

REVIEW OF BARRIERS TO ENTRY, EXPANSION AND EXIT IN RETAIL BANKING

A submission to the Office of Fair Trading by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 50 UK building societies. Mutual lenders and deposit takers have total assets of over £370 billion and, together with their subsidiaries, hold residential mortgages of over £235 billion, 19% of the total outstanding in the UK. They hold almost £250 billion of retail deposits, accounting for just under 22% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.
2. This submission looks briefly at the regulatory and economic context of the review, and highlights the basic importance of trust in financial services that is fundamental to many of the potential barriers to entry, expansion and exit. The questions asked in the call for evidence are then addressed, excluding those relating solely to SME banking. There are substantial barriers to entry to and expansion in retail banking, which are highlighted below.
3. A diversity of business models benefits competition and financial stability, so it is also important that barriers are not greater for mutuals than other providers. If capital instruments that are consistent with mutual ownership are not included in the definition of core capital, this would be an example of a significant barrier to mutual financial service providers relative to other business models.

Context of the review

4. This review takes place alongside several other fundamental reviews into the structure and regulation of the retail banking industry, as mentioned briefly in paragraph 1.2 of the call for evidence. Therefore, the review should take into account the effect of these other work streams and should not report in isolation. Furthermore, the review needs to recognise potential conflicts between various objectives of changing the structure of the industry: facilitating entry and exit might run counter to financial stability goals, both of which might conflict with distributional aims intended to reduce financial exclusion. The review should therefore also consider the impact of any recommendations on these competing policy objectives.
5. In addition, the current economic climate makes entry and expansion difficult as this would entail winning existing business rather than new business. In 2009, outstanding mortgage balances grew by just 1%, and household savings balances grew by 2%. Access to wholesale funding markets remains restricted causing intense competition for retail funds, and the record low level of the Official Bank Rate has put immense pressure on retail banking margins. In such an environment entering the market may not be attractive to potential entrants. Furthermore, the economic conditions may affect different business models to differing extents, which might lessen the ability of some institutions to expand, reducing the diversity of models in the sector, and therefore competitive pressure in the market.

The primacy of trust in the financial services sector

6. The OFT's call for evidence does not appear to give due recognition to the principal importance of consumers' trust in financial services. Although paragraph 3.34 refers to the development of a successful brand as a barrier to entry, establishing trust is more basic than this: a brand can be invested in, but trust is built on consumers' perceptions and moral judgements¹. The fundamental nature of trust means that banking is relational rather than transactional, and this has implications for how the barriers to entry and exit are interpreted.

7. This is not to say that barriers to entry, expansion and exit do not exist in the retail banking market, and that the elimination or diminution of them could not increase competition, but rather that reducing other barriers might not necessarily increase competition when slowly-formed trusted relationships are essential.

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

8. The BSA agrees that the scope of the review should exclude large business customers. But the review should separately identify other players in the personal and SME banking markets, such as the Post Office and NS&I.

9. The Post Office currently offers under its own branding a range of banking services, primarily using products from the Bank of Ireland. Many consumers will not be aware of this relationship, nor that these products are covered by the Republic of Ireland's deposit protection scheme rather than the UK's Financial Services Compensation Scheme (FSCS). Firms that sell their products via the Post Office thus benefit from a close association to a brand that is trusted by consumers, which stems in part from the perception that the Post Office is owned and underwritten by the UK Government, as, by extension, are the products it provides.

10. The previous Government proposed developing the Post Office's banking operations, including the provision of mortgages and savings accounts, and in its Programme for Government the coalition stated that it would look at the case for developing a Post Office Bank. The OFT's review should therefore consider the extent to which the provision of financial services by the Post Office is a barrier to new entrants, and how the potential expansion of its activities in this area would add to this barrier.

11. Deposits with NS&I enjoy an explicit 100% Government guarantee, in contrast to most other deposit-takers which have insurance covering the first £50,000 under the FSCS. Although NS&I has been set a zero net financing target for the 2010/11 tax year this guarantee offers it an unfair advantage in the retail savings market. An example of the effect of this advantage could be seen in November 2009 when NS&I distorted the UK savings market by offering a number of competitive products that attracted substantial inflows: in that month alone savings balances with NS&I increased by £3.1 billion while savings balances held by households with banks and building societies reduced by £1.5 billion. To put NS&I's £3.1 billion increase in balances with NS&I in November in context, across all of 2009 balances at NS&I increased by just £3.6 billion.

