

The supply of banking services by clearing banks to small and medium-sized enterprises

A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK

Volume 1: Summary and Conclusions



COMPETITION COMMISSION

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**Presented to Parliament by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer by Command of Her Majesty
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Members of the Competition Commission as at 19 October 2001

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¹These members formed the Group which was responsible for this report under the Chairmanship of Dr Morris.

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Part I

Summary and Conclusions

1 Summary

1.1. On 20 March 2000, we were asked to investigate the supply of banking services by clearing banks to small and medium-sized enterprises (SMEs—for definition, see paragraph 2.10) (see Appendix 1.1). There are over 3.5 million SMEs in the UK, accounting for some 55 per cent of employment and 45 per cent of turnover of businesses in the UK, and their flexibility and adaptability has been described as crucial to the strength of the economy as a whole. Many, however, as a result of their scale of operation have limited financial and managerial resources, and the quality of service they receive from their banks and the terms on which it is provided are key factors in the success of this sector.

1.2. We found the reference services to include a number of relevant markets: for liquidity management services, which include business current accounts, overdraft facilities and short-term bank deposit accounts; for general purpose business loans to SMEs; for other types of business loans (such as asset finance) to SMEs; and for other business deposits held by SMEs. We also found that there were three separate geographical markets (in England and Wales; Scotland; and Northern Ireland) for liquidity management services and general purpose business loans, but the other markets for banking services were UK-wide. There is significant market concentration particularly in the markets for liquidity management services, 90 per cent or more of such services being supplied by four clearing groups in each geographical market. That degree of concentration has changed little over the last ten years.

1.3. We also found the markets to be characterized by a reluctance on the part of SMEs to switch banks, the reasons for which included the perceived complexity of switching for little financial benefit; the perceived significance of maintaining relationships with a particular bank or particular relationship manager; and the ability of the existing bank to negotiate lower charges or otherwise respond if there is a threat of switching. A substantial majority of SMEs also prefer to obtain their purchases of liquidity management services and general purpose business loans from the same source, with some clearing banks requiring an SME to have a current account as a condition of a loan or a deposit. There is limited price sensitivity among SMEs, prices being regarded as less important than the quality of service provided and availability of funding when needed. We also noted a lack of transparency in the determination of availability and price of overdrafts and general purpose business loans.

1.4. A number of specific practices restrict and/or distort price competition. For example, there is a similarity of pricing structure between the main clearing banks, including in general no payment of interest on current accounts; a pattern of differentiation in charges by the clearing banks, with free banking generally confined to certain categories of SMEs, in particular start-ups and, to a lesser extent, switchers; and use of negotiation to reduce charges for those considering switching. The effect of such differentiation is to limit effective competition to particular categories of customer, preventing the benefit of competition diffusing through to the majority of customers. Taken together, it is our view that these factors indicate a market lacking effective competition among suppliers.

1.5. We also found that there were significant barriers to entry and expansion in the markets for liquidity management services and general purpose business loans. These result in part from many of the above factors, such as the unwillingness of SMEs to switch and the provision of

free banking to start-up businesses by many clearing banks, as well as other factors, such as the importance of reputation as a supplier of banking services to SMEs, the need for a branch network, and the existing personal customer base of the main clearing groups, from which most new SME customers are drawn. Our attention was drawn to a number of technological developments and we expect other recent developments in the supply of the reference services to have some impact on the markets, but we do not see these developments as substantially increasing competition within an acceptable timescale.

1.6. Although some aspects of quality of service gave rise to complaints, SMEs are reasonably satisfied with the banks in this respect, and the cost and availability of lending are in general not a problem. There is, however, scope for the clearing banks to improve performance in a number of ways, for example in dealing with errors and complaints.

1.7. The restriction and distortion in price competition in our view has led to excessive prices and profits. The current profits of the clearing banks on services to SMEs are over £2 billion a year and the average return on equity between 1998 and 2000 is 36 per cent compared with an estimated cost of equity of about 15 per cent. We have, however, recognized that a number of adjustments should be made to these figures. First we have made an allowance, although less than that suggested by some of the clearing banks, for certain intangible assets—the cost of recruiting and training employees, of acquiring customers and of IT software—which, though accounted for as revenue costs, generate future income and on which, in the circumstances of this case, an additional return should be allowed. Secondly, we have also allowed for the higher capital needed to support SME banking because of the risks involved in SME lending. Thirdly, we have recognized that the level of bad debts in the period we examined is likely to be below the long-term level. Fourthly, however, we have adjusted the profit figures of one of the clearing banks to recognize its relatively high costs which, like excessive profits, we do not think should be paid for by customers.

1.8. Despite the cautious approach we have adopted to a number of those factors, we have concluded that the four largest clearing groups—Barclays, HSBC, Lloyds TSB and RBSG—are together charging excessive prices (including interest forgone on non-interest-bearing current accounts) and therefore making excessive profits, in England and Wales, of about £725 million a year over the last three years with adverse effects on SMEs or their customers. For the most part, we found no such excessive prices in Scotland or Northern Ireland.

1.9. We found that RBSG, which includes National Westminster Bank and Ulster Bank as well as RBS Bank, itself has a scale monopoly situation in that it supplies over 25 per cent of the reference services. We also identified a number of practices, each carried out by some or all of the clearing banks (together accounting for over 25 per cent of supply of the reference services), which constitute a complex monopoly situation in that they restrict and/or distort price competition in the supply of the reference services. These include generally confining the provision of free banking services to start-ups and switchers; generally not paying interest on current accounts; giving discriminatory discounts through negotiations; and refraining from price competition in setting prices such that they more than adequately finance an efficient SME banking business.

