# Competition in banking

## A collection of essays

NEW CITY AGENDA

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**Edited by Kawan Patel and Matthew Ball**

**Contributors:** Anders Bouvin, Alex Chisholm, Tony Greenham, Benny Higgins, Cathy Jamieson, Dominic Lindley, Paul Pester, Alison Robb, Andre Spicer, Peter Vicary-Smith

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**About New City Agenda:** New City Agenda is a not-for-profit financial services think tank and forum founded by Lord McFall, the Rt Hon David Davis MP, and Lord Sharkey.

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# Introduction

**by Kawan Patel**

*Head of Projects, Policy and Communications at New City Agenda*

When we released our first report into the culture of British retail banking, one graph generated far more media attention than we had expected. The graph, which was taken from the Bank of England's Quarterly Bulletin in 2010, showed how 16 major banks with combined balance sheets of £8bn (32% of GDP) in 1960 became, through a series of mergers, four big banks with combined balance sheet over £6trn (450% of GDP) by 2010.

This fascination with the size of Britain's largest banks, regardless of the issue being discussed, fitted quite neatly into a line of thinking we encountered time and again whilst interviewing people as part of our research; a train of thought which either blamed poor culture on a lack of effective competition, or saw effective competition as the solution to poor culture.

Debates around access to finance, the fair treatment of customers, financial stability ('too big to fail'), and sustainable economic growth, often similarly cluster around assessments of the banking sector's composition and competitiveness.

Competition, it seems, is the hottest topic in town, and understandably so.

To paraphrase one of our contributors, banking is part of 'the essential economic infrastructure of society'; it is 'a market that really matters'. The competitiveness of the banking sector, in other words, is everybody's business.

This essay series explores the state of competition in British retail banking. Our contributors give their opinions on whether or not the sector is truly competitive; discuss what benefits can be derived from an increase in choice, diversity and transparency; and suggest ways in which the banking market can be made to function more effectively.

We begin by addressing the elephant in the room, the Competition and Market Authority's decision to refer both personal current account and SME retail banking sectors for full market investigations. Alex Chisholm sets out the CMA's reasoning behind the decision in our first chapter.

In chapter two, Peter Vicary-Smith outlines what he believes are the key themes and approaches that should guide the CMA in their inquiry into the personal current account market.

One of these key themes, culture is also addressed by Paul Pester who argues that greater competition 'is the only way to deliver the kind of banking customers want' in chapter three.

Pester's essay also focuses on the importance of transparency, an issue which Benny Higgins claims is essential to ensuring effective competition in chapter four.

Higgins is critical of the notion that new entrants will automatically bring about better outcomes for consumers, a scepticism which also runs through Alison's Robb chapter on the need for a regulatory framework which takes better account of non-PLC models and encourages greater market diversity.

Diversity is one of the primary themes of chapter six, in which Tony Greenham lists the problems he believes competition cannot solve.

Anders Bouvin elaborates on Handelsbanken's belief that a focus on long term relationships and customer service deliver competitive advantage in chapter seven.

In chapter eight Cathy Jamieson discusses the importance of a competitive banking sector to securing better standards of service in business and personal banking, and a more balanced economy.

Dominic Lindley examines the prospects for new entrants which are aiming to use technology to disrupt the retail banking market in chapter nine, and in our final chapter Andre Spicer challenges the assumption that competition alone will solve all of the sector's cultural issues.

# The role of competition in banking markets

**by Alex Chisholm**
*CEO of the Competition and Markets Authority*

Last November, the CMA made the decision to launch an in-depth market investigation into the personal current account and SME retail banking sectors. That investigation is now being conducted by a group drawn from our panel of expert members. It's no part of my role as Chief Executive to interfere with the independence of their decision-making or to make comments that anticipate the investigation process. However, in this essay I will discuss our reasons for referring these markets for a full market investigation, following our 'first-phase' analysis in our market studies. I will also outline some of the other ways in which competition – and the CMA – are relevant to the banking industry.

For consumers, banking performs a vital service across society. Virtually every household in the country uses retail banking services. In our market studies published last July, which led to the launch of the market investigation, we found that in 2013 there were 65 million active personal current accounts in the UK. Small and medium-sized businesses – SMEs – which employ 60% of the country's workforce, hold business current accounts that collectively yielded for the banks £2.5 billion in revenue, and the value of outstanding term loans to SMEs in Great Britain was some £90 billion. And of course larger corporates depend on the banking sector for a wide range of financing facilities.

What's more, banking is of course part of the essential economic infrastructure of our society. As well as being a major industry in itself, it underpins most other economic activity, both consumer and business. We've calculated from Payments Council figures that every day there are 59.1 million payment transactions going through our banking system. Up and down the country there are (in spite of branch closures) over 8,000 bank branches.

So retail banking is a market that really matters. When there's vigorous competition in this market, the economy will benefit from higher quality and better value banking services. Conversely if competition is weakened or frustrated – whether through anti-competitive practices by businesses in the market, or through inherent features of the market – the incentives to offer consumers attractive prices and quality are correspondingly weakened. The CMA's role is to ensure that competition is not weakened or frustrated in these ways, and that incentives to offer consumers attractive prices and high service standards remain high.

The market studies we conducted into personal current accounts and SME banking, published in July, and the consultation that followed, showed reasonable grounds for suspecting that there were features preventing, restricting or distorting competition. On that basis, we decided that it was appropriate to refer these sectors for a full market investigation.

Where there is a vigorously competitive market, the businesses that do the best job of servicing customers – in terms of price and quality of service – tend to win customers and gain market share. The ones that don't can expect to lose customers and market share.

What we found in retail banking was that it didn't seem to be working like this. For both personal and SME customers, very limited market share gains have been made in recent years by those banks with the highest reported levels of customer satisfaction. Conversely, those with some of the lowest satisfaction scores – relatively – didn't seem to be losing significant market share as a result. This is not what one would expect to see in a well-functioning competitive market.

In fact the evidence suggested that market shares had remained remarkably stable over a sustained period. There were a number of possible factors contributing to this apparently muted competition.

First, there seemed to be relatively little switching and shopping around by consumers – which matters because the hope of winning customers, and the fear of losing customers, is of course one of the main drivers to businesses competing vigorously. The new seven-day current account switching service has made switching easier, but switching levels remain at about 3 or 4% a year – figures that compare poorly with other sectors, including the energy sector.

As for SMEs, a survey conducted for our SME banking market study showed that many are concerned at how difficult it is to compare charges.

Second, there seemed to be considerable barriers to market entry and expansion. Barriers include the continuing need to maintain an extensive, and costly, branch network in order to be an effective scale competitor. Although people increasingly use online banking and mobile apps for their banking needs, the survey evidence we saw showed that both personal and SME customers still very much value having a branch of their bank near them. And this is reflected in the banks' business models: despite all the news of branch closures, the larger banks intend to maintain very extensive branch networks; and amongst so-called 'challenger banks', Metro is establishing a substantial new network of branches. Another possible barrier we heard about was the suggestion that smaller banks face disproportionate difficulties and costs in gaining access to essential payment systems like BACS, CHAPS and Faster Payments.

Our November decision to ask the CMA's panel of independent members to conduct a full 'market investigation' into retail banking was not a final decision that the market is anti-competitive. It wasn't, as it were, a 'guilty' verdict. It will be for the panel members running the investigation to decide, at the end of a thorough and detailed 18-month investigation, whether any features of the relevant markets have an 'adverse effect on competition'. If there is such an adverse effect, the panel members can then require measures to remedy that adverse effect. Those measures could in principle be structural – ordering businesses to be divested, as happened a few years ago after the market investigation into BAA, which led to the sell-off of airports in London and Scotland. But there are also other possible remedies if the panel members conclude that there is an adverse effect on competition – for instance so-called 'behavioural'

remedies such as requiring greater transparency and comparability – and they could involve regulatory or legislative changes. All that is not for me, but for the panel of independent members to decide, after they have heard and assessed all the relevant evidence and arguments from interested parties.

There have been numerous investigations by public bodies into banking – by the Financial Conduct Authority (FCA), the Treasury, the Bank of England, and our predecessor bodies, the Competition Commission and the OFT. Plus, of course, the Vickers report in 2011, the Parliamentary Commission on Banking in 2013 and Treasury Select Committee inquiries. And we are fully conscious that a market investigation involves considerable cost, both for the businesses in the sectors under investigation and for the public purse.

So is there the need for another regulatory intervention?

While I can't predict the outcome of this market investigation, it's worth pointing out that, unlike many of those earlier inquiries, the CMA has powers, following a market investigation, to order remedies to any adverse effects on competition that might be identified, rather than merely to make recommendations.

What's more, many of those earlier reports – including Vickers in 2011, and the Parliamentary Commission in July 2013 – explicitly envisaged that there should be a market investigation by 2015 in the absence of a transformative change in the conditions of competition in the sector. While we recognise that there have been important developments – the current account switching service, for example – they don't seem to us yet to have had the transformative effect hoped for, and the long-standing concerns about competition in retail banking largely remain.

So we're confident the decision to launch a full market investigation was well justified. But we will keep firmly in mind the need to avoid unnecessary regulatory burdens.

There is of course more to competition than just market investigations. As part of our duty to promote competition – which benefits consumers and the wider well-being of society – we will seek to combat anti-competitive practices. Part of that involves enforcing the UK and EU competition prohibitions: the prohibition on agreements and concerted practices between businesses that restrict competition, and the prohibition on unilateral abuses of a dominant market position. The prohibition on 'agreements' between businesses that restrict competition can apply even if the agreement isn't legally binding, and even to the most informal kind of arrangement or understanding, which may arise from emails or just conversations.

Compliance is essential, and the sanctions for infringements can be severe. Fines for anti-competitive behaviour can amount to up to 10% of group turnover. And infringements of the prohibitions can have other harmful consequences. Directors of companies found to have infringed the prohibitions can be disqualified from holding directorships. Victims of the infringements – for example, customers who are paying higher charges as a result of the reduction in competition – can sue in court to recover damages for their loss. And there is the reputational damage: it is not good for business to be investigated and found to have gone down to customers.

## Conclusion

Competition in banking is essential to maximising the benefits the sector can bring to consumers in society and to the wider economy. Although it can sometimes seem otherwise, this needn't be an antagonistic process. The competition authorities will come down hard on anti-competitive practices that break the law,

but will work with banks to encourage compliance. The market investigation offers an opportunity for constructive engagement about improving outcomes for customers. And we will support moves to remove disproportionate or excessive regulatory requirements that dampen competition. Focused on the need to serve society by ensuring vigorous competition, we look forward to working with the banks in these endeavours.

