

# **SME Banking**

**Review of the undertakings given by banks following  
the 2002 Competition Commission report**

**August 2007**

(Advice provided to the Competition Commission, 31 January 2007,  
Letter of clarification provided to the Competition Commission  
(Annexe D) on 14 May 2007)

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Note: [...]

This report is published pursuant to section 4(4) of the Enterprise Act 2002. It has been edited for publication in accordance with Part 9 that Act. Among other things, this Part requires that the Office of Fair Trading has regard to the need for excluding from the published report, so far as is practicable, commercial

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<sup>1</sup> 1 Provided to the Competition Commission, following the provision of original advice, on 14 May 2007.

information whose disclosure it thinks might significantly harm the legitimate business interests of the undertaking to which it relates.

# 1 EXECUTIVE SUMMARY

1.1 This report presents the findings of a review of undertakings given by several clearing banks in relation to the supply of banking services to small and medium-sized enterprises ('SMEs') in the UK.<sup>2</sup> These undertakings were given following an investigation by the Competition Commission ('the CC') which was completed in 2002.<sup>3</sup> The report provides advice to the CC on whether, by reason of any change in circumstances, the undertakings are no longer appropriate and either the relevant parties (or any of them) can be released or the undertakings need to be varied or superseded.

1.2 Two sets of undertakings were agreed as a result of the 2002 CC report:

- behavioural undertakings agreed by nine clearing bank groups in the UK, aimed at increasing price transparency, reducing switching costs and limiting the bundling of current accounts with other banking services
- transitional undertakings on the four main clearing banks in England and Wales, broadly requiring them to offer all SME customers either interest on credit balances at a specified rate (2.5 per cent below the Bank of England base rate or higher), or free core money transmission services (such as direct debit payments and cash transfers).

1.3 This review has focused largely on the short-term impact of the transitional undertakings. It has also considered the overall impact of the behavioural undertakings on competition more generally.

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<sup>2</sup> For the purposes of this review, SMEs are defined as businesses with an annual turnover of up to £25 million.

<sup>3</sup> CC (2002), 'A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK', Cm 5319.

1.4 In 2002, one of the CC's conclusions was that it was 'necessary to give the level of prices a decisive and significant shift toward what we considered to be competitive levels'.<sup>4</sup> The OFT has found that the transitional undertakings have been successful in achieving this objective, and that the four main banks have complied with the requirements placed on them. The undertakings have ensured that all customers are offered tariffs either paying interest or offering free banking, and changed SMEs' expectations of what constitutes competitive pricing by a bank.

1.5 At the same time, a combination of general trends in the market and the impact of the behavioural undertakings have increased the level of competition in the market. In particular:

- several of the smaller banks have increased their market share in England and Wales (HBOS, Alliance & Leicester and Abbey have moved from around three per cent to nine per cent collectively) and are looking to increase this growth. The share of the four main banks has fallen from over 90 per cent to around 85 per cent, and there are also signs of increased competition between them
- while levels of switching remain low (around four per cent per year – similar to the rate in 2002), there is evidence that SMEs are now more likely to consider a move to one of the smaller banks, and are more price sensitive than was apparent at the time of the CC report
- SMEs are increasingly banking with more than one provider. The behavioural undertakings appear to have had a positive impact in reducing the bundling of business current accounts with other banking services, and
- new technology is playing an increasingly important role in the business banking market. In key parts of the market, the increasing proportion of customers using internet technology has reduced the

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<sup>4</sup> CC (2002), paragraph 1.13.

importance of branch access as a barrier to servicing customers. Similarly, greater use of automated payments technology has encouraged banks to develop new tariffs offering cheaper rates for use of automated payments. This has contributed to a greater variation in tariffs now than was the case in 2002.

- 1.6 These developments, coupled with the safeguards provided by the behavioural undertakings, suggest that competition can now be expected to constrain the ability of the four main banks to charge excessive prices in a way that was not evident at the time of the CC investigation in 2002.
- 1.7 It is reasonable to expect that price restrictions will distort competition, particularly if maintained for an extended period. Price regulation can affect the competitive incentives for firms to invest in the market, to attempt to gain market share, and to produce innovative products and services. In general, the OFT believes that these costs mean that price regulation should be used only where other remedies are ineffective. In assessing the transitional undertakings, the OFT has considered how the balance of costs and benefits has changed since 2002.
- 1.8 Several third parties, including smaller challenger banks, have argued that the transitional undertakings have hindered the development of competition. The OFT has considered these submissions carefully, and accepts that retaining the price restrictions on the four main banks could distort competition by:
  - limiting the opportunities for entry to and expansion in the market by smaller players, with the effect that SMEs do not benefit from the additional choice and competition that this might offer
  - dampening the incentives for banks to invest and develop innovative products which would benefit SMEs
  - distorting efficient pricing decisions by the banks and introducing a degree of similarity in pricing structure across a section of the market.

- 1.9 On balance, the OFT believes that, if the transitional undertakings were to remain unchanged, these costs would outweigh the benefits. The OFT further believes that varying the transitional undertakings while retaining an element of price regulation would fail to address the costs. For these reasons, the OFT is recommending that the four main banks be released from the transitional undertakings, removing the requirement on them to offer free banking services or to pay interest on business current accounts. The OFT believes that this will free the market to operate in SMEs' best interests, allowing smaller banks to innovate and expand, and provide a competitive challenge to the existing big banks.
- 1.10 The OFT remains concerned by some aspects of the market. In particular:
- while there has been an apparent increase in SMEs' willingness to consider switching, there does not appear to have been a significant increase in actual switching activity since 2002
  - customers appear not always to be aware of their banking costs and do not always find it easy to compare rival offers from alternative providers
  - there also appears to be a lack of confidence in the effectiveness of the switching process among some SMEs, with little awareness of the safeguards on switching set out in the behavioural undertakings.
- 1.11 The OFT considers that the behavioural undertakings will continue to facilitate the development of competition in the market. The benefits they provide in relation to supporting switching and transparency are necessary to future improvements in competition and some aspects of the market would benefit from further support.
- 1.12 In this regard we are continuing a dialogue with the banks about ways to address the perceptions consumers appear to have about the difficulties related to switching and ensure transparency of pricing to enable comparisons. We would encourage SMEs to review the service they receive from their banks from time to time, and to shop around for banking services to ensure they get the best deal in order to maintain

pressure on the banks to make competitive offerings. The evidence we have seen throughout the review indicates that banks generally have well established and effective switching processes which should minimise the extent of difficulties throughout the switching process.

- 1.13 For these reasons, the OFT has concluded that the behavioural undertakings should remain in place. There is evidence that these undertakings are having a positive effect in improving SMEs' access to information on accounts, and making it easier to switch bank. They provide important safeguards for consumers, and the OFT will monitor the banks' behaviour actively in line with the behavioural undertakings, and review the operation of these undertakings in the future. The option of making a future reference to the Competition Commission remains open should the developments in competition take a backward step.