12. There is also a risk from the continued involvement of the State in those institutions that were rescued in 2008 acting as a barrier on entry and expansion. The BSA welcomed the removal of the 100% guarantee covering retail deposits held with Northern Rock bank, but this institution is owned completely by the State, which also has substantial stakes in two very large banks. These stakes might be perceived to be an implicit total guarantee to depositors. The BSA lobbied the European Commission (EC) to impose constrictions on the activities of Northern Rock plc to prevent it using its State backing to distort the UK savings and mortgage markets. In recognition of these risks the EC imposed a number of these

¹ 'Credit is trust' Speech by Andrew Haldane, Bank of England, 14 September 2009
<http://www.bankofengland.co.uk/publications/speeches/2009/speech400.pdf>

conditions on Northern Rock². It would be worthwhile the OFT reviewing the extent to which continued State ownership of banks would constitute a barrier to entry or expansion.

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

13. The general themes of regulatory requirements, essential inputs, barriers to achieving scale and barriers to exit cover the most important elements, with trust being one of the most essential of inputs.

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

14. Financial services providers are undergoing the most fundamental change to capital and liquidity requirements for decades. Much of this change is being driven at a European level, such as the proposed amendments to the European Capital Requirements Directive being consulted on in CRD4. It is difficult to see what changes could feasibly be made by the UK authorities to requirements determined in Europe beyond ensuring that no 'gold-plating' occurs when the Directive is applied in the UK. One area where barriers specific to the entry or expansion of mutuals (as opposed to other business models) may arise is if the definition of core capital in the Directive excludes capital instruments that are consistent with mutual ownership. The BSA has made submissions to HM Treasury, the Basel Committee and the European Commission's consultation to CRD4 to encourage an acceptance of the valuable differences in capital instruments at mutual and co-operative institutions³.

15. In addition, financial regulation prompted by financial stability concerns has tended to favour dominant incumbents in the banking market, protecting them from competition. This can be seen in the consolidation that has taken place since the beginning of the financial crisis. And increased prudential regulation is likely to be a greater proportionate cost to smaller firms than larger ones.

16. Finally, the UK's consumer law regime which the last Government described as "complex and inflexible" is likely to deter new entrants as well as lead to uncertainty for existing providers, regulators, consumers, ombudsmen, etc⁴.

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

17. Anti -money laundering regulations may add to barriers to entry or expansion by hindering account switching by consumers. Different providers may interpret the regulations slightly differently or may apply the regulations strictly to avoid enforcement action from regulators.

18. Membership of the Financial Services Compensation Scheme (FSCS) is another regulatory requirement, although it seems unlikely that it would represent a significant barrier to entry – not least because any new entrant is exempt from paying a FSCS levy in its first year. In subsequent years the new entrant is required to pay FSCS levies calculated on the same scale as existing participants in the market. This is in our view appropriate and it would

² BSA submission to the EC on Northern Rock: <http://www.bsa.org.uk/docs/policy/nrockec2.pdf>

³ 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

⁴ The BSA's submission to BERR's Consumer Law Review, 2008, <http://www.bsa.org.uk/policy/response/dberr.htm>

create unfair competitive distortions if, for example, new entrants were to be exempt from paying the legacy costs that incumbent firms are required to pay.

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

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

19. Accessing payment systems is relatively costly, but not any more so to a new entrant than to an incumbent. Anecdotally, settlement members do compete to provide indirect access when they deal with smaller financial institutions, but not aggressively.

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

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

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

20. Obtaining credit scoring information from third party providers is not considered to be a particularly significant barrier to entry to new entrants compared to incumbents.

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

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

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

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

21. The costs of developing and marketing a new brand for retail banking are substantial, particularly if this is taken to include the establishment of reliability and trust, as these are intangible and largely a matter of perception. They therefore take time to develop and the cost of doing so is difficult to estimate. As discussed at the start of this submission, trust is fundamental in retail banking and represents one of the most substantial barriers to entry.

22. With these substantial barriers to entry, it is currently likely to be difficult to enter the retail banking market on a small scale. Furthermore, in relation to trust, scale may actually be seen by consumers as a proxy for the advocacy of others.