*This essay is based on a speech delivered by Alex Chisholm to the British Bankers Association Conference, on the 4th of December 2014.*

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# A golden opportunity: fixing retail banking

**by Peter Vicary Smith**
*Group CEO of Which?*

Another year, another inquiry into the financial services sector. This time a full 18-month inquiry by the Competition and Markets Authority (CMA) into retail banking, including both the personal current account (PCA) and Small to Medium Enterprise banking markets. This essay focuses on the PCA market and outlines why this new inquiry is needed. It then sets the scene for how the CMA should approach some of the problems in the market.

## The market is important but it isn't working for consumers

PCAs are an everyday part of life for the vast majority of UK consumers. They are where we get paid, how we pay the bills and manage our mortgages and, through the use of an overdraft, where we might turn first to make ends meet in the event of an income shock or particularly expensive month.

Yet despite this clear importance, and plenty of attention from regulators and government, Which? research has repeatedly demonstrated a complex mix of long-standing problems on both the demand and supply side that impede genuine competition and are detrimental to consumer outcomes.

On the demand side, consumer engagement in this market remains too weak to truly drive effective competition: switching rates are low (currently 3.1%)[1]; and because of complex pricing structures, consumers are often unable to make informed product comparisons and select the best account for their needs.[2]

On the supply side, high barriers to entry contribute to high and persistent market concentration. The Big Four banks control 77% of the PCA market.[3] On top of this there is, arguably, a lack of meaningful product and service innovation. Recent advances in faster payment services and increased switching speeds have been pushed through with political pressure and there are accusations that incumbent firms have used their dominance of the payment system itself to limit potential challengers' access to these innovations.[4]

## So what can be done?

Identifying the problems is a relatively easy task. Solutions that can turn around decades of failings are more complex. The CMA should be guided by Which?'s *Six tests of a competitive banking market*[5]. Some key themes that should run through their inquiry are highlighted below.

## There is no (switching) silver bullet

The complexity of problems across the demand and supply side mean that it is unlikely that significant changes are going to be achieved by implementing one single policy response. There is no silver bullet.

There has recently been a focus on improving the speed and reliability of switching, through the introduction of the Current Account Switching Service (CASS). Which? supports this initiative: it has the potential to bring down barriers to switching that consumers previously faced. However, on its own, it will not lead to the change in engagement needed.

Figures from the Payments Council already show the potential limits of its impact. They show that switching rates have recently increased, but still stand at a paltry 3.1%[6]. Nearly six in ten (58%) consumers have never switched their main current account.[7]

This means that when thinking about the demand side, it is important that the CMA looks beyond both the ease with which consumers feel they are able to change suppliers or products and the proportion of consumers switching. They must pay careful attention to outcomes of any potential switch and consumers' motivations for engaging in the first place.

## Outcomes from (not levels of) switching are important for consumers and competition

For consumers, previous research suggests that outcomes are not always improved by switching. One in five consumers who switched current account in the last year say they are not currently confident they are on the best value product.[8]

Outcomes are also important for competition. To understand why, consider a situation where there are two competing banks and a consumer is looking to switch, but makes a choice based on a coin toss. Here, even if all consumers switch every year, each bank will receive half of all consumers and there is no incentive for them to compete based on product offering or price.

This might seem an over-simplistic scenario, but it is easy to see how it could apply to the PCA market. Which? research shows that:

- The vast array of different overdraft charging structures, makes it extremely difficult for consumers to accurately and easily compare current accounts on the basis of cost;[9] and
- Consumer choices are subject to behavioural biases. For instance, rather than systematically approaching product comparison, consumers sometimes base choices on products appearing close to the top of the price comparison site or google page. [10]

So overall, a combination of price obfuscation and consumers using choice heuristics, might lead to switching behaviour that is akin to the rolling of a die and little incentive for banks to innovate to meet real consumer need.

This highlights the importance of progress to make the Midata initiative a reality for consumers. It could help those switching make choices that more consistently improve their outcomes and, in turn, give incentives for providers to innovate and more effectively meet consumer needs. The CMA must consider how its own recommendations can facilitate and support this initiative.

## Providing meaningful choice

Even if switching is made easier, quicker and more informed with CASS and the Midata initiative, the impacts on competition will be muted unless consumers actually want to engage with the market in the first place.

That means that consumers' motives for switching are important. It is concerning that our research shows that some consumers tend to switch in response to a bad experience with their existing bank (a push factor) rather than because they see alternatives in the market that think would better suit their needs (a pull factor).[11]

Our research also suggests that consumers do not see tangible differences in the product and service offerings available from different banks. This impacts on their likeliness to switch. One in three (31%) consumers agree that "there seem to be no differences between banks; I don't think I will receive anything of discernible difference (e.g. in price, quality, service) depending on the one I choose".[12] Our analysis of the market suggests that recent entrants are unlikely to significantly change this view.[13]

This should be an area of focus for the CMA. One way to improve product and service differentiation is to facilitate the entry of challengers into the market. This needs to be done in a way that allows them to

introduce business models, products and services based on meeting consumers' needs through innovation and that are tangibly different to what currently exists.

We only need to look at the impact of relatively new entrants to the food retail market to see the potential here. The recent explosion of Lidl and Aldi has turned this market on its head. Shares in incumbent firms have fallen heavily this year and both firms are quickly picking up market share by providing consumers a distinctly different offering.[14]

Arguably, this has not been the case with challenger brands in the PCA market over the last decade. In part hamstrung by the need to access costly and complex payments systems and infrastructure and the need to compete with the large branch networks of incumbents, product and service offerings have not provided consumers with brands that they can clearly distinguish. Just one in ten consumers say they see a clear difference between the banks.[15]

In this respect, the role of the Payment Systems Regulator (PSR) and their two market studies (on ownership of payment schemes and indirect access to the payment system) will be important. The CMA must play a coordinating role to ensure that the actions of the PSR fully support its goal to increase meaningful competition and improve consumer outcomes.

## Cultural change is key

In delivering real choice for consumers, the CMA must also recognise the important role of cultural change and how this interacts with the potential success of any competition remedies they propose.

In part, a reflection of the scandals that have plagued the industry, just 26% of consumers trust the sector to act in their best interests.[16]

Again, a comparison with the retail market is warranted. In Havas' recent survey on the role of companies in society retail was the rated as the most "meaningful" sector, primarily because people feel it helps them improve and enjoy their lives, and because retail brands focus their communication on these areas. In contrast, retail banks performed badly across a range of areas including the extent to which:

- They treat me with respect;
- I like to be seen using this brand;
- It helps me save money /manage my spending; and
- It makes interactions with the company easy, enjoyable and convenient.

These findings are also reflected in the Which? customer service survey. This shows that six of the top ten brands came from retail but the majority of the UK's biggest banks and brands (including Natwest, Santander, HSBC, Co-operative Bank and Barclays) all appeared well into the bottom half of the scores.[17]

With poor customer service, little or no perceived product or service differentiation and continued news of scandals, mis-selling and inappropriate behaviour, it is hardly surprising that consumers are, on the whole, not engaging fully with the PCA market. Why would you when there appears to be little tangible benefit from doing so?

Changing culture will take time and it is not just about customer service. It goes deeper than that. Cultural change in the PCA market should mean that banks compete actively with each other to provide clearly differentiated product and service offerings that are focussed on consumers' needs and offer value for money. Again, this is something that retail demonstrates. Lidl, Asda, Waitrose and Sainsbury's all clearly try to differentiate themselves in the market and they also compete publicly and vocally on value for money, for example by price matching their competitors. The banks should learn from this level of competition.

The Banking Standards Review Council have a key role to play here, but the CMA must also recognise that, to create a truly competitive market, cultural change will be as important as changes to structures and regulations. Without it, consumers will continue to be badly serviced, disengaged and ultimately worse off because of it.

## Conclusion: there is no silver bullet

The PCA market needs to work for consumers but, currently, it does not.

There is no one-size-fits-all solution to how this can be improved. The CMA will need to put in place a package of remedies to tackle the long-standing failures identified. There are a number of areas where the CMA should focus: it must put in place solutions that reap the maximum potential from initiatives like CASS and Midata; play a coordinating role to ensure that the work of all the relevant regulators (the FCA, PSR and PRA) supports each other; and ensure that the role that cultural change can play is fully explored. Doing so will ensure that, unlike those that came before it, this inquiry leads to a PCA market that truly works for consumers.

The goal is clear. The CMA has a golden opportunity to take us there.

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[1] CMA, Personal Current Account Market Study update, (18 July 2014), p.73

[2] ibid, p.13

[3] ibid, p.9

[4] Payment System Regulator, Ownership, governance and control of payment systems, Supporting Paper 3 (PSR CP14/1.3), (November 2014)

[5] See Which? response to CMA Consultation: personal current accounts and banking services to small and medium sized enterprises, at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/370929/Which_response.pdf

[6] Payments Council, Current Account Switch Service Dashboard: Issue 4: covering the period 1 October 2013 to 30 September 2014, (2014). & CMA, Personal Current Account Market Study update, (18 July 2014), p.73

[7] Which? Consumer satisfaction survey, (March 2014)

[8] Which? Consumer Insight Tracker, (June 2014)

[9] Which? Magazine, 'Bank Charges: calculation impossible', (February 2014)

[10] Which?, 'The Real Consumer experience of 7 day switch: summary research findings of the consumer PCA switching journey', (March 2014): http://www.staticwhich.co.uk/documents/pdf/real-consumers-7-day-switch-experience-364351.pdf

[11] Which? Current Account Satisfaction Survey, (August 2014)

[12] Which? Consumer Insight Tracker, (June 2014)

[13] Which? Money, (February 2015), pp.22-24

[14] At 18/12/14 shares in both Tesco and Sainsbury's were trading at around 40% lower than a year previously.

[15] Which? Consumer Insight Tracker, (June 2014)

[16] Which? Consumer Insight Tracker, (December 2014)

[17] See Which? magazine, (October 2014), pp.16-17

# Competition: the key to better banking in Britain

**by Paul Pester**
CEO of TSB Banking Group

Over the years a lot has been said about needing greater competition in the UK banking market, even before the financial crisis. We've had numerous reviews, parliamentary inquiries and acres of press coverage. All without an awful lot of actual change.

The market has become dominated by large incumbent banks, a trend only exacerbated by the financial crisis, leading to an ever decreasing focus on what is best for the customer, and products and services that have become more and more opaque, making it ever more difficult for customers to make informed and confident choices about their financial products.

In the aftermath of the financial crisis there is a once in a generation opportunity to change this and build a banking industry which genuinely meets the needs of British consumers and the wider economy.

Competition is pivotal to delivering on that ambition.

TSB was created for that very purpose: to bring more competition to UK banking.

We don't see our role as being simply to enter the market and do things in exactly the same way they have always been done.