## 2 INTRODUCTION

- 2.1 This report reviews the effect of the undertakings given by various banks in 2003 in relation to SME banking services. The full text of the undertakings is at Annexe C.
- 2.2 The undertakings were given by the banks to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer following a report of the CC in 2002.<sup>5</sup> This report and the subsequent undertakings were made under the monopoly provisions of the Fair Trading Act 1973 ('FTA73'). The key findings of the report are set out below.
- 2.3 It is the duty of the OFT to keep under review the carrying out of such undertakings and to consider from time to time whether, by reason of any change of circumstances, the undertaking is no longer appropriate and either the relevant parties (or any of them) can be released from the undertaking or the undertaking needs to be varied, or superseded by a new undertaking. Where it appears to the OFT that any person can be released or that an undertaking has not or is not being fulfilled, or needs to be varied or superseded, it is the duty of the OFT to give such advice to the CC as it may think proper in the circumstances.<sup>6</sup>
- 2.4 In its 2002 report, the CC requested that the OFT review the undertakings after three years. The CC expressed concern that the banks might attempt to negate the impact of the transitional undertakings.<sup>7</sup> In such circumstances the CC recommended that the OFT consider referring the matter back to the CC.<sup>8</sup> The CC also considered that the OFT should review whether, in the light of market developments since

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<sup>5</sup> The undertakings have since been transferred to the CC by way of the Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2004, SI No. 2181.

<sup>6</sup> FTA73, Section 88(4).

<sup>7</sup> CC (2002), paragraph 1.16.

<sup>8</sup> CC (2002), paragraph 2.594 (c).

the CC report, the measures put forward could be modified or discontinued,<sup>9</sup> or alternatively whether further measures would be needed.<sup>10</sup>

- 2.5 In January 2006 the OFT announced this review of the undertakings. The review has been carried out under the FTA73 and the Enterprise Act 2002 ('EA02'). Given the CC's concerns, the main focus of the review has been on the transitional remedies in England and Wales. However, the review has also considered the impact of the behavioural undertakings in the context of the general development of competition in the market.

### **Competition Commission's 2002 report**

- 2.6 On 20 March 2000, the CC was asked by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to investigate the supply of banking services by clearing banks to small and medium-sized enterprises. The reference was made under the FTA73 and therefore the CC conducted its investigation using the public interest test. The CC was required to determine whether a monopoly situation existed, whether firms exploited their monopoly position and what could remedy any exploitation.
- 2.7 For the purposes of its investigation, the CC defined SMEs as businesses with an annual turnover of up to £25 million.<sup>11</sup> The CC found banking services to SMEs to be highly concentrated especially with regard to the big four clearing banks, which accounted for over 90 per cent of liquidity management services in each geographic market.<sup>12</sup>

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<sup>9</sup> CC (2002), paragraph 2.594 .

<sup>10</sup> CC (2002), paragraph 1.16.

<sup>11</sup> CC (2002), paragraphs 2.10 and 2.28. The CC's definition was consistent with the turnover threshold employed by the European Commission at that time. Clubs, associations and charities were included in this definition.

<sup>12</sup> CC (2002), paragraph 1.2.

2.8 In addition, customers showed an unwillingness to switch. The CC identified a number of reasons for this, including:<sup>13</sup>

- the perceived complexity of switching for little benefit
- the importance of a relationship with a bank and bank manager
- the banks requiring customers to have a current account as a condition of receiving other services
- the limited degree of price sensitivity by customers
- the lack of transparency around pricing.

2.9 Overall, the CC identified the following practices and features as restricting and/or distorting competition:

- similarity of pricing between the major banks (for example, no payment of interest on current accounts)<sup>14</sup>
- differential pricing to customers with free banking being confined to only some SMEs (mostly start-ups and to a lesser extent, switchers), and the use of selective negotiation to reduce prices for those considering switching
- barriers to entry (including branch infrastructure and high sunk costs).<sup>15</sup>

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<sup>13</sup> CC (2002), paragraph 1.3.

<sup>14</sup> The CC noted that some of the smaller banks in the UK had significantly different pricing structures, particularly in relation to levels of money transmission charges (CC (2002), paragraph 2.101).

<sup>15</sup> CC (2002), paragraph 1.5

2.10 The CC found that as a result of the practices and features outlined above, the four largest clearing banks were charging excessive prices and therefore earning excessive profits in England and Wales.<sup>16</sup>

### **The undertakings<sup>17</sup>**

2.11 In order to address the concerns raised by the CC a number of behavioural undertakings were given by nine banks.<sup>1819</sup> These undertakings were designed to:

- make switching easier and faster
- limit bundling of services, and
- improve price information and transparency to SMEs.

2.12 In addition, the signatory banks were required to investigate and report on the feasibility of branch sharing. Following this the banks developed further their Inter Bank Agency Agreements ('IBAAs').<sup>20</sup>

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<sup>16</sup> CC (2002), paragraph 1.8.

<sup>17</sup> The undertakings are listed in full at Annexe C.

<sup>18</sup> AIB Group (UK) Plc (in relation to First Trust's SME business and branches in Northern Ireland), Bank of Ireland (in relation to Bank of Ireland's SME business and branches in Northern Ireland), Barclays Bank Plc (in relation to Barclays' SME business and branches in England and Wales), Clydesdale Bank Plc (in relation to Clydesdale's SME business and branches in Scotland), HBOS Plc (in relation to Bank of Scotland's SME businesses and branches in Scotland), HSBC Bank Plc (in relation to HSBC's SME business and branches in England and Wales), Lloyds TSB Bank Plc (in relation to Lloyds TSB's SME business and branches in England and Wales), Northern Bank Ltd (in relation to Northern's SME business and branches in Northern Ireland) and The Royal Bank of Scotland Group Plc (in relation to The Royal Bank of Scotland's SME business and branches in England and Wales, and Scotland, National Westminster Bank's SME business and branches in England and Wales and Ulster Bank's SME business and branches in Northern Ireland).

<sup>19</sup> Most of these undertakings came into effect on 1 January 2003. Those relating to switching did not come into effect until 31 December 2003.

- 2.13 These undertakings were aimed at increasing competition in SME banking services over the long term. Some came into effect between 1 November 2002 and 1 January 2003 but others (including most of those relating to switching) did not come into effect until 31 December 2003.
- 2.14 The CC did not consider that the behavioural undertakings would, by themselves, have time over the first two or three years to strengthen competition and reduce the excess prices that it found existed in England and Wales.<sup>21</sup> Therefore, transitional undertakings were sought from the four main clearing banks operating in England and Wales.<sup>22</sup> These undertakings required the four banks to offer either current accounts paying interest (at Bank of England base rate minus 2.5 per cent) or accounts free of core money transmission charges. This requirement was aimed at giving prices a decisive and significant shift toward what the CC considered competitive levels.<sup>23</sup>
- 2.15 In addition the transitional undertakings also provided that the banks supply the OFT with data on any increases to tariffs.<sup>24</sup> This was designed to expose any attempt by the banks to try to offset the costs of the undertakings by, for example:
- increasing money transmission charges
  - increasing interest rates on loans, or
  - reducing lending rates or their willingness to lend.

