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PART 1

COMPETITION AND DIVERSITY IN RETAIL BANKING AND FINANCIAL SERVICES

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The submission is made in two parts. Part 1 considers the nature of competition, the important distinction between markets and institutions in the analysis of competitive pressures, the methodology of contestability, and the benefits to be derived from diversity in the retail banking sector, and the possible emerging structure of the financial system. Section 1 considers the nature of competition and section 2 distinguishes between a focus on institutions and markets. Section 3 discuses the nature of contestability and entry barriers followed in section 4 by a focus on new entrants in banking markets. Section 5 emphasises the role of diversity in enhancing competition. Section 6 discusses the possible implications of the new disclosure requirements on banks. Section 7 concludes with a discussion of how the structure of the financial system might emerge under the pressures of technology and Open Banking. The particular role of technology and Open Banking is considered in detail in Part 2 of the submission.

1. NATURE OF COMPETITION

Three alternative concepts are relevant in the analysis of competition in the banking industry: *competition, contestability* and *effective competition*. The first-mentioned focuses on A simplistic 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.

In many industries (and specifically in banking markets) this 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: i.e. it is easy for new firms to enter the industry at low cost, but equally easy (and at low cost) to exit. 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. Contestability has increased in some banking markets in the UK partly because of developments in technology and digitalisation, and more recently the potential of the Open Banking regime through lowering search costs and the costs of switching for consumers.

A market may appear to be very competitive (as measured in standard ways) but competition may nevertheless not be effective in the market place. In its 2018 Progress Report on its strategic review of retail banking, the FCA notes the low level of switching of personal current accounts with six banks accounting for around 80 percent of the market. The FCA indicates that, for instance, 33 percent of large banks' balances from easy access products were in accounts opened over five years ago.

Even though there may be many competitors in a market, competition is only effective in practice if consumers are able:

(i) to make rational and informed choices between competitors, and
(ii) to exercise that choice at low transactions costs which are lower than any actual or anticipated benefit that may derive from switching.

Both may act to limit effective competition. 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, research commissioned by Abbey National some years ago 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. It was partly to alleviate some of these problems that the then Financial Services Authority introduced a "Treating Customers Fairly" requirement on financial firms.

Even if consumers are able to make rational choices, the actual or perceived 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. In an empirical study of the current account market in the UK, Gondat-Lerralde and Nier (2011) found that switching costs are a key determinant of competition in the market. However, the ease of switching has increased since that study.

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 other services (payments, etc.) supplied by the same bank. The then Competition Commission 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 Competition Commission 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, as noted by the FCA, consumer inertia may inhibit switching and the search for the "best" deal. 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.

As discussed in Llewellyn and Milne (2018), it is an open question whether, and to what extent, the introduction of Open Banking will change all this particularly as, in principle, search and switching costs should decline. Llewellyn and Milne also considers whether the impact will be different for different consumers and in particular due to their age.

Research conducted some years ago by the Consumer Panel of the Financial Services Authority found that, contrary to the evidence, 39 percent 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 still 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.

The absence of relevant and complete 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.

2. METHODOLOGY: MARKETS V. INSTITUTIONS

A major 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 (2002).

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 (e.g. Structure, Conduct, Performance models, Panzar and Rosse Model, *et. al*.) have been applied in an extensive literature. Early approaches have become less appropriate because they are too aggregative. Evidence from the UK, and the work of the FCA, the Competition and Markets Authority and its predecessor (the Competition Commission), indicates that the focus needs to be on micro banking markets and that these markets might need to be defined narrowly both in terms of products/services and different customer groups. Competition takes place in sub-markets rather than generically between firms.

3. CONTESTABILITY OF BANKING MARKETS

3.1 A Contestability Matrix

Competition and contestability in the PCA market is quite different from that in the savings market, and even within each product/service market competition can be different between different consumer groups. It is evidently the case that the degree of contestability varies between sub-markets (products/services and customer groups). While, in the UK, new entrants have entered some banking sub-markets, other markets have been untouched. The Competition

Commission in various reports 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 other banking services to SMEs. 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 a large number of new entrants including (Challenger Banks).

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

FIGURE 1

CONTESTABILITY MATRIX

		CUSTOMER GROUPS		
		Individuals	**Large firms**	**Small firms**
PRODUCTS/SERVICES	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.