TSB's role – and the real value of having greater levels of competition in banking more broadly – is to be able to offer customers more choice and therefore deliver better banking for all UK consumers.

As we went about building TSB, we spent thousands of hours talking to customers and consumers about banking and what they wanted from their bank.

Their views were stark:[1]

- over 95% of people felt banks put profit before people
- only 20% of people thought banks treated customers fairly
- and only 1 in 6 people felt banks think about their role in wider society and how they can contribute positively

What is more, these views are now deeply ingrained in the public's thinking – they are not a short-term reaction in the immediate aftermath of the financial crisis.

In 2014 – seven years after the financial crisis took hold – TSB commissioned research from ComRes which showed that just 10% of people think there has been sufficient change in the banking sector following the financial crisis. Those views get worse the further away from London and the south east you get.

So how will competition help turn around these views and ensure the industry best serves the public?

In our eyes, genuinely effective competition will drive a range of positive pressures on the industry. However, it is the pressure for banks to place customers at the centre of everything they do where the greatest positive impact lies, with two potential outcomes in particular.

First in culture.

Cultural change will not come about through regulation or Government diktat. Genuine cultural change will come about because individual businesses understand and recognise its competitive benefits.

At TSB we are pioneering a new approach to retail banking based on values, behaviour and experience and it is this approach that will inform our own individual culture.

For us, good conduct is an investment, rather than a cost and is certainly not seen as a regulatory requirement. It is a business enhancing driver that is integral to our growth strategy.

That is because good conduct is a way for TSB to stand out and differentiate ourselves in an industry that is trying to regain the public's trust in light of recent scandals.

One of the defining features of TSB's culture is our focus on **how** we behave. It is about service not sales and moving away from the mindset that led to PPI and other products previously designed for the short-term benefit of the bank – rather than customers – and moving to the sort of service that turns customers into advocates.

We have embedded this mindset into the fabric of our culture by making every member of staff at TSB a Partner in the business.

When the bank was floated on the London Stock Exchange in June last year, all 8,600 employees (no matter where they work, or their grade) were granted £100 of TSB shares. These shares must be retained and our employees must demonstrate our clear partnership values if they are to receive any bonus award.

And at the beginning of this year our new remuneration strategy – called the TSB Award – went live. The award has been designed to reflect the performance of the Bank and it will typically reward Partners around 10% of their annual salary.

Crucially, the level of the award will be the same for every single Partner in the business, from bank teller to CEO. What's more, the TSB Award will not pay out unless the bank is profitable and successfully meets other criteria which we believe our customers would support.

We believe this approach will mean that each and every Partner is invested in the long-term, sustainable growth of our bank rather than focusing on short-term risk taking. And it will embed the type of culture we are seeking to deliver based on values and value – rather than short-term profits.

Others may focus on initiatives in slightly different areas, but fundamentally, our research shows that consumers now see culture and behaviour as critical to their decisions on where they want to bank, so in a truly competitive market, we will see all banks who want to be successful pursuing initiatives that drive a genuinely positive culture .

Secondly, we believe greater competition will introduce a much greater emphasis on providing customers with the power to make well-informed and confident choices about their bank and their financial products and services.

Over time, the intricacies of how banks and their products operate have become less and less apparent, serving only to add to the mistrust that exists in the aftermath of the banking crisis.

This of course is not the fault of consumers, but the product of an industry that has not had to face the pressure of genuine competition and think about how to make clear to its customers what the costs and benefits are of banking with them.

We know this is becoming increasingly important for customers because the other set of concerns consumers expressed when we were designing TSB was that they believed banks, and the products they offer, had become too complicated. They were mystified by how banks work and as a result felt less confident about many of the products on offer.

We have sought to address this at TSB by explaining to customers how our products work and how we make our money[2] so that people understand the real costs and benefits of banking and so that we also explode the myth that banking is free in the UK.

We believe people have the right to – and should – understand how their bank works. TSB's Truth and Banking website helps to demystify how TSB works and how we make money. We believe initiatives like this are the only way to ensure customers are able to make truly well-informed decisions about their finances.

We have placed transparency and truth at the heart of TSB's challenger credentials and in a more competitive market, banks will be forced to be more open and transparent because this is what customers want.

## Conclusion

Seven years on from the banking crisis, consumer confidence in banking remains low.

A step-change is needed and competition is the key. It is the only way to deliver the kind of banking customers want and most importantly, they need. And it will be the key factor in ultimately rebuilding trust in our industry.

Without greater competition, the sector as a whole will not face the pressure it needs to evolve.

With greater competition, the need to provide better products, be open and transparent with customers

and instill the right culture and behaviour, will become priorities for UK banks.

Greater competition will see the balance of power shift to customers – customers who will vote with their feet if the service and products that their bank offers do not provide them with the required standard, as they will be safe in the knowledge that they can get a better deal elsewhere.

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[1] YouGov, (2013)

[2] See TSB Truth & Banking website – http://www.tsb.co.uk/investors/truth-and-banking/

# Transparency can help fix retail banking

**by Benny Higgins**
CEO of Tesco Bank

The UK banking landscape has undergone significant change in the last decade. A number of new banks have entered the market; others have been acquired or forced to divest branches after receiving state aid; while millions of customers have gone through a fundamental change in how they do their banking with the growth of digital and mobile banking. But despite these changes, the competitive forces within the UK banking sector are not driving better outcomes for customers. Customer satisfaction levels are low, yet despite the welcome introduction of the Current Account Switching Service (CASS), customers are not voting with their feet in the numbers you would expect in a healthy competitive market. As a result, many of the banks get away with offering their customers a very poor deal – generating billions of pounds in revenue for themselves as a result.

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So why is that? Do we need more banks to create more competition? Is it customer apathy – the perception that all banks are the same and so why bother switching? Is it that customers are very happy with their bank? Has the current account switching service not done enough to make it easy for customers to move accounts? Or is it something else? And more importantly, what can we do to make it better for customers?

Over the next 2 years the Competition and Markets Authority (CMA) have an opportunity to address these questions and we warmly welcome their review. The key issue is to determine what needs to change to make the sector better for its 49 million UK customers.

So let's look at the first question posed above – are more banks the answer? Having recently completed the task of launching a current account we are well aware of how hard it is to enter the current account market. Any new bank requires significant investment, particularly in the IT costs associated with setting up well-functioning, reliable systems. Further, new banks must meet stretching capital requirements, as well as having access to payment systems such as CHAPS, BACS and faster payments either directly or via an agency agreement. However, these so-called barriers to entry are necessary. Above all else, customers must be able to trust their bank to be safe and secure and so we would not support regulatory intervention to significantly lower barriers to entry.

But it would be a mistake to conclude that the introduction of new banks will automatically bring about more competition and better outcomes for customers. There are many examples of sectors that are highly competitive with relatively few competitors. The UK supermarket sector being just one good example. And there are also examples of so called "challenger" banks that have entered the market in recent years that

treat their customers in exactly the same way as the larger, established banks. This only exacerbates the problem and reinforces the perception that all banks are the same.

Apathy is a key issue. Customers do not see a big enough difference between what the banks are offering and so they have no real incentive to switch. For example, more than 80% of current accounts do not pay credit interest. And most of the big banks (and some of the so-called 'challengers') have moved to daily or monthly fees for arranged overdrafts instead of, or sometimes as well as, a standard interest rate. The banks that use these fees often claim they are simpler for customers, but in reality they are often a hugely expensive way to borrow – particularly for customers who only dip into their overdraft every so often. This means that some customers are paying hundreds of pounds more every year for their overdrafts than they would if they switched to a bank that didn't use these charging structures. Yet even that is not encouraging greater switching.

Perhaps customers are actually very happy with their current bank? Well, for some customers that will be true, but overall customer satisfaction levels are low – particularly for the most established banks. The CMA reported that customer satisfaction levels routinely sit below 60% for the four largest banks. Furthermore, even among satisfied customers, our research has shown a significant proportion of customers with no intention of switching to a bank that paid them £45 a year in credit interest (an amount a customer with the average credit balance among UK current accounts would earn with some of the interest paying current accounts available on the market). Yet the rapid rise of interest paying current accounts has not led to a significant increase in switching.

The introduction of the CASS (Current Account Switching Service) has been a big step forward in making it easier for customers to move banks. Before its introduction switching banks took on average between 18 and 30 working days, with many customers negotiating with both their 'old' and 'new' bank for over a month. With CASS, once accepted the process takes seven working days and the customer only deals with the 'new' bank. And since its introduction, there have been an encouraging increase in the number of customers switching.

While this is to be welcomed and recognised as a necessary step in removing a barrier to effective competition, the switching numbers are still very low. That may be because customers still perceive switching to be too difficult and there is work to do to continue to raise awareness of the switching service. However, mechanisms to improve switching can't and won't remove the other considerable obstacles to effective competition, in particular ensuring there is complete transparency in what customers pay to their bank, and what they receive in return. That is the key issue to ensuring effective competition.

Supermarkets operate in a market where comparability and transparency are the norm. A customer can easily compare the cost of their grocery shopping and make a choice on where they shop based upon this. The same cannot be said of the current account market where charges are often hidden, products complex and the communications to customers are all too often opaque and confusing. And while we acknowledge that the two markets have significant differences, customers have a right to be able to make straightforward comparison between products. Without the ability to compare accounts customers will continue to have relatively low levels of engagement with their current account and switching will remain at low levels.

So what can we do about it? Some have suggested the introduction of mandatory account fees would remove the so-called 'myth' of free banking and encourage customers to shop around. We don't think that

would be right for customers as, in the absence of increased transparency, it would not drive a better deal for them and would only cost customers more.

For this market to work, the industry's collective energy and effort should be directed on ensuring that customers can quickly and easily understand the value and the cost of a current account to them in simple and clear terms. If customers had a clear view of how much their bank account really costs them in charges (particularly for arranged overdrafts), what their banks give them back in return, and what they could be getting from other providers (as is true in the supermarket industry), I believe far more customers would vote with their feet – forcing all the banks to work far harder for their customers.

For that reason, we are very supportive of the Government's MiData initiative. If all banks sign up to it as we have and make it work, it will be a much needed step in the right direction in providing greater transparency for customers, making it easier for them to compare current accounts. It is heartening that the big 4 have signed up and I think every current account provider should be encouraged to do so.

## Conclusion

To conclude, it is clear that the banking market is not operating effectively for customers and reform is required. Although the introduction of the CASS was a watershed moment in the industry, more needs to be done and the industry must not resist reforms to overdraft charges, fees and transparency to enable customers to see the true cost of their current account. The CMA has a golden opportunity to take action that will increase competition in the PCA market. I hope that it is one that will be seized upon as it will ultimately be to the benefit of the customer.

