public shareholdings in Britain's leading banks. We also urge the committee to examine ways of encouraging new entrants to the banking market in order to provide small businesses with a greater choice of banking services.

A copy of eBay's evidence to the Independent Banking Commission is attached [not printed]. I hope you will give this full consideration.

Clare Gilmartin
eBay's Vice President for European Marketplaces

January 2011

Written evidence submitted by Callcredit

In the oral evidence provided to you by Mr Higgins of Tesco bank on Tuesday this week, reference was made to Callcredit and our unique Over-Indebtedness Initiative. For purposes of clarification I thought it would be helpful to provide some background and operational information on the Initiative.

I have set out below a high level overview to assist your understanding, and that of your fellow committee members. In addition I would be happy to meet with you to provide more detailed information should you require it.

Just over four years ago, Callcredit launched its unique Over-Indebtedness Initiative (OII) created in association with the UK's leading high street banks. This development was prompted by growing concerns about borrower over-commitment, including the work of the Over-Indebtedness Taskforce. The OII uses consolidated income and debt data to assess affordability and provide a strong understanding of consumer indebtedness and ability to pay. It signals where a consumer's ability to meet their credit commitments may be compromised. The service has recently been opened to other lenders and enhanced to provide an over-indebtedness score which indicates the likelihood of a customer entering into financial difficulty.

Callcredit is and always has been committed to helping lenders make responsible lending decisions, through the provision of tools that assist with the assessment of affordability and indebtedness.

Credit data is shared by banks with Credit Reference Agencies (CRA's) under the rules governing Principles of Reciprocity. They do not share data directly with each other. Callcredit in its role as a CRA facilitates the sharing of debt and income data which is available to both current account and non current account providers. For all lenders, whether they supply current account data or not, the solutions use current account data to identify the most at risk and indebted customers.

This enables us to provide lenders with key indebtedness reports, based on their customers' debt to affordability position. In summary, these include:

- Details of those existing customers whose financial positions warrant close monitoring.
- Details of existing customers who are severely over-indebted and need proactive debt advice.
- When they are considering offering credit, an affordability check to complement the information provided by existing credit checks.

Lenders can then determine the most appropriate course of action for their customers ensuring that levels of over-indebtedness are not increased, thereby protecting consumers. These key outcomes are the overriding objectives and purpose of the Over-Indebtedness Initiative.

If you require further information please do not hesitate to contact me. I am available to attend a meeting with you and your colleagues at your convenience.

Graham Lund
Managing Director

10 December 2010

Written evidence submitted by Delta Economics

1. Background to Data Behind the Delta Economics Submission

1.1 Delta Economics has been surveying the same panel of entrepreneurs in the UK since the late summer of 2008. They surveyed growth-oriented entrepreneurs who run young companies (2–10 years old) with turnovers of above £250,000. The sample size in 2008 was 1,800, this had fallen to 900.

1.2 Between 2008 and 2009, the average turnover of businesses in the survey dropped from £1.51 million to £1.23 million (or nearly 23%). Between 2009 and 2010 turnovers rose again to £1.58 million (or 31%).

1.3 The companies in the sample in 2010 are the ones that have survived the downturn. On average, they have invested £180,000 at start-up in their business. They will put in nearly 70% of that amount from their own money (or £126,000), often from their own savings. The remainder of the money comes from a variety of sources as illustrated in Figure 1.

Figure 1

SOURCES OF EXTERNAL START UP FINANCE ACCESSED

Source of finance to start business	*Percentage of respondents*
Family and friends	14.0
Private investors	32.3
Bank	29.0
Credit cards	0.7
Equity finance	3.4
Small firms loan guarantee scheme (SFLGS)	2.0
Enterprise finance guarantee (EFG)	2.1
Other government grants	7.4
Other directors	14.9

Source: Delta Economics, COGS 2010

1.4 These are the "survivor" companies who are set on a growth path and therefore may not have the same patterns of access to finance as a more general small business population, although access to SFLGS finance and VC finance is consistent with other surveys. What is remarkable, however, is how few companies use bank finance when starting up their business.

1.5 Just 15.8% of these companies are looking for finance now and this figure has not changed since 2009. This gives some credence to the view that demand for finance has slumped during the recession. 81.6% of those who are looking for finance now are looking for growth finance, 29.0% for working capital and 66.5% are looking for finance for investment.

1.6 Those who are looking for finance now are predominantly looking for finance from bank overdrafts (20.3%) or bank loans (57.6%).

1.7 85.2% of those who say they are not looking for finance now are not looking for finance because they say they have no need for it, as illustrated in Figure 2.

Figure 2

REASONS FOR NOT ACCESSING FINANCE

Reason for not looking for finance	*Percentage of respondents*
No need for finance	85.2
No point in trying because banks aren't lending	20.5
Cost of finance too high	19.8
Lending terms are too stringent	22.6
Deterred by bank manager or other bank staff	8.4
Have the finance myself	57.0

Source: Delta Economics, COGS 2010

The number of respondents answering that banks were not lending in 2009 was 17%, so this suggests that that there has been a slight increase in the numbers answering positively to this question.