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<sup>20</sup> In particular the major banks agreed to provide further information on IBAs through their websites.

<sup>21</sup> CC (2002), paragraph 1.12.

<sup>22</sup> Barclays Bank Plc, HSBC Bank Plc, Lloyds TSB Bank Plc and Royal Bank of Scotland Group Plc.

<sup>23</sup> CC (2002), paragraph 1.13.

<sup>24</sup> Following the recommendation at CC (2002), paragraph 2.594(a).

### 3 THE SME BANKING MARKET IN THE UK

- 3.1 This chapter describes the background to the supply of SME banking services in the United Kingdom. It considers the features of banking services, focusing particularly on liquidity management services (including current accounts). It also briefly considers the nature of the demand side of the market – SMEs in the UK.
- 3.2 The information in this chapter is based on information provided to the OFT by banks, banking groups and SME representatives, and from publicly available sources.

#### Banking services to SMEs

- 3.3 Banking services can be divided into three broad types: money transmission, debt and savings.<sup>25</sup> Money transmission services are provided primarily through business current accounts, which give instant access to money and offer a range of specific money transmission facilities (for example, cash and cheque deposit, cheque writing facilities, access to BACS, CHAPS, direct debit, and standing order facilities). For debt and savings, the range of available products and providers is much wider.
- 3.4 In its 2002 report, the CC found that current accounts, as well as providing money transmission services, were also used for short-term deposits and to provide small amounts of credit through overdraft facilities. The CC concluded that current accounts were part of a product market for liquidity management services, including overdrafts and short-term deposits. For SME banking services as a whole, the CC identified four separate markets:
- liquidity management services, including current accounts, overdrafts and short-term deposits
  - general purpose business loans

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<sup>25</sup> 'Competition in UK Banking', D. Cruickshank, March 2000, p.143.

- specialist business loans (such as asset finance), and
- other business deposits.

3.5 The CC also considered the geographical scope of these markets. It found there were separate markets for liquidity management services and general purpose business loans in England and Wales, Scotland and Northern Ireland. The markets for specialist business loans and other business deposits were considered to be UK-wide.<sup>26</sup>

3.6 Of these, much of the OFT's review has focused on liquidity management services in England and Wales. It was in this market that the CC found that banks were making excess profits, and consequently recommended the transitional undertakings to provide a form of price regulation.

3.7 As part of the review, the OFT sought evidence on the use of personal accounts by businesses. It is difficult to make a robust estimate, since the banks themselves frequently do not know whether a personal customer is using an account for business purposes. Mintel points out that there are around 4.3 million small businesses operating in the UK, whereas BBA figures indicate that there are only 3.3 million small business bank accounts in existence – suggesting that there may be a large number of businesses not using business accounts.<sup>27</sup> TNS research for the final quarter of 2005 suggests that 80 per cent of businesses (with turnover up to £1 million) used a business account, 10 per cent used a personal account and 10 per cent used both.<sup>28</sup> The evidence provided to the OFT suggests that the usage of personal accounts for

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<sup>26</sup> CC (2002), paragraphs 2.50-2.58.

<sup>27</sup> Mintel (2006), 'Small Business Banking – UK- October 2006', p24. This figure relates to business with annual turnover of less than £1 million.

<sup>28</sup> Small Business banking, Year End Q4 2005 produced for Lloyds TSB, TNS (February 2006).

business purposes is particularly common among very small businesses, with larger businesses more likely to use specialist business accounts.<sup>29</sup>

- 3.8 Overall, it appears likely that personal banking imposes a competitive constraint on business banking, particularly for small businesses (especially sole traders). However, there is not sufficient evidence of a change since 2002 to warrant revisiting the CC's market definitions for the purposes of this review.

## **Banks operating in the market**

- 3.9 While there are a large number of providers for some banking services for SMEs, such as loans or mortgage products, there is a more limited number of clearing banks that provide a full range of liquidity management services (including business current accounts). As noted by the CC in 2002, four main banks have historically controlled a large share of business current accounts. The following section briefly provides background on these four main banks, along with some of the smaller banks competing in the market.

### **The four main banks**

#### **Barclays**

- 3.10 Barclays is a UK based financial services group which supplies banking services to around 60 countries in Europe, USA, Africa and Asia. Barclays has around 25 million customers, and around 118,000 employees world wide.

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<sup>29</sup> The Warwick Business School Survey (2004), ('Finance for Small and Medium-Sized Enterprises: A report on the 2004 UK Survey of SME Finances, Dr Stuart Fraser, Warwick Business School') found that 16 per cent of the current accounts used for business purposes, amongst zero employee business, were personal accounts; 'virtually none' of the accounts used for business purposes, among businesses with 10 or more employees were personal accounts (p. 75).

3.11 Barclays' operations in the UK SME sector are organised in two divisions:

- Retail Banking – includes SMEs with annual turnover typically up to £1 million. This includes those customers in the Local Business Banking division which prior to January 2006 was part of the previous Small Business Banking division and serves more than 14 million retail customers in the UK. Barclays provides business current account services to around 641,000 small businesses
- Business Banking – includes SMEs with turnover typically over £1 million. Until the end of 2005, this category of SME customers was divided into two smaller divisions each with a particular turnover threshold.

## HSBC

3.12 HSBC Holdings plc (HSBC) is headquartered in London, and operates in 82 countries and territories worldwide through businesses in five regions: Europe, Hong Kong, the rest of the Asia-Pacific region (including the Middle East and Africa), North America and Latin America. HSBC is one of the largest banking and financial services organisations in the world and has around 10,000 offices world wide.

3.13 HSBC offers the following tariffs to its SME customers:

- Small Business Tariff
- Business Direct Tariff (launched in April 2006)
- Treasurer Tariff
- Schools and Colleges Tariff

3.14 HSBC also has a significant proportion of SME customers who have individually negotiated charges. These are customers who typically have turnover between £500,000 and £25 million. Those businesses with turnover of less than £500,000 are offered one of the above tariffs appropriate to their business needs.

## Lloyds TSB

- 3.15 Lloyds bank acquired Cheltenham & Gloucester Building Society in 1995, and later that year merged with TSB to form the Lloyds TSB Group plc. In the 1990s Lloyds TSB Group made other significant acquisitions (Scottish Widows Fund and Chartered Trust Group plc). In 2001 Lloyds TSB announced its intention to acquire Abbey National which had a presence in SME banking business. However the acquisition was blocked by the Secretary of State on the recommendation of the Competition Commission.<sup>30</sup>
- 3.16 Lloyds TSB's SME business is divided into two main categories:<sup>31</sup>
- Business Banking – for businesses with annual turnover up to approximately £2 million
  - Corporate Banking – for businesses with turnover of more than £2 million.

## RBS Group

- 3.17 RBS Group is a financial services group engaged in a wide range of banking, financial and finance-related activities in the UK and internationally. In March 2000, it acquired the NatWest Group, creating one of the largest business and financial services groups in Europe.
- 3.18 RBS Group has a particularly strong presence in the UK, being the largest business banking provider, as well as offices in Europe, USA and Asia. By 2002 RBS Group was the second largest bank in Europe and fifth largest in the world by market capitalisation.