1.10. We found such practices of the four largest clearing groups (as listed above) to be against the public interest in that they result in those clearing groups charging excessive prices to SMEs in England and Wales to an extent that would not be expected in a fully competitive situation and, in one case (NatWest), have permitted an inefficient level of costs. There are other adverse effects (in Scotland and Northern Ireland, as well as England and Wales) on choice and the level of information available to SMEs resulting from the practices of the same four clearing groups, but also from the practices of the other four main clearing groups in Scotland and Northern Ireland—NAB, BoS, BoI and AIB trading in Northern Ireland as First

Trust Bank. The problems we have identified arise because the practices are carried out by all the main clearing banks in each relevant market, ie from the complex monopoly situation, and not from any action on the part of RBSG as the scale monopolist in isolation.

1.11. We believe that the adverse effects on SMEs are significant given their role in the economy, and we therefore contemplated a wide range of behavioural remedies. Our preference is to remedy the adverse effects identified by encouraging competition. We have recommended a number of measures to apply to all the eight main clearing groups to reduce barriers to entry and expansion. Primary among these are measures to ensure fast error-free switching which we regard as crucial to a more competitive market. In addition, we have recommended measures limiting bundling of services, and improving information and transparency and an examination of the scope for sharing of branches. Measures to improve switching are themselves likely to improve the ability of SMEs to shop around in the event of high prices or poor service, but we have also suggested other measures for inclusion in the industry code proposed by the British Bankers' Association for introduction in March 2002 to alleviate some of the occasional but serious concerns of SMEs about their relationship with their banks.

1.12. The behavioural measures we have recommended will over time assist entry and the development of competition, and help to reduce the current incidence of excessive prices, as well as addressing the adverse effects on choice and information. However, there will inevitably remain many constraints on SMEs switching supplier and on competition and entry. We do not believe that those measures, together with technological and other developments in the supply of the reference services, will have sufficient impact on competition within the next two to three years to ensure that the incidence of excessive prices for banking services (including interest forgone particularly on current accounts) of the four largest clearing groups in England and Wales would disappear in a reasonable period of time. We see serious objection to structural remedies. For example, the divestment of branches or SME banking businesses would potentially affect personal customers as well as SMEs, which may themselves prefer to stay with their former bank rather than lose their established relationship with it. Options of a tax or licence fee or fund would not directly remedy the adverse effects identified.

1.13. We therefore turned to the charges made by the clearing banks to SMEs. It became clear that it was necessary to give the level of prices a decisive and significant shift toward what we considered to be competitive levels. We have looked at the overall level of excessive profits and prices in services to SMEs but we have seen reason to believe they arise to a substantial extent from the benefit to the four largest clearing groups of funds on non-interest-bearing current accounts and on shorter-term, smaller deposit accounts. The increase in the ratio of SME deposits to loans, to the point where the level of deposits is now broadly equivalent to that of loans, exacerbates this effect. A requirement to pay a market-related rate of interest on current accounts would not give rise to the administrative difficulties or burdens of regulating other charges, for example of money transmission or lending.

1.14. We found that excess prices are charged only by the four largest clearing groups in England and Wales. We have recommended that the four largest clearing groups be required to pay interest on current accounts in England and Wales at Bank of England base rate less 2.5 per cent. Over the period 1998 to 2000, this would have required payment of interest of about 3.7 per cent and reduced prices to SMEs on average by about £525 million. At current lower interest rates the effect would be smaller (requiring an interest payment of about 2 per cent), as would be the benefit to the clearing banks of funds on current accounts. This remedy will result in the remuneration relating to the assets owned by SMEs (some £17 billion at December 2000) largely being received by the SMEs themselves. The four largest clearing groups should be allowed alternatively to offer SMEs accounts that are free of money transmission charges, as applies in the personal sector; or to offer SMEs a choice between the two options.

1.15. This remedy allows for the fact that we see some improvement in competition. Our findings and remedies are moreover independent of the economic environment in that our bad

debt analysis has already allowed for the fact that buoyant economic conditions will be interspersed with potentially serious recessions. That analysis also encompasses sufficiently severe possibilities as to be effectively independent of the uncertain consequences of recent terrorist incidents. While we fully recognize the seriousness of these incidents, they do not bear upon whether the supply of banking services to SMEs is competitive or not, nor whether lack of competition has permitted and would continue to permit overcharging of SMEs for these services. Should interest rates fall in the event of recession, reducing the income to banks from SME deposits, the impact of our remedies would also reduce.

1.16. The remedy addresses the excessive profits and prices of the four largest clearing groups in supplying banking services to SMEs, but in no way adversely affects the terms on which banks lend to their customers. Hence, we see no justification for the clearing banks, in response, to increase money transmission charges or interest rates on loans, or reduce lending to SMEs as some clearing banks said they would do. We recognize the risk that the clearing banks will seek to negate the effect of paying interest on SME current accounts by increasing money transmission charges, but we are conscious that regulating money transmission charges—the obvious response to this risk—would represent a substantial burden. In consequence, we recommend that the four largest clearing groups should publish and provide to the Director General of Fair Trading (DGFT) information on any changes in money transmission charges for SMEs, and that users and user groups should also draw to the DGFT's attention any increases in charges or interest rates, or evidence of any decline in quality of service or willingness to lend. We further recommend that, three years after implementation of the remedies, the DGFT should review whether further measures are needed or, on the other hand, in the light of market developments, whether any or all of the measures we have put forward can be modified or discontinued.