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 ten-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, whilst the degree of market concentration of the largest banks is often modest and they have only limited market power; when the analysis is conducted on disaggregated basis large banks often do have market power.

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 (e.g. with respect to the extent that a product is regarded as commoditised, i.e. purchased mainly on the basis of price), the profitability of different sub-markets varies, there may be cross-subsidies between different markets, and the way banks compete differs between sub-markets. On the other hand, the PCA has found no substantial element of cross subsidisation.

As recognised by the FCA, 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 earlier the focus of two Competition Commission enquiries in the UK where the conclusion was that competitive pressures vary greatly between different sub-markets, e.g. between, for instance, loans to SMEs and savings deposits for personal customers. For instance, the Competition Commission 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. It is necessary, therefore, to focus on the collection of narrowly-defined markets if the true nature of competitive conditions in a national banking industry is to be understood. It also means that aggregate concentration figures (e.g. Herfindahl indices) may give a distorted and misleading indication of market power.

3.2 Entry barriers and contestability

It is evident that 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 (see Llewellyn and Milne, 2018). 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.

All of this will potentially be enhanced over time through Open Banking (Llewellyn and Milne, 2018).

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.

The degree of contestability therefore varies considerably between sub-markets in banking.

4. NEW ENTRANTS INTO BANKING MARKETS

Many of these arguments can be illustrated by considering the experience of new entrants into some banking markets. Competition is often 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.

The impact of new entrants is not measured by the market share they secure which may be quite limited. The biggest impact may be 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. 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.

Large incumbent banks have certain historic advantages and which act as entry barriers for potential new entrants:

- Compared with new entrants, large incumbents are able to develop a multiple access/delivery structure (branches, internet, etc) which caters for different consumer preferences. This is difficult for new entrants to replicate.

- The FCA notes that the branch network has historically been a major route through which new accounts are opened.
- they have a dominant position in the PCA market which in turn is a major source of relatively cheap funding, a source of other fees, and the potential for cross-selling other products.

- PCAs tend not to be very mobile with the implication that incumbents in the market have legacy advantages.

5. COMPETITION THROUGH DIVERSITY

Competition in banking markets is more likely to be enhance through diversity in the banking and retail financial services sectors (most especially with respect to ownership structure and business models) than by more firms entering the industry with the same business models as existing incumbents. Mutuals (mainly building societies) are a particular example of firms with a different ownership and business model. And yet the critical mass of the mutual sector has been substantially eroded most especially due to the wave of conversions to plc status. It is interesting to note that not one of the converted building societies now exists on a stand-alone basis having either failed or been absorbed by incumbent banks with a shareholder value business model.

Mutuals do not pay dividends to external shareholders. Instead, this feature of the mutual model can be used to reduce the margin between the interest rate they charge to borrowers and what they pay to savers (on which, see Drake and Llewellyn, 2001). This 'margin advantage' of mutual financial institutions due to them not having to pay dividends on external capital, and the systemic advantages of a mixed financial structure, represent economic and welfare benefits from having, for instance, a mutual building society sector. There is a potentially powerful *systemic* interest in sustaining a strong mutual sector and, therefore it is a legitimate public policy issue. Regulation, for instance, should not impede diversity or unnecessarily restrict the operation of particular business models

There are several key issues in this regard which point to the benefits that potentially flow from diversity in the banking industry:

- The effect that a strong mutual sector has in enhancing competition because mutuals adopt a different business model compared with banks.

- Because mutuals are not owned by investment institutions, they are not subject to the short-termist pressure of the capital market.

- Most building societies (and many mutual and co-operative banks in other European countries) are locally or regionally based and have a particular focus and expertise on their communities.[i]

- The advantage through having a mix of institutions with different portfolio structures with the potential to reduce overall systemic risk because institutions are not homogeneous. The more diversified is a financial system in terms of size, ownership and structure of businesses, the better it is able to weather the strains produced by the normal business cycle, in particular avoiding the bandwagon effect, and the better it is able to adjust to changes in consumer preferences. As put almost two decades ago in a *Financial Times* editorial (27 April 1999):

> '… a pluralist approach to ownership is conducive to greater financial stability. With their contrasting capital structures, banks and building societies balance their risks and loan portfolios differently. Systemic risk is therefore reduced'.