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# Beyond PLC Banks: Competition through Market Diversity

**by Alison Robb**
Group Director, People, Customer, Communication and Commercial
at Nationwide Building Society

## The Building Society Sector

Building societies are a vital source of diversity in UK retail financial services, which is an industry dominated by PLC banks. The top five providers of personal current accounts, for example, are all PLC banks and collectively account for around 85% of the market.[1] Building societies are strongest in the mortgages and savings markets (where collectively they hold around 19% of both outstanding mortgage and retail savings balances)[2] although Nationwide has a 6.6% and growing share of the current account market.[3]

Building societies are mutuals, owned by their members and operated for their benefit. Most building society customers are members, with rights to speak at meetings and to vote on how their society is run. Mutuality is not an arcane technicality of corporate governance: it is fundamental to how building societies do business and at the heart of the sector's culture.

As mutuals, building societies do not have shareholders in the same way that banks do. Whereas PLC banks must strike a delicate balance between serving the interests of customers and those of shareholders, mutuals have no such obligation and can focus relentlessly on the needs of their members. Without pressure to satisfy the short-term interest of shareholders, building societies aim for long-term value creation, optimising (rather than maximising) profits in order to ensure solvency, to invest in the business, and to offer member benefit.

Building societies' mutuality makes them inherently customer-centric organisations, which is reflected in the higher levels of service, trust and value-for-money that customers attribute to building societies, compared to banks.[4]

## Challengers and incumbents

Building societies are probably the best known and longest established alternatives to PLC banks in UK retail financial services. However, there are, of course, other kinds of provider which contribute to the diversity of the industry. Across the broad spectrum of retail financial services there are, for instance, electronic payments companies; peer-to-peer lenders; credit unions; monoline insurers; personal loan and credit card companies; as well as firms from other industries that have diversified to offer banking or payment services (such as supermarkets, manufacturers of electronic devices, and mobile telecoms operators). As the pace at which new technology emerges continues to increase, we can expect a slew of new players over coming years, with innovative digital and mobile banking and payment offerings.

So, the industry is populated by a widening range of players with different business models and corporate forms. An important question, however, is whether these players can challenge the primacy of the large established banks, exerting on them the kind of competitive pressure that forces the banks to innovate, to charge lower prices, and to offer excellent service.

In a well-functioning market, you would expect organisations with high levels of customer satisfaction to grow their market share, while those with relatively lower satisfaction levels should shrink as customers seek a fairer deal elsewhere. The UK's retail banking markets, however, do not always seem to work in this way: specifically, the large PLC banks appear to be able to broadly maintain their market shares, despite their customers reporting levels of satisfaction that are lower than for some of their competitors.[5] This fact suggests that the big banks enjoy what economists call "market power", which is to say the ability to act in a way that is not constrained by the usual dynamics of a healthy, competitive market.

The sources of the large banks' market power may include the economies of scale that they enjoy; the deep pockets they have for marketing and customer acquisition; and their strong position with new and young customers (parents are likely to open bank accounts for their children with the same bank that they use, further strengthening the incumbents' positions). The extent to which the large PLC banks have and are able to exploit market power will doubtless be a central plank of the Competition and Markets Authority's present investigation into the personal current account and SME banking markets.

## Concentration

Adding more providers to a marketplace (or, in the language of economists, reducing market concentration) is often proposed as a solution to competition problems. Instinctively, the case for more providers seems fair: surely ten providers of retail financial services must represent more choice for consumers than eight providers. However, focusing purely on the quantitative (the number of providers) to the exclusion of the qualitative (the *kind* of providers) is a mistake. If, in the above example, the two new firms offer very similar propositions to the eight existing ones, how much added choice do consumers truly have?

To ensure genuine consumer choice of the kind that stimulates competition, a marketplace needs providers to offer different propositions with, for example, one provider leading on price, another on levels of service, and a third on innovation, allowing consumers to award their business to the firm that best meets their priorities.

## Market Diversity

There has been a welcome shift in emphasis recently, recognising that market diversity is every bit as important as concentration. Andrea Leadsom MP, the Treasury Minister with responsibility for financial services, said in a speech in September 2014:[6]

"Building societies are key contributors to diversity within the financial sector… We need diversity among our financial institutions, because that is what gives the customer choice. We need the customer to have choice, because that is what promotes competition. And we need competition, because that is what keeps our financial sector world-class."

Homogenous markets are the enemy of true consumer choice.[7] Where a market is characterised by providers with similar models, offering similar products at similar prices and with similar levels of service, consumers will feel no motivation to switch to another provider. In other words, without the credible threat that customers will leave one provider for another which better serves their needs, the "virtuous circle" of competition is broken.

## Transparency and comparability

So why is the amount of competitive pressure that smaller providers can put on the large PLC banks so limited? Despite generally offering keener prices and better service, why do the challengers find it so difficult to attract customers away from their larger competitors?

Part of the answer lies in customers' inability to understand whether they currently have a fair deal, or whether they would be better off switching to another provider. This inability stems from the fact that financial products often cannot be easily compared. In personal current accounts[8], for example, which account is best for you (from a pure cost perspective) will depend on how you use the account - whether, for instance, you maintain a high balance, or use an overdraft, or make regular international payments. Comparing accounts therefore requires customers to conduct relatively complex calculations based on their predicted transaction patterns, which is enough to put off most people.

The Government's MiData initiative is trying to address the challenges faced by consumers when attempting to compare personal current accounts. The vision for MiData is that it will allow customers to upload their

account data in order to receive a tailored recommendation, based on their own transaction history, on which accounts would be best for them. Providing the service is properly formulated, MiData could act as a spur to greater competition. As the service and other new comparison tools are developed, it is important that they should respect the fact that customers will often be prepared to pay more to receive a better service; they should therefore assist customers to include factors other than price in their considerations, such as customer satisfaction and trust levels, and complaint statistics, for example.

The highly regulated environment in which financial services providers operate can reduce transparency and comparability for customers by adding complexity. Ever more onerous conduct regulation, for example, has pushed providers to create lengthier and more detailed terms and conditions for their products. When faced with thirty pages of small print, many customers will simply shrug their shoulders and sign on the dotted line. As the Chief Executive of the FCA, Martin Wheatley, said in a recent speech:[9]

"… no-one reads those T&Cs. We simply trust in the good will of the firm delivering them. …As a means of reducing information asymmetries and reducing complexity, mandated disclosure often doesn't work."

Regulators now recognise that simply providing customers with ever-more information does not help them to make good decisions and are increasingly turning to behavioural economics (which combines the disciplines of economics and psychology) to design interventions that are more effective in practice at engaging consumers and impacting their behaviour.

Enhanced transparency will bring the pricing and service advantages of mutuality into sharper focus. However, there is only so far that transparency can take you: the positive impact that mutuals and other alternatives to PLC banks can have on competition will remain constrained until they can compete with the banks on equal terms.

## Levelling the playing field

The regulatory framework that governs UK financial services is predicated on the PLC model. Building societies and other corporate forms are not always sufficiently embedded in the regulatory process from the outset, and may therefore be disproportionately impacted by regulation. These effects are observable in, for example, the leverage ratio (a prudential measure which is blind to a firm's risk profile, so broadly has a greater impact on low risk institutions such as building societies) and by the more onerous conditions that apply when building societies raise capital via Core Capital Deferred Shares, than when PLCs issue ordinary shares.

Building societies are not asking for special treatment, but rather for policy and regulation to be formed in a way that takes adequate account of all corporate models. To this end, the sector has called for legislation to create a statutory duty for regulators to foster diversity and to report to Parliament annually on the effectiveness of competition in financial services, including measuring the level of diversity and the actions they have taken to promote mutuals.[10]

## Conclusion

Building societies make a crucial contribution to the diversity of retail financial services markets, offering consumers real choice and the inherent benefits that mutuality confers. However, the ability of building societies to challenge the entrenched positions of the large PLC banks is constrained. While advances in transparency and product comparability, driven partly by regulators' adoption of behavioural economics techniques, are welcome, they can only go so far. To allow mutuals and other non-PLCs to compete with the large banks on fair terms will require a regulatory framework that takes better account of non-PLC models and encourages regulators to foster market diversity.

1 Competition and Market Authority, Personal Current Accounts – Market Study Update, (July 2014), p.22

2 As at end Q3 2014; Building Societies Association: http://www.bsa.org.uk/statistics/bsa-statistics/

3 Share of main and packaged current accounts; Nationwide Interim Results for period ended 30 September 2014.

4 Building Societies Association: A Manifesto for Financial Mutuals, (November 2014), p.4

5 Competition and Markets Authority, Personal Current Accounts – Market Study Update,(July 2014), p.34

6 https://www.gov.uk/government/speeches/economic-secretary-i-am-very-positive-about-the-future-of-the-building-society-sector

7 As an aside, it is worth noting that, beyond stimulating competition, diversity in financial services performs another important function: it promotes financial stability. A market with a single business model, figuratively speaking, puts all its eggs in one basket and is, consequently, highly vulnerable to economic shocks. A more diverse market will be better able to absorb such shocks as it reduces the likelihood that all parts of the market will be affected.

8 Of the UK's 43 building societies, 6 currently offer personal current accounts.

9 http://www.fca.org.uk/news/beesley-lecture

10 Building Societies Association: A Manifesto for Financial Mutuals,(November 2014), p.7

# What competition cannot solve

**by Tony Greenham**
Programme Head, Finance and Business, at the New Economics Foundation

You could argue that it all started to go wrong in 1971. That was when the Bank of England introduced Competition and Credit Control, a monetary policy that did the opposite of what its name suggested. Controls over competition and credit were loosened in accordance with the belief that the market was the only legitimate determinant of economic outcomes. From here on, competition was the magic remedy that would lead us to the sunny uplands of an efficient, economically useful and customer friendly banking industry. Unfortunately it has not, and cannot.