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<sup>30</sup> Further information on the prohibition of the merger between Lloyds TSB and Abbey national can be found at <http://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=43112&NewsAreaID=2&NavigatedFromDepartment=False>. The CC report on the merger was *Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger (Cm5208)* MMC (2001).

<sup>31</sup> In addition, the Agricultural Mortgage Corporation plc is a subsidiary of Lloyds TSB.

- 3.19 For operational purposes NatWest Bank plc and Royal Bank of Scotland plc service business customers through different business areas of the bank, generally making a distinction based on turnover of a customer's business.
- 3.20 RBS now operates the Corporate Markets division which includes the UK Corporate Banking (UKCB) business customers with turnover of more than £1 million. However, business customers with turnover of between £1 million and £25 million are generally managed by the Commercial Banking division which is a sub-division of UKCB and those with turnover of more than £25 million are generally managed by UKCB direct. The Retail Markets division generally manages business customers with turnover of less than £1 million.
- 3.21 NatWest's SME operation is identical to the divisional split of RBS based on the same turnover thresholds.

### **Smaller banks**

#### **Abbey<sup>32</sup>**

- 3.22 Abbey offers banking products to meet the day to day banking needs of SMEs, including a business current bank account, business no notice reserve account, and the availability of overdraft facilities. Businesses are also supplied with a Visa debit card. The only term lending product currently offered by Abbey is a commercial mortgage product. Abbey has informed the OFT that historically its strategic focus and capability is directed at smaller SMEs.
- 3.23 Accounts are offered through telephone banking, post and internet, and ATMs. Abbey also offers additional services such as CHAPS, international telegraphic transfers, bankers' drafts, foreign drafts. Abbey

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<sup>32</sup> Three of the smaller banks – Abbey, Alliance & Leicester and HBOS – were identified by the CC in 2002 as having the potential to expand and challenge the four main banks in England and Wales. These are referred to collectively in this review as the 'challenger banks'.

is able to arrange for the provision of services such as insurance through third parties.

## Alliance & Leicester

- 3.24 Alliance & Leicester Commercial Bank (ALCB) currently segments its business customers into three broad groups.
- 3.25 Direct customers, with a turnover of up to £1 million, are typically serviced through a combination of channels – via Post Office Counter, through telephone banking service, by post or through an online banking facility. Customers with a turnover of between £1 million and £10 million also receive relationship management support through a Business Centre, with dedicated managers allocated to support customers in a face-to-face manner. Corporate customers with a turnover of £10 million or more receive a similar service proposition to Business Centre customers, but the level and nature of support will be tailored to their individual requirements.

## HBOS

- 3.26 HBOS was created in 2001 by the merger of Bank of Scotland with Halifax. Following the merger, Halifax remained focused on retail banking, with some 700 branches across England and Wales, while Bank of Scotland (BOS) was built on a predominantly Scottish franchise in Retail, SME and Corporate markets but had a significant number of SME customers in England. Prior to 2001, a total of 20 Bank of Scotland SME branches were located in England, primarily within the city business districts, and mainly supporting secondary banking relationships.
- 3.27 Since the merger, HBOS has developed its Halifax branch network in England and Wales to service SME customers under the Bank of Scotland business banking brand. All branches can now accept and issue cash, and process cheques on behalf of Bank of Scotland customers. Ongoing servicing requirements continue to be met from their remote or local relationship manager. The branch network

continues to acquire SME business customers on behalf of Bank of Scotland.

- 3.28 HBOS provides a full range of banking services, comparable with the four main banks in England and Wales. These include credit card services (for example, provision of Business Visa, credit card processing facilities, merchant services), payment processing (for example, BACS and CHAPS), general insurance (for example, commercial, travel, vehicle, professional indemnity), and a range of other financial services. Expert advice is available to customers through specialist and non-specialist relationship managers.

### Co-operative Bank

- 3.29 The Co-operative Bank (Co-op) provides SME banking services throughout the UK and operates two divisions in its SME business. The Business Banking Division services SME customers with a turnover of less than £1 million and the Corporate Banking Division services with a turnover threshold of £1 million or more.
- 3.30 Since 2002 Co-op has been growing its portfolio of SME customers requiring current account services. In relation to its business banking customers the focus is on direct banking and services delivered through the internet and telephone. Co-op's Corporate Division delivers its services through its network of corporate banking centres. In addition to this both its corporate and business customers have access to its branch network.
- 3.31 Co-op also has a relationship with Alliance and Leicester Commercial Bank which enables its customers to use Post Office facilities. Co-op has a relationship with HSBC who provide bulk cash processing services to customers.

### Clydesdale

- 3.32 Clydesdale bank was first established in Glasgow in 1838 and through a series of mergers and acquisitions it grew from a local Glasgow bank to

one of the major Scottish banks. Clydesdale has a network of over 150 branches in Scotland, London and the North of England.

- 3.33 Clydesdale is currently expanding its operations to the South of England with its Financial Solutions Centres offering an integrated business banking service to its customers. Since 1987 Clydesdale has been a member of the National Australia Bank, an international financial services group.

#### Other smaller banks

- 3.34 The OFT consulted with a number of other smaller banks including; Northern, Yorkshire, AIB (including First Trust) and Bank of Ireland.

### **SMEs in the UK**

- 3.35 As noted by the CC, there is no commonly accepted definition of SME.<sup>33</sup> The CC defined SMEs as businesses with an annual turnover of up to £25 million, noting that this was consistent with one criterion in the definition of SMEs used by the European Commission, namely having sales revenues of up to €40 million. The OFT notes that the European Commission has since adjusted the SME definition, including raising the turnover threshold to €50 million.<sup>34</sup> However, given that the CC used this definition in 2002 and some banks segment business areas at a £25 million threshold, the OFT has continued to follow the CC's definition for the purposes of its review. This approach also makes it easier to compare our findings with those of the CC, and hence to assess whether there has been a change of circumstances in the market since the CC report.

- 3.36 On this definition, SMEs make up the vast proportion (around 99 per cent) of businesses in the UK by number – and account for around 4.5 million businesses in total. As shown in Figure 3.1, there has been a

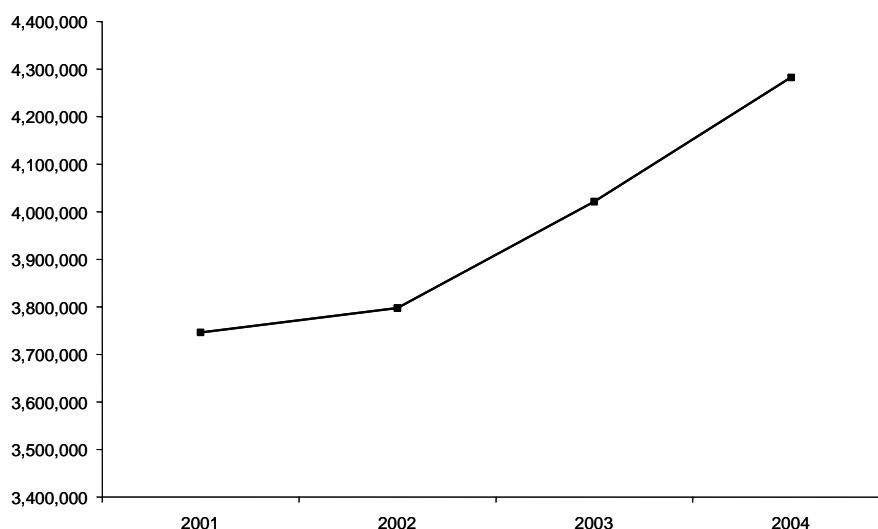
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<sup>33</sup> CC (2002), paragraph 2.9.