1.8 Delta Economics has conducted in-depth interviews over the last two years with 150 entrepreneurs, financiers and business support professionals in the UK and beyond. The tightening of credit has been a feature of these discussions and, from the experiences of entrepreneurs in accessing finance and from financiers themselves, the automation of credit risk profiling along similar lines by providers of finance has limited the degree to which individual providers have leeway to make decisions other than on the basis of credit scores, proven track-record and confirmed future contracts. Smaller turnover businesses have been particularly affected as the margins in this segment are small, meaning that there are fewer providers who increasingly price for risk, which pushes up costs.

2. Interpretation and Implications for Treasury Select Committee Inquiry into Competition and Choice in the Banking Sector

2.1 In 2008, 38% of founders looked to banks to provide their external finance that they were not providing themselves. The figure is 29% amongst the "survivor" companies in 2010. This highlights a significant point; that the banks are not necessarily the biggest or the best source of start-up finance. The survivor entrepreneurs sought a great variety of finance including private investors, other directors and family and friends. They were also prepared to take a financial risk themselves. It is a mistaken belief that banks will provide loans without collateral and/or some form of co-investment by the entrepreneur and this data points out just how substantial that risk is for the entrepreneur.

2.2 Inevitably, therefore, banks are not the most appropriate source for start-up finance where amounts are small and risks to the banks are high. This is a well-known fact—hence why the role of family, friends and private investors is so substantial at the start-up stage. However, there is some evidence to suggest that before the financial crisis a number of banks were less risk averse than others, providing more in terms of individual interpretation of business plans and less pricing for risk.

2.3 As the banks have merged and the credit environment has tightened, our qualitative research suggests that banks have gone over to credit risk profiling which is an automated process. The scope for providing differentiated services to start-up and growth businesses has become more limited. This means that the relationship manager's role in building a trust base to financing the business may have become more limited. Some 8.4% of those who have not accessed finance were deterred their bank manager from doing so, possibly because of the fact that the credit history or risk profile would mean that the finance application would be rejected. Our qualitative research also supports the suggestion that relationship managers themselves may have deterred smaller, riskier businesses from putting in applications for finance that are likely to be rejected.

2.4 Given that our sample was biased towards growth-oriented entrepreneurs, this is likely to be magnified across a general business population and would lead to a conclusion that banks are themselves limiting the numbers of applications that are turned down before they go through the process. As all banks are putting companies through the same credit assessments the extent to which a longer term trust relationship with a bank-manager can circumvent this process is limited.

2.5 Similarly, because of the risks in the growth business market, banks have tended to move away from the smaller turnover businesses because this is an unprofitable and vulnerable segment of the market.

2.6 The fact that entrepreneurs put in so much of their own resources into financing their businesses at the start-up phase means that they are inherently risk averse too. The number of people saying that they felt there was no point in going to banks because they were not lending increased between 2009 and 2010. More worryingly, 85% say they have no need for finance, yet our survey is of an exclusive group of growth-oriented founders of businesses. If they are not looking for money and say that they have the money themselves, this will limit the extent to which they can grow over the long term.

3. Concluding Remarks

3.1 The evidence suggests that the systemic credit tightening is having a more profound effect on demand for and supply of finance to the small business sector. The concentration in the business banking sector is less important than the fact that all banks are using automated credit profiling processes which rely on external credit scores, risk profile and firm contracts, rather than pipeline and track record; criteria which are the same across the sector.

3.2 Lower turnover and younger businesses are proportionately riskier and prices for banking services to this sector have inevitably risen as banks increasingly price for risk. This is common across all the firms operating in this market. Again, this is a function of the market rather than a function of concentration.

3.3 The above two points mean that choice is limited to the small business; they cannot select on the basis of a personal relationship with a manager, because in the end this will not be as important as the tighter credit control systems across the sector in determining whether or not the business accesses finance.

February 2011

Further written evidence submitted by the Payments Council

1. Introduction

1.1 The Payments Council is pleased to have the opportunity to submit further written evidence to the Treasury Committee's inquiry into *Competition and Choice in the Banking Sector*. This follows our previous submission made in September.

1.2 Given the focus during evidence sessions on the ownership of payment systems and account switching, this second memorandum from the Payments Council specifically addresses these issues.

1.3 This response covers the contracted schemes, with the exception of the UK Domestic Cheque Guarantee Card Scheme as it has been agreed this scheme will close on 30 June 2011.

2. Ownership of Payment Systems

2.1 The Payments Council can trace its origins back to Sir Donald Cruickshank's report on *Competition in UK Banking* in March 2000. After a series of reviews, culminating in the OFT-led Payment Systems Task Force, it was agreed by the members of that Task Force and the previous Government that a new body be created to govern the UK payments systems. This led to the establishment of the Payments Council in 2007, with a Board which comprises industry directors and four independents who collectively wield a veto, plus an independent non-voting chair.

2.2 The Payments Council has three core objectives:

— to have a strategic vision for payments and lead the future development of cooperative payment services in the UK;

— to ensure that the payment system is open, accountable and transparent; and

— to ensure the operational efficiency, effectiveness and integrity of payment services in the UK.