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The problem with the cult of competition is that, perhaps like any belief system, it seems to have become a pervasive mantra that sweeps all before it and does not tolerate heretical objections. If we are to judge from a Bank of England memo at the time recommending the deregulation of credit, its earliest proponents understood this:

"He who argues for a fundamental change must, to some degree, be preaching a faith. [I believe that] competition is capable of stimulating efficiency and innovation ..."[1]

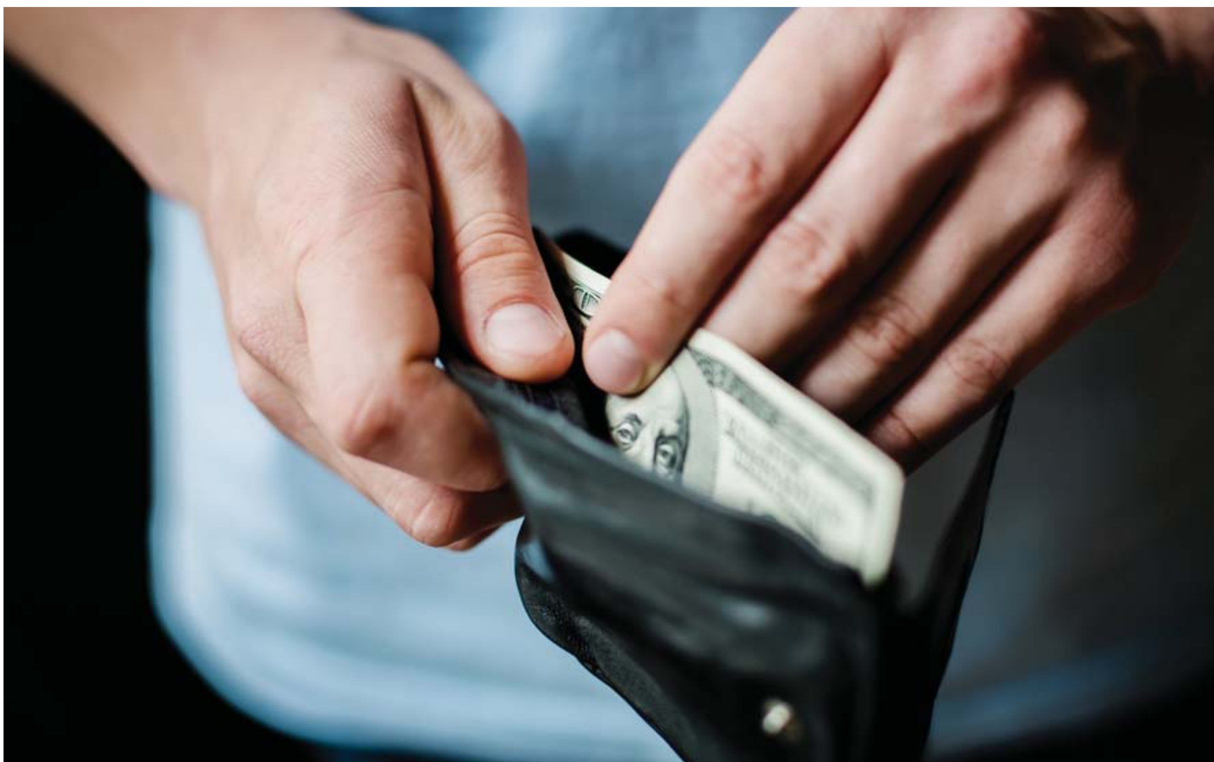
There are at least three reasons why this faith has been misplaced. But before setting these out, let me be clear that these reasons do not add up to an argument for either monopoly or state control of banking. We certainly need the right kind of competition but blind faith in competition will not do. We need to understand precisely where competition is useful, but also what problems it cannot solve.

## The self-destructive herd – the fallacy of composition

The starting point is the unique position of banks in the modern economy - banks create money. When banks extend credit to their customers they inject brand new bank deposits into the economy. Equally, when they reduce the total amount of credit, they are withdrawing money from circulation.[2]

This system seems counter-intuitive to many people and most are unaware that the power to create money was ever delegated by the state to private banks.[3] Why does this matter?

The amount of money in circulation is a major determinant of boom, bust and financial stability. Which parts of the economy get allocated credit has major economic, social and environmental impacts.



But from the point of view of the whole economy, and the public interest, should more credit flow to renewables than fossil fuels? Are SMEs starved of credit? How can we ensure everyone has access to banking services? These are questions that competition policy cannot answer. Yet the Competition and Credit Control policy signalled the end of attempts to manage credit creation in the overall public good.

Left to their own devices, competing private banks will allocate too much credit to property and consumption, and too little to business investment. This is not because they are doing anything wrong ***individually***, but because of the fallacy of composition - their individually rational actions add up to the wrong outcome ***collectively***.

For example, it makes perfect sense banks to seek collateral for their loans, and when badly designed financial regulations under the Basel Accords[4] are added to the mix, banks face strong incentives to lend for property purchases and disincentives for lending to businesses. Rising property prices only reduce the apparent risk of default for each bank encouraging yet more property lending, even though the risk of a property crash is increasing overall.

Indeed, the greater the competition in the market, the more fiercely banks will compete to extend credit during the boom – exactly the opposite of what is required to safeguard not just financial stability but the banks' own financial security.

The number of mortgage providers in the UK increased markedly in the run up to the financial crisis as oversees sub-prime lenders rushed in, after which they departed more quickly than they had arrived.[5]

It seems the wrong kind of competition can accelerate boom and bust.

## Power corrupts – the problem of information asymmetries

Effective competition is not simply about more firms vying for customers' business. This can be an important ingredient, but not necessarily the most important. The textbook theory of perfect competition requires a number of other conditions to be fulfilled.

For customers to wield market power over suppliers, they need to understand perfectly what they are buying. This is more difficult if all products are different – customers need to be able to compare like with like. Second, customers need to have full information about the features of the product and all the related and potential costs associated with it. Third, customers must behave rationally. Fourth, the cost of comparing and switching products, including the customers' time and effort, must be low. Finally, the product must be something the customer buys repeatedly and frequently so they can learn from previous experience and switch to the best products and suppliers.

No one expects to find these textbook conditions in real life, and lack of perfection does not undermine the rationale for markets. But we must also not gloss over serious flaws. Not all markets are equal. The conditions described above apply rather well to getting your hair cut. Unfortunately they apply very badly to banking services.

Take personal current accounts, for example. Comparison is made difficult by banks bundling current accounts up with other services such as mobile phone and travel insurance, often as a deliberate marketing strategy.[6] Other banking products exploit well known irrational traits in consumer behaviour.[7,8] Teaser rates,

where an attractive initial interest rate changes to an uncompetitive one after an introductory period, are a widespread example of banks' exploitation of human frailties. To make competition more effective in these cases requires more regulation, not less – by banning teaser rates, say, or introducing standard products at a fixed prices forcing banks to compete on customer service.

Now consider payment protection insurance, probably the biggest UK mis-selling scandal of all time.[9] This product is purchased very infrequently giving customers no opportunity to learn from past bad experiences. Information is also highly imperfect and one-sided because the seller enjoys an information advantage over the buyer.

Such imbalances of power, known as information asymmetries, are pervasive throughout the banking industry. Finance is a complicated discipline and banks have substantial expertise that consumers often severely lack.

In such conditions, customers are ripe for exploitation. Competition simply becomes a race by banks to see who can exploit the most. The cure for misselling is not competition, but structural and regulatory reform - regulation to improve transparency and punish misselling, and structural reform to change the incentives of bank staff away from maximising profits and maximising customer benefit instead.

Banking is a trust industry, much like law, accountancy and medicine, where non-expert and potentially vulnerable clients have to rely on the integrity of the professionals who serve them. It remains to be seen whether such cultural change is even possible in shareholder-owned corporations.

## Choice and diversity are not the same as competition

Which brings us to the final reason why competition is not enough – the need for diversity. Real customer choice requires a range of different providers, not just a large number of identical firms competing fiercely to sell exactly the same thing in the same way to the same customers. We don't need major new challenger banks if they are going to be the same as the existing ones. What we need are different ***kinds*** of banks.

Innovations such as peer-to-peer lending are helping to increase the diversity of business models, but we need diversity in scale, ownership and geography too. British customers who want to choose a co-operative or local bank are uniquely poorly served by international standards.[10] Diversity is not just important for choice. An increasing body of academic research shows that more diverse banking systems are more resilient to financial crises.[11]

## Conclusion: Putting competition in its place

Competition is important, but only in the right context. It was a sign of the times when we closed the Office of Fair Trading and created the Competition and Markets Authority. Competitive markets are very far from being sufficient to produce fair outcomes for customers.

Banking policy should place two fundamental principles alongside the principle of increasing competition. First, that the nature of banking products means that products must often be highly regulated and firms must demonstrate that they are able to always put customer interests before profit. Second, the better measure of customer choice is diversity, not competition.

Of course competition can be beneficial, but if we do not pay attention to the problems that it cannot solve, and adopt the right strategies to solve them, an obsession with competition might instead make matters worse.

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# Why building long-term relationships with satisfied customers delivers competitive advantage

**by Anders Bouvin**
CEO of Handelsbanken UK

Recently, it has been rare for a week to go by without receiving a research report or event invitation on the topic of customer-centric business models and how to create one. This theme is selling seats like hot cakes in the banking sector right now. And reflecting on the banking market revelations of the last few years, it is perhaps not hard to see why.

This emphasis seems aimed at helping answer a single, central question: how can you turn customer service to competitive advantage? This might appear, at first, to be a perfectly reasonable question. But I cannot avoid turning this question on its head and instead asking: under what circumstances, in retail banking, could focusing consistently on customer service not result in competitive advantage?

I have often felt a similar confusion when reading press commentary about cultural change in banking and in response to the idea that the particular initiative being reported should be seen as a PR or CSR step by the bank in question - a short-term, required step towards public rehabilitation. This seems, to me, to imply that any longer term, more deeply entrenched programme of improving customer service would act as a drag on profitability, rather than a key driver of sustainable commercial success.

I'm not sure why or from where this idea of a conflict between customer service and competitive edge gained currency. But it certainly does not tally with our own experiences of running a profitable bank over many decades. For us, the core principles of running a successful bank have always been simple and evident, even if adhering to them in practice takes constant focus, self-discipline and fine-tuning throughout our organisation.

Whilst a bank is foremost part of the service industry, it is also different from many of the organisations that make it up, because the services we provide deal with important customer commitments that require dependable financial support long into the future. For example, support to ensure a business can develop new and better products, make more of them or sell them into new markets; and support to enable an individual to establish long-term financial security for their family.

For us then, it follows that to succeed in a world of long-term commitments we must strive every day to strengthen and deepen the relationships we have with our customers. And naturally it also follows that, in order to develop these lasting relationships, we need to maintain an unwavering focus on customer service.

Knowing and understanding our customers, and being able to satisfy their individual needs, is absolutely the key to long-term success for our business. Our everyday obsession with forging broad, strong and lasting customer relationships based on service excellence has led to Handelsbanken being more profitable than its market competitors for each of the last 42 years. And this in turn has resulted in strong, sustained growth in the Handelsbanken share price over many years. Since the financial crisis alone, our share price has increased by 112 percent.

I don't suggest here, by any means, that the distinctive model I am about to describe is the only way to achieve both high levels of customer satisfaction and profitable business. But it works for us and we are still learning and tweaking the model as we go along. After all, four decades is not such a long time in business.

Since we operate a values-led management model, it makes sense for me to explain our way of thinking first.

Our idea of how we should run a successful bank is rooted in trust and respect for the individual; an unshakeable belief in people and in their desire and ability to do good things well. Based on this belief, we have developed an operating model that devolves decision-making power to our branches and to staff in other areas of responsibility throughout the bank. This is made possible through a strongly decentralised organisational structure.