<sup>34</sup> 2003/361/EC

trend increase in the number of SMEs since the CC report, and hence a source of potential new customers for the banks.

**Figure 3.1: Growth in number of SMEs in UK**



Source: Small Business Service

3.37 It is also important to recognise the churn in the existing SME customer base. One bank suggested to us that the average lifetime of an SME is around three years. This creates a steady supply of new entrant businesses for which banks compete to offer services.

3.38 Although the CC treated SMEs as a single market for the purposes of its competition analysis in 2002, it recognised that SMEs have a wide range of characteristics, and make different demands on banking services.<sup>35</sup> This point was stressed by banks and business representatives alike during the course of the OFT's review. Figure 3.2 shows how the four main banks in England and Wales have structured their businesses, generally dividing SME customers on the basis of annual turnover.

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<sup>35</sup> CC (2002), paragraphs 2.14 and 2.28.

**Figure 3.2: Segmentation of business customers by the four largest banks**

	<b>Barclays</b>	<b>HSBC</b>	<b>LTSB</b>	<b>RBSG</b>
Small business/ retail banking	Small business – turnover up to £1M	Retail commercial – turnover up to £500K	Business banking – turnover up to approx. £2M	Retail markets division – turnover up to £1M
		Medium business – turnover £1M to £10M		Commercial banking – turnover £250k–£25M
Medium business/ managed relationships	Large business – turnover above £10M		Corporate Banking – turnover £25M to £750M	
Larger corporate customers				

## 4 COMPETITION IN SME BANKING SERVICES

### Introduction

- 4.1 This chapter examines competition in the market for banking services to SMEs, and the changes that have occurred since the CC report. It focuses on liquidity management services in England and Wales, as this is the sector to which the transitional undertakings apply. It also presents some evidence on wider banking services across the UK, and the impact of the behavioural undertakings on market development.
- 4.2 It finds that over the past five years a number of the smaller banks have expanded their position in the market, competing actively with the four main clearing banks, although the overall rate of account switching by existing businesses remains broadly unchanged at around four per cent per annum since 2002. It also finds that there have been new developments in technology which have lowered some of the previous barriers to entry and expansion.
- 4.3 The chapter uses information provided to the OFT by banks, banking groups, and SME representatives. It also draws on the findings of a customer survey carried out for the OFT (the 'OFT customer survey').<sup>36</sup> The OFT has also used third-party research on banking services to supplement its primary information, including the European Commission's sector inquiry interim report, published in July 2006.<sup>37</sup> The OFT has spoken to the Commission in the course of its enquiries.
- 4.4 The chapter is structured as follows:
- first, it considers how market shares have changed, and how switching has affected these market shares

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<sup>36</sup> Survey of 1,222 SMEs conducted by IFF Research Limited in April and June 2006. Further information on the methodology employed can be found in Annexe C.

<sup>37</sup> DG Comp (2006), 'Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, Interim Report II: Current accounts and related services', July 2006.

- second, it considers the reasons why established SMEs appear reluctant to switch, and whether there have been changes in these factors since 2002
- third, it addresses banks' behaviour, particularly in relation to features of pricing behaviour which were considered by the CC in 2002
- fourth, it considers the outcomes for SMEs, including movement in banking charges since 2002
- finally, it considers remaining entry barriers and entry costs, including the role of the branch network and new technology.

## **Market structure**

4.5 The supply of liquidity management services to SMEs in England and Wales has historically been dominated by the four main clearing banks – Barclays, HSBC, Lloyds TSB and RBS Group (including NatWest). Table 4.3 shows estimated market shares in the liquidity management services market in England and Wales, calculated alternatively on the basis of number of accounts and value of account balances.<sup>38</sup> It compares market shares as observed by the CC (based on 1999 data) with estimates based on data provided by the banks for 2005.

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<sup>38</sup> Absolute value of credit plus debit balances.

**Table 4.3: Estimated market shares in the liquidity management services market in England and Wales**

	Share by number of accounts (%)		Share by value of accounts (%)	
	1999	2005	1999	2005
RBSG (incl. NatWest)	[...]	[...]	[...]	[...]
Barclays	[...]	[...]	[...]	[...]
Lloyds TSB	[...]	[...]	[...]	[...]
HSBC	[...]	[...]	[...]	[...]
<b>Four largest clearers</b>	<b>92</b>	<b>85</b>	<b>91</b>	<b>85</b>
HBOS	[...]	[...]	[...]	[...]
Alliance & Leicester	[...]	[...]	[...]	[...]
Abbey	[...]	[...]	[...]	[...]
<b>Challengers</b>	<b>3</b>	<b>9</b>	<b>4</b>	<b>9</b>
Others	6	6	6	6
Total	100	100	100	100
Value (£bn)/number (m)	5.4	6.0	76	106
HHI	2,190	1,926	2,410	1,988

Source: OFT calculations based on banks' information. Columns may not sum due to rounding. The OFT was not able to obtain full information from all smaller banks ('Others' in the table), so has assumed that their position has remained static since 2000. Based on the information we have seen suggesting that some of the smaller banks have increased their market share (as noted in paragraph 4.9), the OFT believes that this is a conservative estimate.

4.6 The figures in Table 4.3 suggest that the share of the four largest banks by number of accounts has fallen from around 92 per cent in 1999 to 85 per cent in 2006. This finding is consistent with other evidence gathered in the course of the review. For example, 83 per cent of SMEs in the OFT customer survey (across the UK as a whole) had their main business account with one of the four main banks. A survey conducted by TNS in the last quarter of 2005 found that 85 per cent of customers

in England and Wales had an account with one of the four main banks.<sup>39</sup> In terms of value of account balances, the information provided by the banks suggested that the four main banks have a market share of 85 per cent compared with 91 per cent in 1999.<sup>40</sup>

- 4.7 There has also been a marked movement in relative shares between the four main banks over a relatively short time period. [...] and [...] have seen their market share fall, while [...] has gained market share. For example, the market share of the three largest banks has reduced by more than seven per cent from 74 per cent to 67 per cent. This contrasts, to some extent, with the stability of market shares amongst the four largest banks reported by the CC in 2002.<sup>41</sup>
- 4.8 HBOS, Alliance & Leicester and Abbey jointly have around a nine per cent share of the market (by number of accounts) compared with three per cent in 1999. Based on the OFT's estimates, HBOS has made the most notable gains (compared with Bank of Scotland and Halifax prior to the merger), to around [...] per cent of liquidity management accounts.<sup>42</sup> Abbey and Alliance & Leicester have also been able to increase their market share. Traditionally these two banks have focused on the smaller end of the business market. However, there are signs that [...], in particular, is attempting to expand its medium-sized business customer base. [...]