- Though there have been exceptions with building societies expanding excessively into commercial property loans, mutuals tend to adopt a lower risk profile because their main source of capital is that generated within the business. Unlike with a plc, capital that is destroyed through, for instance, bad lending cannot easily be replaced by raising new capital in the market. Furthermore, the pressure to maximise profits is lower, there is therefore likely to be less short-termist approaches to business, there is less likely to be asset-substitution pressures, and mutuals' members (owners) are likely to be more risk averse than shareholders in shareholder value institutions.

- In an uncertain market environment, diversity has advantages as it cannot be predicted which form of corporate structure is best suited to all particular circumstances. As put by Ayadi *et al* (2009) the case for diversity includes: 'reducing institutional risk, defined as the dependence on a single view of banking that may turn out to have serious weaknesses under unexpected conditions such as the current crisis'.

- Building societies are more likely to develop "relationship banking" models: mutuals are better placed to sustain a long term relationship with their customers (members)

While not explicitly discussing mutuals, the then Executive Director for Financial Stability at the Bank of England, Andrew Haldane, set out the beneficial effects of diversity for the robustness of financial networks:

> Within the financial sector, diversity appears to have been reduced for two separate, but related, reasons: the pursuit of return; and the management of risk. The pursuit of yield resulted in a return on equity race among all types of financial firm. As they collectively migrated to high-yield

> activities, business strategies came to be replicated across the financial sector. Imitation became the sincerest form of flattery.
>
> So savings co-operatives transformed themselves into private commercial banks. Commercial banks ventured into investment banking. Investment banks developed in-house hedge funds through large proprietary trading desks. Funds of hedge funds competed with traditional investment funds. And investment funds – pension, money market mutual, insurance – imported the risk the others were shedding…
>
> Through these channels, financial sector balance sheets became homogenised. Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant. When environmental factors changed for the worse, the homogeneity of the financial eco-system increased materially its probability of collapse. (Haldane, 2009a, pp. 18-19)

In contrast to most other European countries, the degree of diversity with respect to ownership structures of financial institutions in the UK is low and has been in decline for several years. The result is a dominance of a mono culture based on the shareholder value model.

The case for a financial system being populated by a diversity of organisational forms is as significant as the merits and drawbacks of each particular model. Cuevas and Fischer (2006), for example, argue that a financial system that presents a diversified institutional structure, including institutional types, will be more efficient in promoting economic growth and reducing poverty. It is in this respect that a significant public policy issue arises. A financial system populated by a diversity of ownership structures is likely to be more competitive and systemically less risky than one populated by either all plcs or all mutuals.

Much was lost to the British financial system by the demutualisation of building societies, both in terms of the intrinsic merits of the mutual model, and in terms of systemic diversity and competition. *The Times* in a leading article has also questioned the wisdom of de-mutualisation:

> 'Of itself, the move to plc status was harmless. But it had two dangerous elements. It liberated those once cautious building society bosses to diversify into new activities, and provided them with the capital to do so. It also loaded them with remuneration packages so poorly structured that they encouraged short-term recklessness.'

6. NEW DISCLOSURE REQUIREMENT ON BANKS

The Competition and Markets Authority has also decided to make an Order requiring suppliers of current account services to regularly publish results of independent surveys of their customers' views on service quality. Banks are required to publish the results of surveys about customers' willingness to recommend their current account suppliers. As stated by the CMA, service quality metrics are to be published prominently by each provider on their websites, in branches and in promotional leaflets. Data should be provided on a regular basis as open data to third parties such as price comparison websites. The CMA has a broad conception of Open Banking in that it wishes to ensure that customers are able to compare service qualities of current and prospective providers by requiring banks to make information available about their customers' willingness to recommend their services and to publish certain operational performance metrics in respect of personal current accounts and SME bank services. It would also like to encourage customers to consider their existing banking arrangements and to take appropriate action, such as searching, comparing or switching providers or products. Prompts for such action may be issued periodically, at key milestones in a customer's banking relationship.

7. FINANCIAL SYSTEM STRUCTURE

Part 2 of the submission focuses on the role of technology and Open Banking. The impact of competition, Open Banking and the evolution of technology has the potential to induce structural change in the retail financial services industry including who supplies financial services, how customers interface with service providers, challenges to the value chain in the provision of services and products, the range of products and services offered by different financial services firms, and the extent to which traditional financial services firms may forge strategic links with FinTech firms.