In practical terms, each of our branches operates as a small business working to a "church spire" principle. This means that our branches only bank those businesses and individuals in the community they are present

– i.e. in the area you can see from the top of the local church spire. This enables each one to make decisions locally and provide a service that is truly tailored to the individuals and businesses in their community.

It is no surprise then that our British expansion has been caricatured as a Captain Mainwaring comeback. Indeed, we do offer customers the kind of bespoke, community banking that many remember from the days before service became centralised and depersonalised.

Yet our approach is distinctive in many other ways too, from our financial prudence and stability, to our focus on relationships rather than transactions. For more than four decades we have managed our bank through a framework of core principles, which include prudence, thrift and long-termism.

Chief among these principles is that business success comes from having satisfied customers. And since our local branch employees are best-placed to understand and satisfy our customers' needs, the bank entrusts virtually all decisions to them, from credit assessment to product terms and pricing. Head Office's role is merely to support our branches' efforts to serve their customers as well as they can, and to help ensure the firm framework of principles within which we must all operate are well understood.

In order for our branches to be able to focus fully on customer satisfaction, we have steered clear of working with volume targets or sales campaigns, and of the financial incentives used to meet them. Instead of bonuses, all staff share in the long-term success of the bank through a profit-share scheme known as Oktogonen. For every year the bank is more profitable than our competitors, a portion of this 'additional' profit is foregone by our shareholders and invested into Handelsbanken shares on behalf of each employee.

This is of the same monetary value right across the bank - from the administrative assistant to the branch manager - while the accumulated allocations and capital growth cannot be claimed by any staff member before they reach 60.

This profit-share scheme steers us all to take prudent decisions today with long-term risk and customer outcomes in mind. And having met our one corporate goal – of being more profitable than the average of our competitors in each and every year, for the past 42 years – we have found that such prudence translates into both profitable and sustainable business.

It is precisely because we are all working to the same customer satisfaction goal, and because staff throughout the bank are trusted and expected to make all the important decisions concerning their 'patch', that we have achieved these results. Handelsbanken has been ranked top for customer loyalty and satisfaction for the past six years, in an independent survey of UK individual and corporate banking customers. This is a position the bank has held in its birthplace of Sweden since such independent surveys began back in the late 1980s.

The predictability of our model also contributes further to our financial strength: in their most recent assessment, Bloomberg Markets ranked Handelsbanken one of the world's strongest banks for the fourth year running; the bank retains one of the highest credit ratings of any in Europe, and our capital ratio far exceeds the more stringent requirements being introduced across Europe.

Demand for the genuine local relationship banking that Handelsbanken has offered for several decades remains strong and growing across Great Britain. Customers place a high value on the ability to speak to someone at their branch who knows them personally and whose direct line number and email address they are readily given. Knowing that your account manager will take the time to understand your specific financial situation in detail and, crucially, who is empowered to make decisions on your loan, your mortgage or your overdraft means that many of our customers view us as an integral partner in their business' development or in the management of their own personal finances.

If it is true that, in the banking world in general, the importance of relationships and customer service had somehow faded from view for a time, today they appear to be coming back on to the agenda.

## Conclusion

In Handelsbanken, we have always focused on the importance of relationships and service. It is central both to our culture and to our success so far. In fact, it's so central that I struggle to get my head around that initial question: how do you turn customer service to competitive advantage?

Today, we have branches serving individual and business customers in approaching 200 communities throughout Great Britain. We choose not to conduct any central marketing activities and instead develop our name through word of mouth recommendation within the local communities we serve. We can only achieve continuing commercial success by serving our existing customers consistently better than our competitors, whatever changes in the world around us, and we find this a fantastic way to stay focused on what our customers care about.

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# Competition is crucial to better banking and a more balanced economy

**by Cathy Jamieson MP**
Shadow Financial Secretary to the Treasury

Improving the performance of the banking and financial services sector is central to Labour's overarching economic strategy.

We want to build a productive and balanced economy which provides well paid, high skilled and secure jobs and training opportunities for young people across the country. This will help to boost productivity, spur economic growth and increase tax revenues – vital to closing the deficit and reducing the national debt.

The banking and financial services sector has a crucial role to play in this, and we are determined to ensure that it is operating effectively – with the appropriate degree of competition.

We want markets to serve the needs of consumers, so a Labour Government will intervene in cases where low levels of competition are shown to be resulting in poor services and high prices.

There are three key reasons why improving the level of competition in banking is so important.

Firstly, in order to realise our ambition of a robust and sustainable economy, businesses must be able to access the funds they need to grow and flourish.

In recent years, the market in retail finance has stagnated. Whilst this can in part be attributed to the efforts of banks to consolidate their balance sheets to meet the higher demands of regulators, it is also due to a chronic lack of competition.

This lack of competition has led to higher prices, with nearly a quarter of small businesses that want finance, but are put off applying, citing the cost of borrowing.

Secondly, a healthy level of competition will increase creativity and encourage innovation, leading to more choice and better products for consumers in both personal and retail banking.

Thirdly, increasing the level of competition will help to repair some of the reputational damage of recent years and restore trust in the banking sector.

Without the discipline provided by competition, and the threat of customers moving quickly and easily between banks, there have been too many cases of banks taking their customers for granted and providing poor services.

In extreme but too frequent cases, there has even been exploitation of customers through the mis-selling of Payment Protection Insurance and Interest Rate Hedging Products.

With the latest round of bonuses due to be announced in coming weeks, banks need to show that they are committed to serving the needs of customers and the economy, not just themselves.

However, taking action to increase levels of competition in the banking and financial services sector is not just about addressing the problems of the last few years; it is about addressing the deep-rooted problems of the last few decades.

The lack of competition in UK retail banking is not new, and has been well established by a series of independent, authoritative studies.

The Bank of England observed how the demutualisation of the building societies in the 1980s and 1990s resulted in the sector becoming more concentrated, whilst in 2002 the Competition Commission noted significant concentration in banking services for SMEs.

Although some progress was made in addressing this concentration, that progress was reversed in the wake of the financial crisis.

Indeed, the enforced mergers necessary to stabilise the market – and the economy – led to even greater consolidation. Therefore, and as the Independent Commission on Banking chaired by Sir John Vickers noted,

the financial crisis caused a market that was already concentrated to become even more so.

The Commission also found that, compared to other economies of a similar size, the UK's banking sector is, by international standards, highly centralised and concentrated.

This concentration is of particular concern in the retail finance market. The Competition and Market Authority's Personal Current Account market study update, published in July 2014, found that, as of December 2013, four banks – Lloyds Banking Group, RBS, HSBC and Barclays – controlled 77.2 per cent of the market in personal current accounts (PCAs).

Meanwhile, the CMA's market study of banking services to small and medium-sized enterprises found that the four largest providers of Business Current Accounts (BCAs) provide 85 per cent of BCAs in England and Wales, with the sectors in Scotland and Northern Ireland even more concentrated.

This state of affairs would, perhaps, be easier to justify if the market was working for consumers and businesses. But the evidence suggests that it isn't.

The Bank of England's most recent Money and Credit statistics show that, in the last quarter alone, lending to small businesses fell by £200m.

Meanwhile, the Federation of Small Businesses' Small Business Index has highlighted that firms are still struggling to get the finance they need to expand, and has called for greater competition and choice in business banking. This is in part due to the fact that Government schemes to expedite lending have not been as successful as had been hoped.

Over the past couple of years I have spent a lot of time speaking to people in the banking and financial services industry, and one of the things I have consistently been told is that many banks have become too conservative in their approach to lending.

Although this can partly be attributed to the impact of new regulations on bank balance sheets, there are other reasons.

For example, many of the larger banks use similar systems for deciding whether or not to lend to customers. If one bank doesn't lend to a business it is likely that others won't either.

The uniformity of pricing and products offered by the big banks who dominate retail finance, and the difficulty customers have in comparing them, has led to low levels of switching, despite the introduction last year of the new seven day switching service.

These factors combined mean that, for those unable to secure the finance they need, there is too little differentiation in the market, and too little chance of them securing the finance they need from elsewhere.

It is clear, therefore, that the lack of competition in banking is too well-established, entrenched and intractable to be tackled by short term, cosmetic solutions.

That is why a Labour Government will take decisive action to address the lack of competition in banking, and ensure that banks meet the needs of businesses, consumers, and the wider economy.

Last January, Ed Miliband unveiled our proposals to reform the industry in a way that will introduce greater competition and a better service for consumers in the retail and personal finance markets.

He explained why we need at least two new effective challenger banks to enter the market, and set out how this can be delivered by building on existing divestments and ensuring that new and recent entrants to the market can compete effectively with incumbent banks.

The first step in achieving this was to ask the Competition and Markets Authority to report, within six months of a new Labour Government, on how steps to improve competition could be implemented.

Since then, the CMA has recognised the problem we have been highlighting and announced it is launching a full competition inquiry into the markets for current accounts and small business banking.

A Labour Government will work with the CMA review and will ask them to advise us on how we can improve competition in a logical and effective manner.

We will ask the CMA to advise us on the introduction of a maximum threshold for market shares, which would trigger another market investigation if breached.

And we will also ask them to propose an appropriate timeframe for carrying out any reduction in market share recommended, and to set levels of divestment for individual banks.

By improving the level of competition and ensuring that no one bank holds too large a share of the market, we are confident that we can increase lending, at more affordable prices, and secure a better service for consumers.

In addition to this, a Labour Government will also create a new British Investment Bank, underpinning a regional banking network that will invest money locally.

In order to ensure the bank has sufficient resources, we will allocate it the over £1 billion expected from the sales of licence fees in the next Parliament.

We also want to make it easier for banks to access the information they need to make informed decisions about lending, and that is why we will investigate ways to deliver a Central Credit Register for SMEs, as described by the Bank of England's Financial Stability Report in November 2013.

This would allow challenger banks to more easily assess the creditworthiness of small businesses, making it more straightforward for them to enter the market, and therefore increasing competition.

Finally, we believe there is still considerable scope for encouraging greater diversity in the sector by promoting alternatives to the PLC model.

The new and tougher regulations introduced to the payday lending market will see many payday lenders exit the market. This should provide an opportunity for expansion for safer and more ethical lenders. A Labour Government will help them take that opportunity by extending the current levy on the profits of payday lenders, and using the additional money raised to increase the level of Government funding for alternative credit providers, such as credit unions.

## Conclusion

We believe that by reforming the banking and financial services sector in the way we propose, we can create more and better choices for customers, making it easier for businesses and wealth creators to access the finance they need to grow and flourish.

This will help us ensure that the banks are serving the needs of their customers and acting in the interests of the wider economy.