This means that the Council is responsible for driving change in UK payments and for fostering a climate in which innovation takes place, to the benefit of payment service providers and the users of the system.

2.3 After two years' operation of the Council (during which time it published the first National Payments Plan), the OFT reviewed the Payments Council in 2009 and reported that the establishment of the organisation was a definite improvement on what prevailed before its creation. The OFT also concluded that the consultation on the National Payments Plan contributed to its objective on openness and accountability. The review did highlight some areas where further work could be done and it was agreed that the Payments council would publish a self-assessment against criteria set out by the OFT every two years, along with progress on work in the identified areas. The next review will be completed by the end of 2011.

2.4 The Payments Council works closely with its contracted schemes, for the benefit of the UK payments industry. These include:

— Bacs Payment Schemes Limited;

— CHAPS Clearing Company (covering two schemes: the CHAPS Sterling and Faster Payments);

— LINK ATM Scheme;

— Cheque & Credit Clearing Company Limited;
— Belfast Bankers' Clearing Company Limited; and
— UK Domestic Cheque Guarantee Card Scheme.

2.5 The clearing schemes are run by their respective Boards which are responsible for setting the work programmes of the schemes and their entry criteria.

3. Regulation of Payments

3.1 The Banking Act 2009 gave the Bank of England statutory powers to oversee payment systems that are recognised (by HM Treasury) as systemically important.

3.2 In addition, the Payment Services Directive was implemented in the UK through the Payment Services Regulations (PSRs) in November 2009. A large proportion of the PSRs is to govern the relationship between a customer and their payment service provider—in terms of the information that the customer receives regarding transactions on their account and how payments are executed—but there are also two other important elements to the Regulations. Firstly, the OFT has a role to ensure that access to payment systems that are not designated under the Settlement Finality Regulations remain transparent and objective; and secondly, this legislation enables non-banks to enter the payments market and brings them into regulation for the first time. The consequence of this should mean that the market for offering payment services remains competitive.

3.3 Most recently, the OFT undertook a *Review of barriers to entry, expansion and exit in retail banking*, which included a look at the UK's payment systems. The Payments Council, together with the schemes, contributed to this review and we were pleased to see that the OFT concluded that new entrants are able to access industry-wide payment schemes such as CHAPS and Bacs; and that those choosing to access payment systems as an agency bank are able to shop around and secure good arrangements at competitive rates.

3.4 In summary, we feel that there is no evidence to suggest that the current ownership arrangements of the UK's payment systems is in any way damaging the service that the banking industry's customers receive, nor is it creating a barrier to increased competition in financial services. There have been many changes over the last decade, most of which have increased the levels of transparency and accountability within the system.

4. Account Switching

4.1 We have noted the interest given to the issue of account switching during the oral evidence sessions. The ability to allow consumers to switch current accounts with ease has been an on-going debate for several years, and in response the industry has put in measures to make the process as simple as possible.

4.2 The industry has facilitated switching by issuing switching guides which consumers can choose to use as guidance and undertake the changes to their payments themselves; and by introducing a switching service which allows users to accept an offer from their new financial institution of having the changes undertaken on their behalf, in a way which minimises their involvement.

4.3 A switching service called "Transfer of Direct Debits and Standing Orders" (or ToDDaSO) has been in operation in the UK since 2001 and been available as an automated service since November 2004. As the banks arrange for regular payment instructions to be transferred to a new current account on the customer's behalf, switching services significantly reduce the administrative burden for both customers and third parties. The customer is given clear timescales as to how long each part of the switching process will take and the guarantee that both financial institutions involved will cancel any bank charges the customer may have to pay as a result of any mistake or unnecessary delay caused by those financial institutions when the current account is transferred.

4.4 There is an additional provision within the ToDDaSO service that the new financial institution, at the request of the customer, notifies Direct Debit originators of the new accounts details on a timely basis and that originators process these changes immediately or at the latest within three working days of receiving the transfer advice.

4.5 However, we recognise that, despite the success of the switching arrangements that we currently have in place and that they are generally considered to be some of the best in the EU, there is scope for reviewing the ToDDaSO service to see how it can be improved for customers and we will be working with Bacs, which runs the service, to consider this. Additionally, we will be proactively engaging with our members to see what further collaborative arrangements, beyond those under ToDDaSO could better facilitate the process of switching for customers.

5. Account Number Portability

5.1 One method of facilitating switching that has come up in several oral evidence sessions is that of account number portability. This has been explored by the industry and the competition authorities in the UK several times in the past and in all cases it was concluded that the costs and risks of implementing and operating portable account numbers significantly outweighed the benefits. It was also recognised that the UK's switching service delivers many of the benefits of portable account numbers in minimising the administrative burden for consumers and third parties, as it handles the transfer of regular transactions to the new current account on behalf of the consumer.

5.2 Whilst we have no reason to believe that the evidence that led the industry, as well as external commentators, to conclude that this was not the best way of facilitating switching has changed in any material respect, we will nevertheless commit to reviewing this again when we undertake the work mentioned in para 4.5—which, in itself, should have an impact on the rationale for such a change.

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