As entry barriers in some areas are likely to be eroded, and increased use of platforms develops (see next section), a wider range of different types of service providers is likely to emerge, and different suppliers of financial services will adopt different business models, the retail financial services industry is likely to become populated by a wider range of business models. This means that incumbent firms will be forced to compete with new competitors which have fundamentally different business models. This implies greater heterogeneity as between consumer behaviour, business models of banks and other financial services firms, and value-chain models.

The Bank for International Settlements (2018) has proposed five general scenarios within which different business models would play differing roles (figure 1):

1. Better banks: Large incumbent banks digitise, leveraging technology to change their current business models but remain Full Service Providers and retain the customer relationship and core banking services.

2. New banks: New entrants or challengers (including Big-Tech companies such as Amazon) with full-service, built-for-digital platforms replacing incumbents as Full-Service Providers. Under this scenario, some incumbent banks may struggle to compete long-term except in some niche markets.

3. Disrupted banks: In this model, financial services are broken up, with incumbents able to carve out niches. Provision of services comes via a network of modular providers, a mix of Product/Service Suppliers and their own Interfaces.

4. Relegated banks: Banking services are commoditised, and incumbents become product suppliers or merely Utilities, ceding the customer relationship to FinTech or Big Data companies whose front-end platforms provide the interface.

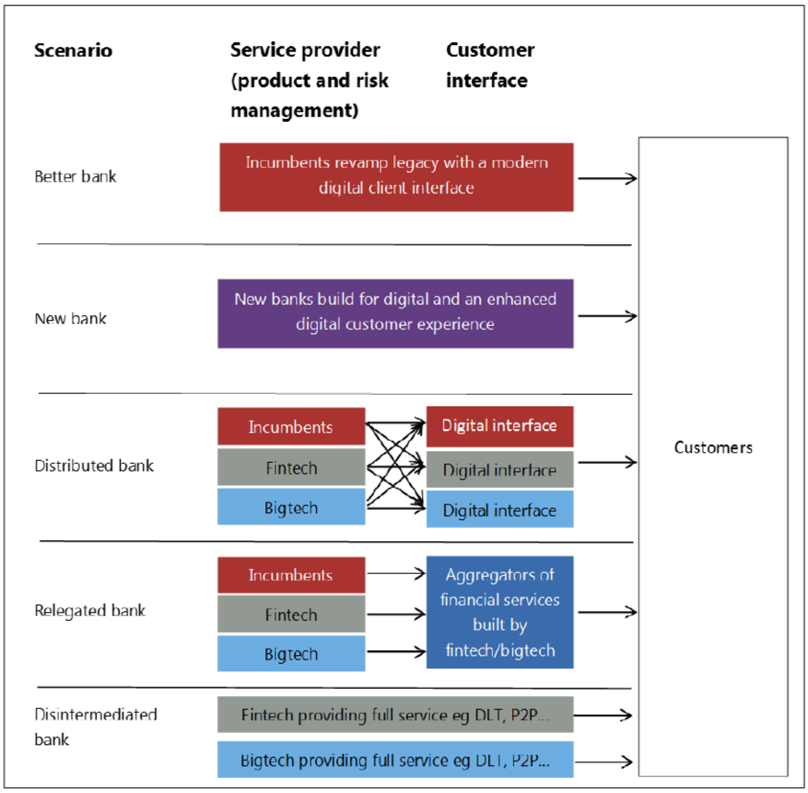
5. Disintermediated banks: FinTechs using more agile platforms and technologies to provide services without balance sheet intermediation; incumbents are squeezed out. This is deemed unlikely in the short- to medium-term.

Conflicting pressures are likely to emerge. On the one hand, as argued in the McKinsey 2016 *Global Banking Review*, some incumbent financial firms are likely to lose business and revenues on a large scale. On the other hand, many of the pressures that have been identified create enhanced opportunities and the potential to raise efficiency even if this might necessitate the adoption of different business models and structures.

In reality some combination of different scenarios may apply across different market segments, and these changes may take place at varying rates.

FIGURE 1

Graph 5: Overview of the five scenarios and the role players



Colour code: red indicates incumbent banks; purple new players; grey specialised fintech companies; and blue bigtech companies.

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