# Can fintech revolutionise retail banking?

**by Dominic Lindley**
Consultant and financial services expert

Two decades ago if you wanted to rent the latest film you went to a 'Video library', normally run by giant 'Blockbuster', paid your fee and took the video home. You then had to take another trip out to return the video or risk paying penalty fees for keeping it longer than permitted. In 1997, the website Netflix was opened after one of its founders was unhappy about paying $40 in late fees after renting Apollo 13. Now, Blockbuster is bankrupt and Netflix is producing award-winning content such as House of Cards.

KBUSTER
CLOSING DOWN
EVERYTHING MUST GO!
EVERYTHING REDUCED*
CLOSING DOWN
EVERYTHING MUST GO
*EXCLUDES ALL RENTAL PRODUCTS, CONFECTIONERY, SNACKS & DRINKS
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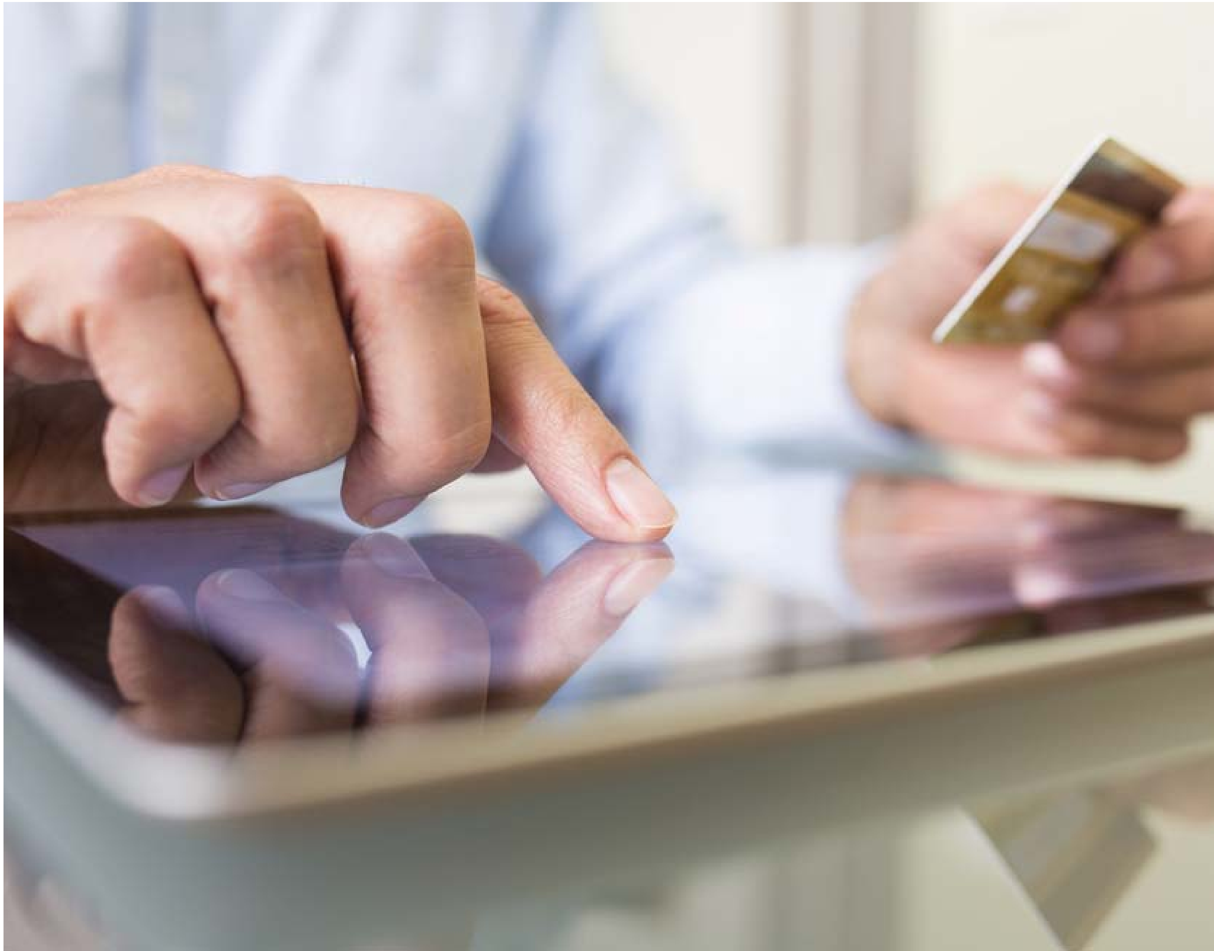

Could a similar process be about to occur in retail and SME banking? Companies which are combining financial services with technology, known as fintech, plan to revolutionise the financial services market. Some are new start-ups, or finsurgents, others are owned or backed by existing banks. With a relentless focus on the customer and innovative use of technology they are changing the definition of what it means to be a bank and offer a bank account, savings, lending or investment product.

Fostering new fintech business models could help improve competition in the market for retail and SME banking – overcoming the high barriers to entry, complexity and lack of switching identified by the CMA. Digital new entrants could offer a potential new source of competition and Personal Financial Management services could empower consumers and help them find the best deal. Specialised new entrants such as Peer-to-Peer lenders, small business banks and money transfer operators could also take on the banks and enhance competition.

## Digital new entrants

Digital new entrants will offer a wide range of banking products but will have no branch network – reducing their operating costs. They will rely on the internet and mobile channels to sign-up customers. By building their systems from scratch new entrants could lower costs as they won't have to operate legacy IT systems, which can account for 70%-80% of banks IT spending.[1]

**New digital banks – Atom and Fidor:** Atom plans to launch in the second half of 2015, offering a full range of banking products. It will be the UK's first digital bank. Its founder Antony Thomson has said "To put branches in place now would be like BT bringing back phone boxes. Now everything can be done online or through mobile."[2] The bank has around 60 staff and is based in the North East.

Fidor is a German-based bank which has applied for a UK banking licence. Social banking (Banken Mit Freuden) is at the heart of its business model. The more 'Likes' its Facebook page gets, the lower the interest rate all customers will pay on their overdraft. Rewards are also paid to customers for interacting in the 'Fidor community', such as asking or answering a question, sharing a money-saving tip or providing an idea for the bank to develop. Customers can send money to others using bank accounts, email addresses, phone number or twitter usernames. Consumers can also lend to or borrow from friends with a Fidor account. Instead of just offering its own products, Fidor integrates selected partners including P2P lenders into its account.

**Moven and Simple – a whole new "user experience":** Behind the scenes they are backed by a conventional bank, but they are using smartphones to give consumers a whole new experience. Moven and Simple are helping consumers spend their money wisely. They are changing what it means to use a bank account – moving it from a tool to make transactions to a tool to managing money. The feedback they provide is instant, automatic and displayed clearly.

Moven offers instant notification of each transaction straight to a smartphone and analysis of how spending compares to previous months. If spending is at a slower rate than previous months then the gauge is green, if it's a faster rate then it's red. Spending is categorised into "Needs" – essential living expenses; "Wants" – discretionary spending such as dining out and entertainment; and "Savings". Connecting multiple accounts gives a combined view of all a consumer's spending.

Simple calculates a "Safe-to-Spend" balance by deducting upcoming committed expenditure. This helps reduce the volatility of the customer's spending – helping them avoid running out of money just before payday. Its "Goals" function enables consumers to set savings goals and makes savings less painful by putting small amounts of savings each day towards meeting savings targets.

## Personal Financial Management

The second category of new entrants are Personal Financial Management (PFM) services which are intended to help consumers cut through the complexity, understand their financial circumstances and save money. The intention is to provide consumers with a comprehensive picture of their financial situation and use this insight to monitor the market and help them make better decisions.

For consumers, keeping track of their finances and making sure they get the best deal is difficult. Banking business models can rely on inertia, with loyal customers who do not switch regularly getting a poor deal. As the speed and complexity of the market increases choices more difficult. This reduces effective competition and can make it more difficult for new entrants to break into the market.

PFM services could enhance competition by empowering consumers and making them more responsive to price and quality. This could force bank business models to rely less on inertia and sneaky fees which catch consumers out. It is worth recalling the impact that Netflix had on the Blockbuster business model. In 2000 Blockbuster collected 16% of its revenue - around $800 million - from late fees. By 2009 this had fallen to $134 million, or just 3% of revenue.[3]

Money Dashboard offers a comprehensive picture of your current, savings and credit card accounts, summarising this information and displaying it in graphs on the 'Dashboard'. Tools can be used to categorise transactions, get reports of spending and see how savings balances have evolved. Entering forthcoming spending on a financial calendar can be used to understand how the position could change. Consumers are offered the ability to save on their energy bills – prompting them to sign-up by highlighting their spending on gas and electricity. It could expand these services into savings, credit cards and current accounts, making use of the data it holds about how consumers are using these products to offer them a personal recommendation of a better deal.

Credit Sesame in the US creates a financial profile when consumers sign up including their credit score, debt balances, loan-to-income ratio and house value. Consumers can track their loan payments, interest rates and credit score. Credit Sesame provides personalised recommendations of credit cards and loans - constantly monitors the market and alerting consumers if a better deal becomes available.

## Specialised niche players

The final category of new entrants are specialised or niche competitors. Instead of competing across the entire landscape of banking products, these fintech businesses are targeting a specific product segment. They seek to target the products that are most vulnerable to technological disruption, which the UK banks are exiting, or those from which the banks make significant profits.

**Peer-to-Peer lenders – cutting out the banks:** Peer-to-Peer (P2P) lenders connect lenders directly with borrowers, cutting out the banks. By removing the banks from the equation and operating online these companies claim to offer better rates for borrowers and better returns for lenders. The largest sites, Zopa, Funding Circle and Ratesetter have been joined by a plethora of new entrants offering products including buy-to-let mortgages, property loans, business invoices and renewable energy projects. On the savings/investment side they offer products ranging from instant access to longer-term fixed rate and variable rate accounts. Many also offer different risk-grades of accounts with higher risk coming with higher headline return but a greater risk of capital loss. Some also give consumers the ability to sell on their existing loans if they need to get out before maturity.

P2P lenders will grow significantly over the next few years. The major firms are on course to lend more than £1 billion in 2014, with strong growth set to continue into 2015. P2P lenders will need to more than deliver on these plans if they are to become a major source of competitive threat to the high-street banks. In the third quarter of 2014 major banks lent around 30 times more to consumers through personal loans and overdrafts than P2P lenders. In the consumer segment, P2P lenders have concentrated on unsecured personal loans. Their presence could be one of the reasons why personal loan rates are at their lowest for 2 decades. By contrast, rates on overdrafts are at a record high and credit card rates are the highest for almost 13 years. It would undoubtedly provide a further competitive impetus to banks if P2P lenders could expand into these sectors.