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<sup>39</sup> Small Business banking, Year End Q4 2005 produced for LTSB, TNS (February 2006), slide 13.

<sup>40</sup> In some cases the market shares calculated on the basis of value of account balances provided by the banks appeared to be at odds with wider market expectations and the banks' qualitative views. While the OFT made concerted efforts to obtain consistent figures, it also adjusted one of the market share estimates (for HBOS) following discussions with the bank.

<sup>41</sup> CC (2002), paragraph 2.65. The CC reported some changes amongst market shares of the major providers between 1990 and 2000, however these changes occurred over a longer period than those found by the OFT.

<sup>42</sup> According to TNS research, HBOS has a market share of around 6 per cent across the UK as a whole, including Scotland.

- 4.9 In addition, some of the smaller banks with SME banking operations have expanded their SME businesses over the last five years. Co-operative Bank, for example, has expanded its direct banking facilities and marketing services in association with the Federation of Small Business. [...]. Clydesdale has expanded its SME banking operation through Southern England and Wales since 2002 through the introduction of new services. AIB (GB) has expanded its operations by opening new branches and increasing staff numbers.
- 4.10 A number of smaller banks have entered the wider business banking market, including Bank of Cyprus, Triodos, Handelsbank, Investec, Butterfield and ING. In total, 25 banks are signatories to the Business Banking Code.<sup>43</sup> In relation to wider banking services, Lloyds TSB points out that there are also recent entrants competing for business in individual products which traditionally would have been provided by a branch-based bank. These include Commercial First (offering secured loans to the commercial market); PayPal (with 100 million users worldwide); and Tesco (which launched a business credit card in 2006).
- 4.11 In related markets, the evidence gathered during this review suggests that there has been a small reduction in the share of the four main banks in the market for general purpose business loans (including commercial mortgages) in England and Wales [...] as shown in Table 4.4:

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<sup>43</sup> Signatories to the Business Banking Code are listed on the Banking Code Standards Board website: [www.bankingcode.org.uk/faq.htm](http://www.bankingcode.org.uk/faq.htm)

**Table 4.4: Estimated shares in general purpose business loans in England and Wales**

	Share by number of accounts (%)	
	1999	2005
RBSG (incl. NatWest)	[...]	[...]
Barclays	[...]	[...]
Lloyds TSB	[...]	[...]
HSBC	[...]	[...]
Four largest clearers	90	89
HBOS	[...]	[...]
Alliance & Leicester	[...]	[...]
Abbey	[...]	[...]
Others	7	6
Total	100	100

Source: OFT calculations based on banks' information. Note that percentages may not sum to 100 because of rounding.

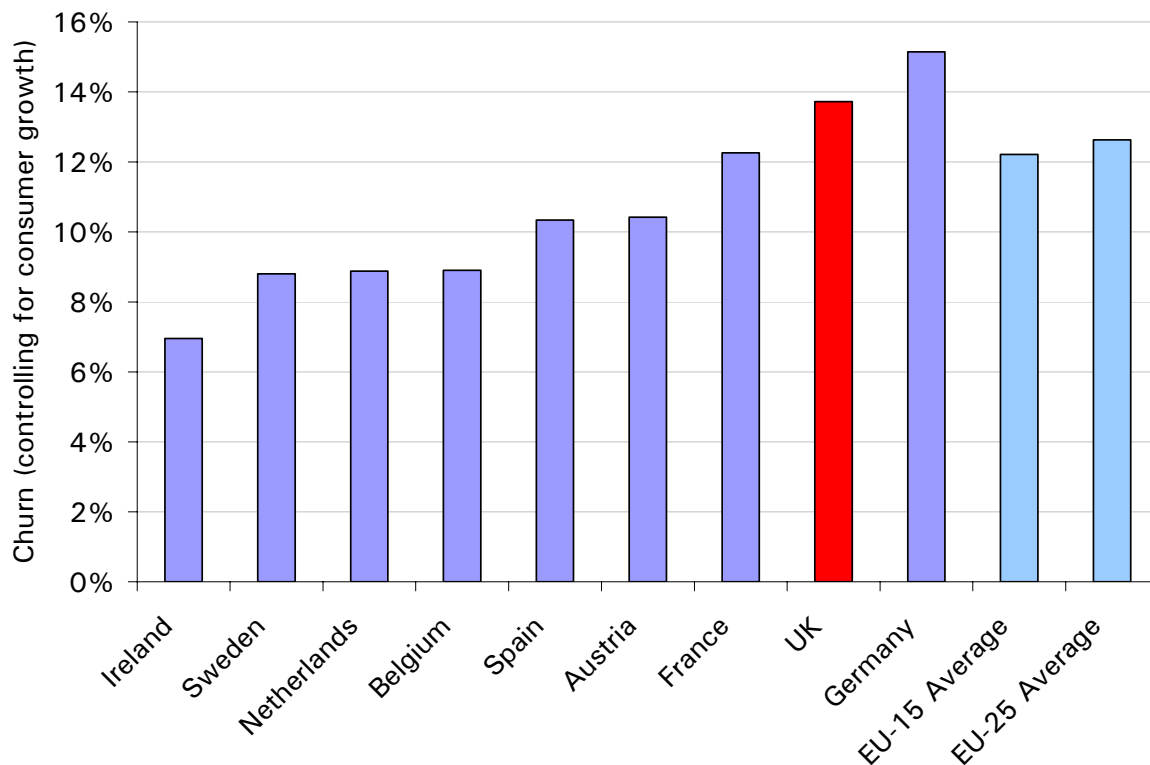
## Customer churn

4.12 Evidence collected by DG Comp as part of its sector inquiry into retail banking suggests that customer churn in the UK is above average for the EU—DG Comp found that churn in the UK SME sector was 13.7 per cent, compared with an EU-15 average of 12.2 per cent.<sup>44</sup> This could indicate above-average customer mobility, although it is important also to factor in wider differences between markets across EU member states.

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<sup>44</sup> DG Comp (2006), 'Sector inquiry under Article 17 Regulation 1/2003 on retail banking: Interim report 2: Current account and related services', July 2006, p.102. This compares with UK personal customer churn of 5.07 per cent compared with an EU-15 average of 7.55 per cent. (These figures were after controlling for growth). Churn is defined as the ratio of the sum of current accounts opened in a year plus current accounts closed in a year divided by two times the total number of accounts at the beginning of the year.

**Figure 4.5: Estimated customer churn in selected EU countries**



Source: DG Comp (2006).

4.13 Average longevity of an SME's banking relationship provides another indicator of the mobility of customers between banks and willingness to switch. DG Comp found that average longevity of the SME banking relationship was 7.7 years in the UK, compared with 8.6 among the EU-15. The OFT customer survey found that the proportion of SMEs who have been with their current business bank for more than 10 years has risen slightly but significantly (31 per cent in 2006 against 26 per cent in 2000). The proportion of SMEs who had been with their bank for less than two years has remained relatively stable between 2000 and 2006 (37 per cent against 35 per cent in 2000).