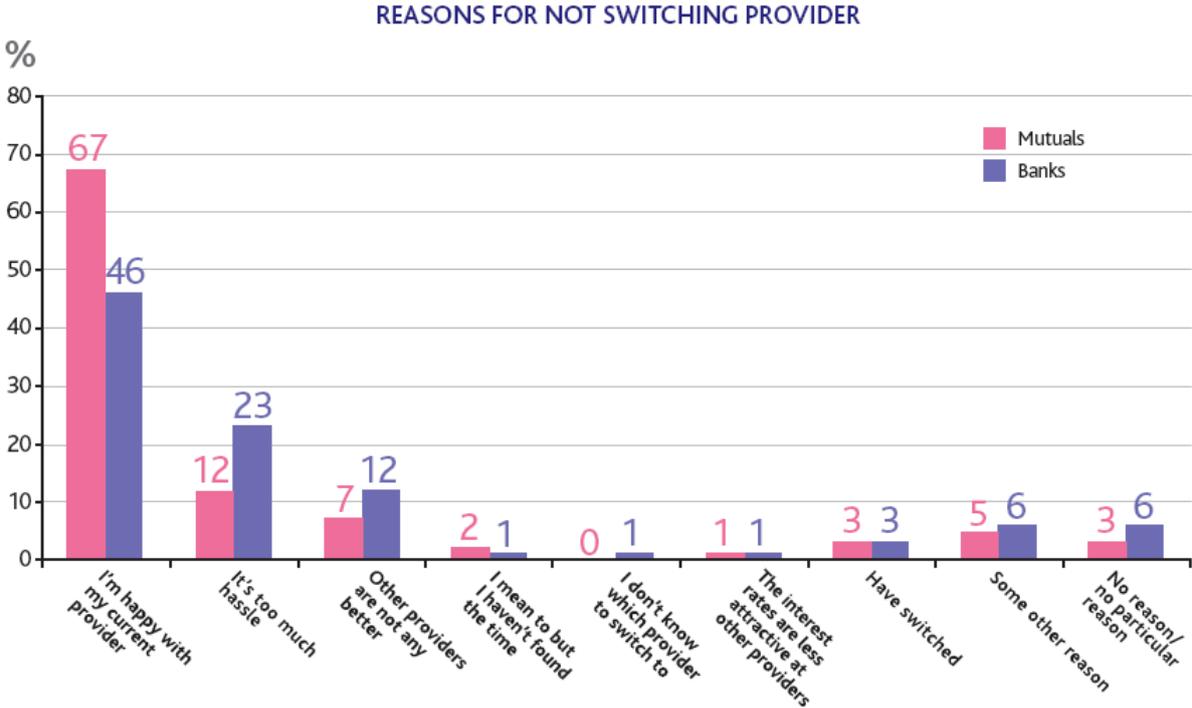
23. The range of products available to consumers largely reflects differences in demands from different groups of customer. For example, some customers may value the certainty of fixed interest payments on a mortgage, while others would prefer a variable rate, perhaps because they believe rates will fall in the future. In this context, customer inertia may indicate satisfied customers.

24. Other studies have found low levels of switching and the longevity of customer relationships to be indicative of low levels of competition in retail banking⁵. However, these factors may be symptomatic of the primacy of trusted long-term relationships in banking. We encourage the OFT to determine what is the optimal level of switching and length of relationship in assessing the level of competition in banking. It may be that the optimal levels are different for different segments which may be distinguished by their levels of financial capability. Previous research by the BSA has concluded that the more financially literate

⁵ <http://www.oecd.org/dataoecd/44/18/39753683.pdf>

somebody was, the more they relied on the interest rate rather than behavioural or psychological factors in their choice of account⁶.

25. In recent research by the BSA into customer satisfaction and service standards mortgage and savings customers were asked why they did not switch to a different provider. At mutual institutions, more than two-thirds did not switch because they were happy with their current provider. At other banks this proportion was just 46%. There is the perception that switching providers is difficult, with 12% of mutual customers and 23% of other bank customers saying the hassle of changing prevented them from acting. Another significant reason for not switching provider is that consumers perceive all providers to be essentially the same, so there is little point in changing. This was selected by 7% of customers of mutuals and 12% of customers at other banks. The results are summarised in the chart below.



Source: Survey by GfK NOP of 1,968 adults aged 16 or over, 11-16 March 2010⁷

26. Improvements have been made in account switching processes in recent years, with the OFT and the banking industry agreeing to make costs more transparent and the switching process more reliable and trusted. Facilitating switching is a key commitment under the Banking Conduct of Business Sourcebook (BCOBS), and before it, the Banking Code, and the BSA would question how much further requirements in this area would help. It is possible that consumers perceive the difficulty of switching to be greater than it actually is.

27. Regarding customer inertia, money laundering regulations may add to the difficulty in switching accounts, as mentioned in paragraph 17 above.

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

28. All financial service providers have been affected, directly and indirectly, by the turmoil in financial markets since 2007 and the subsequent recession. However, it is not obvious that scale is directly linked to consumers' confidence in an institution. Some of the largest banks in the UK needed support from the Tripartite authorities at the height of the crisis, and

⁶ 'The individual's saving decision', BSA, 2007, <http://www.bsa.org.uk/docs/circularpdfs/6544att.pdf>

⁷ 'Customer service at mutuals is better than at banks', BSA, 2010, <http://www.bsa.org.uk/docs/consumerpdfs/customerservice.pdf>

these banks experienced substantial deposit outflows at this time. A number of building societies – large and small – were the beneficiaries of these deposits. In the last year some of these deposits have been withdrawn from building societies as banks have competed aggressively for retail funding due to continued difficulties raising funds in wholesale markets. During the crisis, building societies observed an increased awareness among savers of FSCS limits and the corresponding movements in savings balances by individuals to maximise their coverage across providers.