On the SME side there is also significant potential for P2P lenders to grow and some have entered into agreements for banks to refer on borrowers which the banks are unwilling to finance.

The near-term risk to the P2P industry is that with so many new entrants it is certain that some will fail. More P2P lenders are offering a claim of "security" by setting aside a certain amount of money in a

"provision" fund. By doing this they are becoming more and more like banks. Consumers are now relying on the ability of the P2P sites to screen borrowers and also on their skills in setting aside an appropriate amount of money in these funds.

**Investments/Financial advice:** Banks have withdrawn from the investment and financial advice market in recent years. This was due to rules abolishing their ability to receive commission from product providers combined with a reluctance to explain charges directly to the consumer. New entrants are aiming to make investments more accessible.

Nutmeg is an online investment manager offering a choice of 10 different portfolios depending on the consumer's attitude to risk. It invests in low cost Exchange Traded Funds and charges one single fee for its services with some additional cost from the investment in the underlying funds. Money-on-toast offers online financial advice and a series of risk-rated portfolios.

**Small business banking:** Holvi from Finland is currently in pilot mode in the UK offering business banking services aimed at the "Makers and Doers". Its standard payment account is a similar type of service to those offered by consumer brands Moven and Simple, helping businesses understand their income and expenditure. Holvi adds a number of integrated services targeted at small businesses including the ability to accept payments and establish an online store. It also allows businesses to submit invoices and keep track of their accounts.

**Money transfer:** International transfers can cost £15-£40 at some banks with additional charges levied when money is changed into another currency. New entrants such as Transferwise and Azimo are offering low cost international transfers online and through mobiles.

## Action for policymakers

Policymakers and regulators can take a number of further steps to promote these new innovative business models.

**Payments systems regulator to promote open access:** An early task for the new Payments Systems Regulator will be to ensure that fintech businesses have access to the payment system on fair terms and that incumbents do not use their ownership of the payments system to stifle innovation.

**FCA to require open API systems for banks:** The Government has already promised that consumers will have access to their current account usage data in a standard format. A report from Fingleton Associates[4] recommended that banks should agree an open API standard (or common language) to allow consumers to permit third party applications to access a wider range of data about all of their banking products, including savings, loans and credit cards. Encouraging standardised formats for this data will help encourage the development of Personal Financial Management sites, helping consumers to see all of their information in one place and find the best deal. Banks are unlikely to agree these standards on their own so the quickest way of achieving this would be for the FCA to set the standards.

**Proportionate regulation for new entrants such as Peer-to-Peer lenders and digital banks:** But regulators must also be alive to the new risks created by these business models – this should include setting standards around the size and transparency of P2P provision funds. Regulators should also ensure that their rules do not tilt the playing field in favour of the high-street banks. If the FCA introduces tough regulation capping the cost of short-term credit for new entrants then it should also apply these provisions to existing banks.

**Push through innovations such as allowing virtual deposit of cheques and online identity verification:** Many fintech business models will rely on mobiles as the primary mechanism to deliver services. Work allowing virtual deposits of cheques should be expanded to allow consumers to electronically prove their identity by scanning their passport.

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1 http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/121107.htm

2 http://www.theguardian.com/money/2014/apr/09/atom-digital-bank-metro-first-direct

3 Blockbuster tries to rewrite script in bankruptcy, Associated Press, (September 2010)

4 http://www.fingletonassociates.com/wp-content/uploads/2014/12/141202_API_Report_FINAL.pdf

NEW YORK STOCK EXCHANGE

# Competition is no cure-all for culture

**by Andre Spicer**
Professor of Organisational Behaviour at Cass Business School

In 2012, the banking sector realised fundamental change was needed. Despite the near collapse of the global economy, the failure of a number of financial institutions, and the state bail-out of others, there had been little fundamental change within the culture of the sector. In many ways, things had actually gotten worse following the financial crisis. There were fewer players, culture within each of the banks was even more driven by sales metrics, and many customers felt that they were getting a raw deal. This created a climate where unethical practices such as mis-selling, and manipulation of over the counter markets flourished.

All this started to change on a summer's day in 2012. When the news broke that bankers thoughout the city had been manipulating the LIBOR benchmark, many of the largest financial institutions in the world were forced to take a long hard look at themselves. There was a widespread feeling that the banks may have learned little from the greatest financial crisis in 80 years, and that fundamental change was necessary.

Many of the financial institutions reacted quickly. They replaced their senior leadership and reworked their mission statements. Out went a strict focus on maximising shareholder value and in came a new found interest in responsibility, integrity, and ethics. Some firms took a long searching look at their past behaviour. Departments charged with managing risk expanded rapidly.

Policymakers also started to ask what had gone wrong. The Parliamentary Commission on Banking Standards ran a comprehensive inquiry into the banking sector. It identified 26 potential root causes of failures in the sector. They ranged from undue faith in mathematical models, to a lack of diversity and the absence of personal responsibility. But two problems which stood out were competition and culture. Policymakers worried that the internal cultures of the banks encouraged inappropriate and unethical behaviour and a lack of competition meant there was little pressure to change.

According to many policymakers and regulators, the UK banking sector was failing to live up to demands of the public because there was an absence of meaningful competition. The market was dominated by four large players. Competition in the sector had actually decreased following the financial crisis. Some medium sized players such as Bradford and Bingley had disappeared. Two larger players, Lloyds and HBOS, had been pushed together.

Regulators were concerned that the reduction of firms in the sector could mean that institutions did not face the rigors of competition which would force them to offer their customers the best possible deal. The implication was that by increasing competition, company culture would improve. The reasoning went like this: If there was a lack of competition, there would be no incentives for banks to improve their culture and offer customers a better deal. If, competition was increased through introducing new players into the market, these new players would seek to attract customers away from incumbents through better offers. A better organisational culture would likely be part of the package. This would in turn create incentives for the larger players in the market to improve their internal cultures. As a result, the culture of the whole industry would be raised through increased competition.

Assumptions about the healing properties of competition have resulted in some policy changes in the UK banking market. Chief among them is the new switching regime which allows individuals to move their accounts between banks with a minimum of effort. There has also been the formation of a new challenger bank, TSB, from over 600 Lloyds branches. Alongside these initiatives enforced by government, a number of 'challenger' banks such as Virgin Money, Handelsbanken and Metro Bank continue to expand their branch networks. Alternative forms of finance like crowd funding have also started to appear on the scene.

There are some signs that increased competition has had an impact on the culture of the industry. In our report on The Culture of Retail Banking, we found that challenger banks had relatively good cultures which put customers at the front and centre of their offers. Many took inspiration from other sectors such as retail. The large banks had also made significant efforts to move away from a hard-driving sales culture. They have launched culture change initiatives by establishing the right 'tone from the top' and then cascading it down the organization. Large banks now also openly compete on the basis of their improved culture.

Clearly competition has driven up standards within the sector. However, there are at least four reasons to believe that competition is not to be a cure-all:

First, the UK retail banking sector has never been particularly competitive. Since 1918, the UK retail banking sector has been dominated by just a handful of large players. Over time, these banks gradually merged, further increasing concentration in the sector. There have been repeated government inquiries about a lack of competition in the sector, often prompted by complaints that customers and business were getting a bad deal. It is questionable to what extent any of the measures introduced by any of these inquires meaningfully increased competition.

Second, increased competition does not necessarily raise standards. There were moments when new models appeared in the sector where competition did increase. The big bang which brought more foreign banks to the UK, as well as the demutualisation of building societies, created aggressive new retail banks. However, it is not entirely clear whether these new competitors actually drove up the ethical standards of the sector. Many historical analyses of the 2007 financial crisis point out the risk-hungry culture of investment banking was largely a creation of the big bang and the influence of US institutions. Furthermore, during the financial crisis, many of the institutions which had the most aggressive sales culture and fared the worst were actually ex-building societies.

Third, there has been a decrease in the diversity of business models in the sector. Previously, the UK banking sector had a rich variety of different models of banking including large universal banks, regional banks, building societies, co-operatives and private banks. Gradually this diversity has been eroded. Recently we have seen the Co-operative bank effectively becoming privately owned. This means there is only one significant institution in the sector with an alternative business model – Nationwide. This is a significant risk to the sector. It means that if the dominant business model of retail banking fails, then so does the entire sector. In the past, the diversity of business models meant that if one business model failed, then there were other institutions with alternative business models which could ensure continuity.

Finally, increasing competition does not mean consumers necessarily make better choices. There is now a wealth of evidence in behavioural economics which shows that consumers are not rational utility maximisers who automatically switch to the best deal available. Consumer decisions in markets like banking are plagued by dynamics like temporal discounting (valuing quick gains over longer term returns), information asymmetries (consumers having far less expertise and information than institutions) and endowment effects (people demanding much more to give up a service they have than they would pay to acquire it). All these dynamics mean that an increase in competition will not necessarily lead to a system where customers move to the best offers. In fact, there is plenty of evidence to suggest customers will stick with offers which are very poor indeed.

If regulators, policy makers and financial institutions are serious about improving culture in the sector, it is vital they start to think seriously about how the limits to competition might be addressed. I think there are a four big questions which need to be asked.

First, if concentration is the history norm in the UK banking sector, then how it is possible to ensure the large incumbents continue to improve their cultures? In our report on the culture of retail banking, we suggested that culture is likely to take up to a generation to change. It is vital that the largest financial institutions remain committed to their current course of action. The big danger is that by dropping their current culture change initiatives they will squander all the progress which they have made so far .

Second, if competition does not always lift ethical standards in the industry, then how is it possible to ensure entrants into the industry do not drive down standards. We have already seen the problems which came with the boom in pay-day lenders. Policy makers need to be vigilant in monitoring and legislating new entrants into the market, particularly when they rely on new models. By doing this, they will ensure new entrants do not bring down standards.

Third, how can a lack of diversity in the market be addressed so that the sector includes a range of different business models and offerings? There are some bright spots such as Handelsbanken which has effectively introduced an employee-owned model. Much work, however, remains to be done to encourage a wider range of business models.

Finally, if consumers don't switch even when competition increases, then how is it possible to help them make wise choices? Many of the insights from behavioural economics would be useful here. Steps may be taken which involve providing consumers with more information and background knowledge, alongside measures which encourage consumers to think about the longer term, and tools which allow a better comparison of offers on the market.

## Conclusion

To ensure the banking sector does not repeat the mistakes of the past, it is vital there are meaningful changes within culture. Increasing competition is certainly part of this process. But competition alone is not enough. We need to ensure large incumbents continue to improve their culture, there is a greater diversity of business models in the sector, that new entrants raise standards and that we help consumers to make the best choices. By doing these things, we will be able to build a fairer and more effective banking sector.

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