4.14 Behind these overall rates of churn, banks are competing for two potential sources of new customers:

- new entrant or start-up SMEs without an existing business account

- existing SMEs who choose to switch banks. This switching process can take several different forms, ranging from outright switching – transferring all banking services – to partial transfers including multi-banking with more than one institution. The latter is harder to identify in detail.

4.15 Of these two sources, new entrants make up a larger proportion of new banking customers. Data provided by the four main banks suggested that between 14 per cent and 26 per cent of new customers joined as switchers from other banks. In part this reflects the natural process of SMEs entering and exiting the market.

## Switching

4.16 A number of surveys have attempted to estimate rates of switching among banks, summarised in Table 4.6.

**Table 4.6: Recent estimates of switching rates for SME banking services**

Survey	Annualised switching rate	Year of survey	Sample size	Definition of SME
OFT	4.3%	2006	1,200	> £25million turnover (c.75% with turnover > £1million)
Warwick	2%	2004	2,250	Fewer than 250 employees (c.95% with turnover > £1million)
FPB	4.6%	2004	1,400	Member of FPB (c.75% with turnover > £1million)
TNS	3%	2005	9,000	> £1million turnover

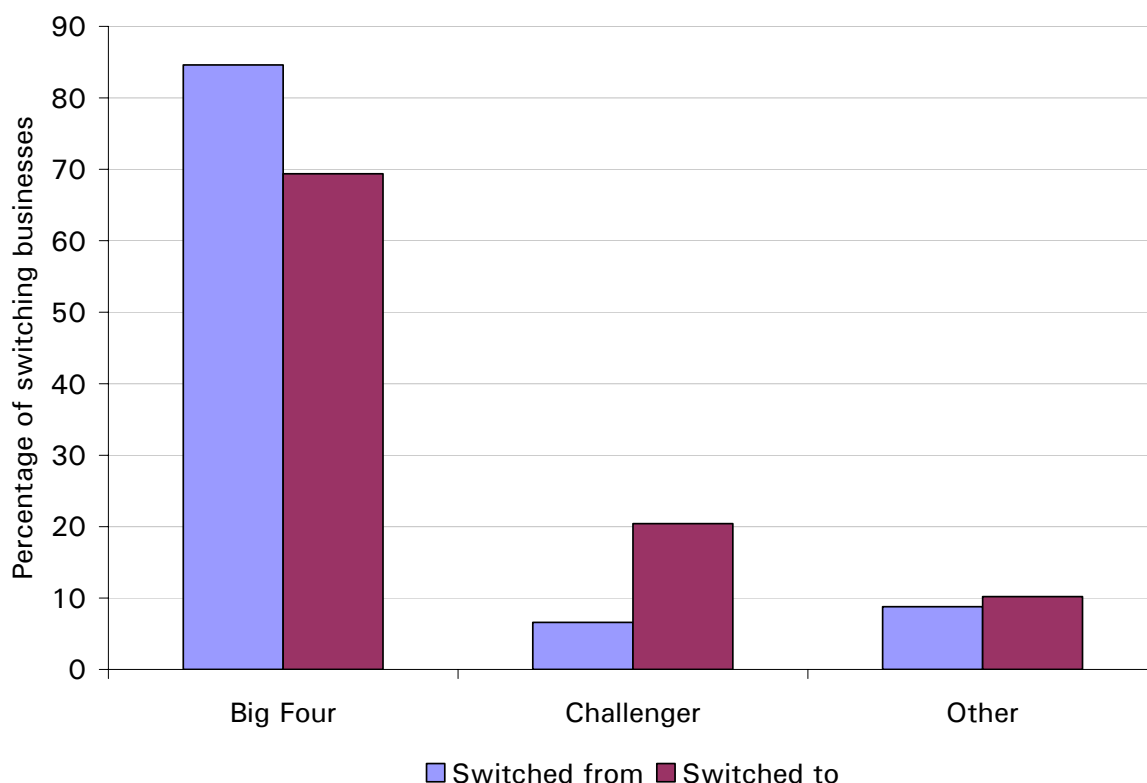
Source: Various

4.17 Overall, the level of switching we have been able to identify remains low (at around four per cent per year). Given the differences in methodology, it is difficult to conclude with any certainty whether switching rates

have increased or decreased since the 2002 CC report. The most direct comparison is between the OFT Customer Survey 2006 and the survey carried out for the CC in 2000, using the same definitions and methodology. The OFT Customer Survey found that 13 per cent of customers had switched banks in the last three years, compared with 12 per cent in 2000.

- 4.18 However, the OFT Customer Survey suggests that switchers have moved disproportionately to smaller banks relative to their existing market share, suggesting that the smaller banks have been net gainers from switching. This is illustrated in Figure 4.7. The trend suggests there is some momentum gathering towards increasing competition in the longer term.

Figure 4.7: Estimated rates of switching to and from different banks



Source: OFT Customer Survey 2006. Note – evidence is annualised, based on switching over a three year period up to 2006.

4.19 Figure 4.7 suggests that switching leads to roughly a 15 per cent shift from the main four banks to one of the smaller banks. Based on an annual switching rate of around four per cent, this suggests that switching could lead to a fall in the combined market share of the four main banks of around 0.6 per cent per year.<sup>45</sup>

4.20 These trends are generally confirmed by evidence presented to us by the banks:

- One of the four main banks suggested that there has been an increased level of switching away in the past two years. It argued

<sup>45</sup> Calculated as 4 per cent \* 15 per cent = 0.6%.

that switchers are increasingly switching on price grounds, indicating a growing degree of price sensitivity. It also provided research showing an increase in 'first-time' switchers. In 2003 more than one in four switchers away from the bank were moving for the second or more time. However, these 'frequent switchers' had only accounted for [...] to [...] per cent of switchers away from the bank so far in 2006.

- Another of the main banks suggested that there has been an increasing rate of customers switching away from their products, with the rate increasing from [...] per cent in 2005 to [...] per cent in 2006. It also noted that, of SMEs who had left the bank, the second highest number had switched to one of the challenger banks.
- Another of the main banks claimed that the proportion of switchers moving away to HBOS and Alliance and Leicester has doubled.

### **Start-ups and new entrants**

4.21 The OFT was not able to gather consistent information from all the parties to determine their respective shares of new start-up customers. The OFT is aware of anecdotal evidence from the challenger banks that they have been able to gain volume through attracting start-up customers. The OFT has also seen evidence from TNS, suggesting that Abbey and HBOS both captured around five per cent of start-ups in 2005.<sup>46</sup> (This research does not give a comparable figure for Alliance & Leicester). More detail is shown in Table 4.8.

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<sup>46</sup> Small Business banking, Year End Q4 2005 produced for LTSB, TNS (February 2006).