29. Overall, however, research has suggested that trust in financial service providers has remained relatively stable through the crisis. A survey on consumer trust in financial services by Nottingham Business School that has been running for four years found that “trust... is in fact remarkably robust in the face of industry specific crises and economic difficulties”⁸. The report concludes that trust in financial services providers could be expected to display some durability as established beliefs are not easily undermined.

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

30. The majority of firms with existing brands in other sectors that have entered banking in the last decade or so have tended to do so via joint ventures with large incumbents in the banking industry. For example, Tesco had a joint venture with RBS and Sainsbury’s with Bank of Scotland, while Virgin worked in partnerships with RBS and Norwich Union, the insurance company. This again highlights the difficulty in establishing a trusted reputation in retail banking. It may also be a recognition of the importance of reliability (“technical” quality in one theory of service quality⁹) in financial services above softer aspects, such as the attitude and behaviour of staff (as measured by “functional” service quality).

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

31. There will obviously be differences in the benefits, costs and availability of suitable locations for branches across different regions related to population density, local demography, commercial rental prices, and so on. However, mutuals have tended to keep their branches open to a greater extent than banks, or indeed, post offices. From 1995 to 2008, the number of building society branches reduced by 19%, compared to a 30% reduction at both banks and the post office. This is because mutuals place great value on their links with their local communities, and consider the impact on customers when assessing branch performance, not just the financial costs of operating the branch.

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

32. Growing use of alternative channels such as online and telephone has undoubtedly reduced some customers’ use of branches. However, for many customers the branch continues to be important, particularly at the account opening stage. Developing a trusted brand is likely to be easier with branches as this enables face-to-face contact. Therefore, it is frequently the case that other channels are complimentary to the branch network, rather than in place of it. Firms that rely solely on channels such as the internet or phone tend to have small market shares, and be part of a larger group that contains a branch network. It is noteworthy that of the entrants coming to the market in recent years all have either tried to leverage an already trusted brand, or are using branches to establish this trust (for example, MetroBank).

33. The financial crisis also demonstrated that branches can be a useful physical presence in situations where confidence in a financial institution has been damaged. For

⁸ <http://www.theforum.Co.Uk/Documents/Whitepapersreports/Public/Trustindex.Pdf>

⁹ ‘Service quality issues in financial services’, Nath, P, and Devlin, J, Financial Services Research Forum, Nottingham University Business School, 2007

example, with the collapse of Icesave, the online bank operated by the Icelandic bank Landsbanki, there was a great deal of uncertainty about the security of customer deposits as there were no branches. And during the run on Northern Rock, the crash of the bank's website heightened fears about the safety of the bank, but at least worried savers were able to queue at the bank's branches.

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

34. Building a branch network is a significant barrier to entry or expansion, one which these divestments potentially reduce, but other substantial barriers remain. It is likely that a relatively large incumbent will be best placed to acquire the fairly considerable branch networks divested by RBS and Lloyds and also have sufficient resource to address any other barriers to entry or expansion.

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

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

35. Existing direct State support may prevent some institutions from reducing their retail banking activities to the extent that might otherwise have occurred. The Special Resolution Regime should help to reduce this barrier to exit in the future, at least for non-systemic firms.

36. As mentioned above, the Financial Services Compensation Scheme may act as a barrier to exit if firms have to pay a proportion of the outstanding costs following the calls on the scheme in 2008.

Conclusions

37. There are substantial barriers to entry to personal and SME banking, including increasingly stringent capital and liquidity requirements, investments in technology, systems, branches and staff, and the establishment of a trusted and reliable brand. In addition, current market conditions make retail banking a difficult market to enter at present.

38. The recent turmoil in financial markets and the subsequent recession have affected all institutions operating in retail banking markets, but mutually owned institutions generally performed better through the crisis than their plc peers, and research has shown that standards of customer service and satisfaction are higher at mutuals. Having diversity in the business models and ownership structures of providers has been seen to benefit both competition and financial stability.

39. Mutual financial service providers certainly do not object to new entrants and would welcome barriers to expansion being reduced. However, mutuals do object to unfair competition. During the crisis, large incumbent plc banks benefitted disproportionately from the intervention of the authorities, and some continue to enjoy State backing. It is therefore important that such barriers are removed and others are not allowed to arise that discriminate against specific business models; for example, the definition of core capital in the regulatory requirements should allow instruments that are consistent with mutual ownership.

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