**Table 4.8: TNS estimates of market shares in England and Wales, 2005**

Bank	Share in E&W	Share of start-ups in E&W
Barclays	21	21
HSBC	19	21
Lloyds TSB	20	22
RBS Group	25	18
BIG 4	85	82
HBOS	4	5
Abbey	4	5

Source: TNS (2005)

4.22 Broadly, the evidence suggests that the smaller banks have gained a slightly higher share of start-up customers than their overall market share. However, this overall finding is driven largely by the apparently low share of start-ups gained by [...]. The shift from the main four to smaller banks also appears less marked than in the case of switching by existing customers.

4.23 As an estimate of the impact of start-ups on overall market shares, the OFT notes that the information in Table 4.8 is consistent with a shift from the four main banks to smaller banks of around three per cent.<sup>47</sup> Assuming that the annual rate of entry by start-ups is around 10 per cent, this would suggest a decline in the combined share of the four main banks of around 0.3 per cent per year.<sup>48</sup>

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<sup>47</sup> In other words, this assumes that challenger banks attract a three per cent higher share of start-up customers than their current share of the existing market.

<sup>48</sup> The estimated impact on the four main banks' market share of new start-ups (0.3%) and of switching as set out in paragraph 4.19 (0.6%) sums to around one per cent per annum, which is consistent with the overall market share trend presented in Table 4.3.

## Multi-banking

- 4.24 Several banks have argued that market shares based on SME business current accounts do not reflect the reality of SME banking services providers' market shares for individual SME banking services (such as SME loans). It has been argued that, increasingly, market shares for individual SME banking services are greater than their SME current account market shares. One bank stated that multi-sourcing (for example, use of brokers) and multi-banking has played a large part in this development with over 40 per cent of SME customers using more than one SME banking service provider.
- 4.25 The OFT customer survey found that 12 per cent of businesses had another business account with another bank. A fifth (20 per cent) had wider services (including current account) with another bank. The Warwick Business School survey indicates that over 40 per cent of SMEs use more than one SME banking services provider.<sup>49</sup> TNS research showed that 54 per cent of SME customers with turnover of up to £1m borrowed through an alternative financial supplier to their main bank.
- 4.26 Based on the CC's finding in 2002 that there is a separate market for liquidity management services, the fact that SMEs are choosing to move to other banks for alternative products does not directly affect the assessment of competition in the reference market. Nevertheless, increasing multi-banking and unbundling of banking relationships might reduce the importance of current accounts as a 'gateway' into other banking services. For example this could reduce the main banks' ability to leverage sales of other financial products such as loans and insurance policies through their large share of current accounts thus allowing more competition in the market for the other financial products.

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<sup>49</sup> Warwick Business School (2004), 'Finance for Small and Medium-Sized Enterprises: A Report on the 2004 UK Survey of SME Finances', page 77.

## **Summary on market shares and switching**

- 4.27 In summary, the above analysis has suggested that there has been a net transfer of customers away from the main four banks at the rate of around one per cent per year. This has led to marked growth (in percentage terms) by the main challenger banks – Abbey, Alliance & Leicester and HBOS. There has also been movement of customers between the four main banks.
- 4.28 There is evidence that the smaller banks are picking up a disproportionate share of those SMEs who choose to switch. The challengers also appear to have picked up market share by taking on start-up businesses.

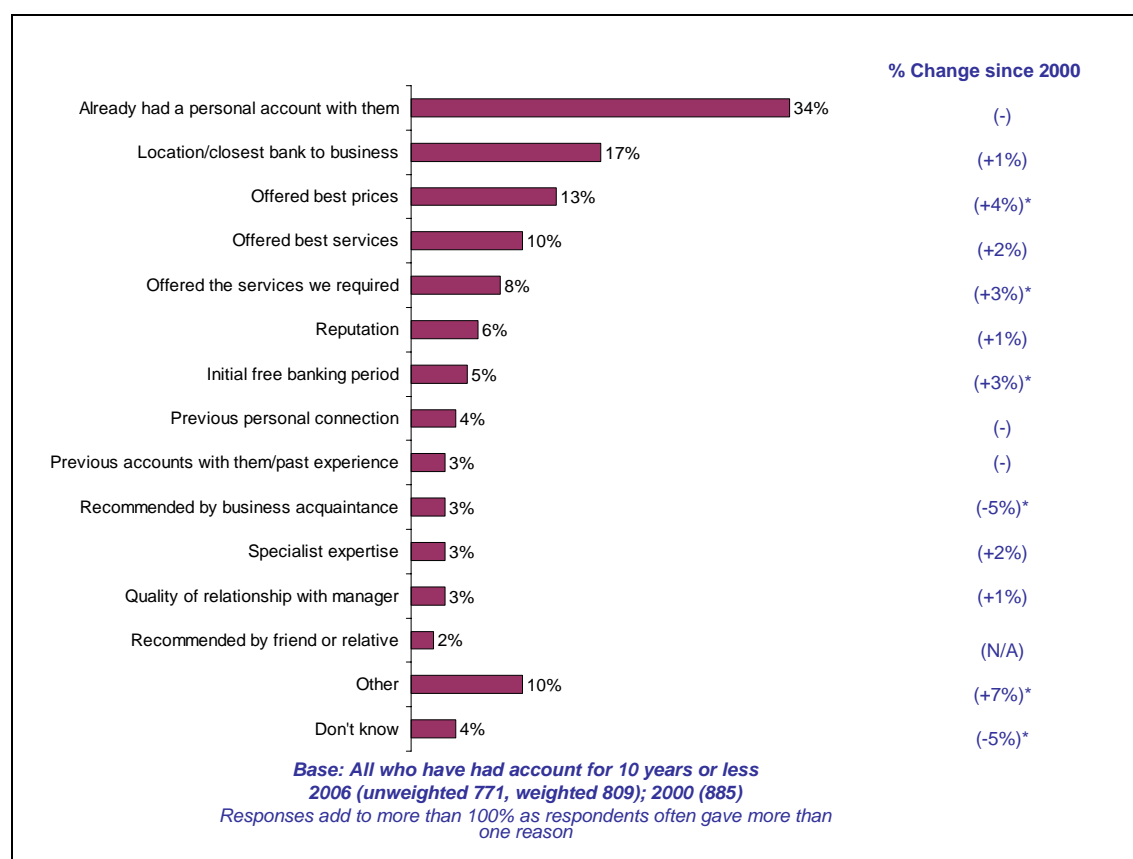
## **Customer attitudes and switching costs**

- 4.29 This section considers why SMEs appear reluctant to switch, and whether there have been any changes that might suggest that switching has become easier since 2002, even if this is not reflected in actual rates of switching.

### **Changes in customer attitudes**

- 4.30 The OFT has considered whether customer attitudes have changed since 2002. The OFT customer survey collected evidence on SME attitudes, which can be compared with a similar survey conducted by the CC in 2000.
- 4.31 Figure 4.9 records the main reasons stated by SMEs for choosing a particular bank. The top three were: that they already had a personal account (34 per cent); the bank was conveniently located or was the closest bank to the business (17 per cent); and that the bank offered the best prices (13 per cent).

**Figure 4.9: Reasons why SME chose bank for main business account**



Source: OFT customer survey 2006

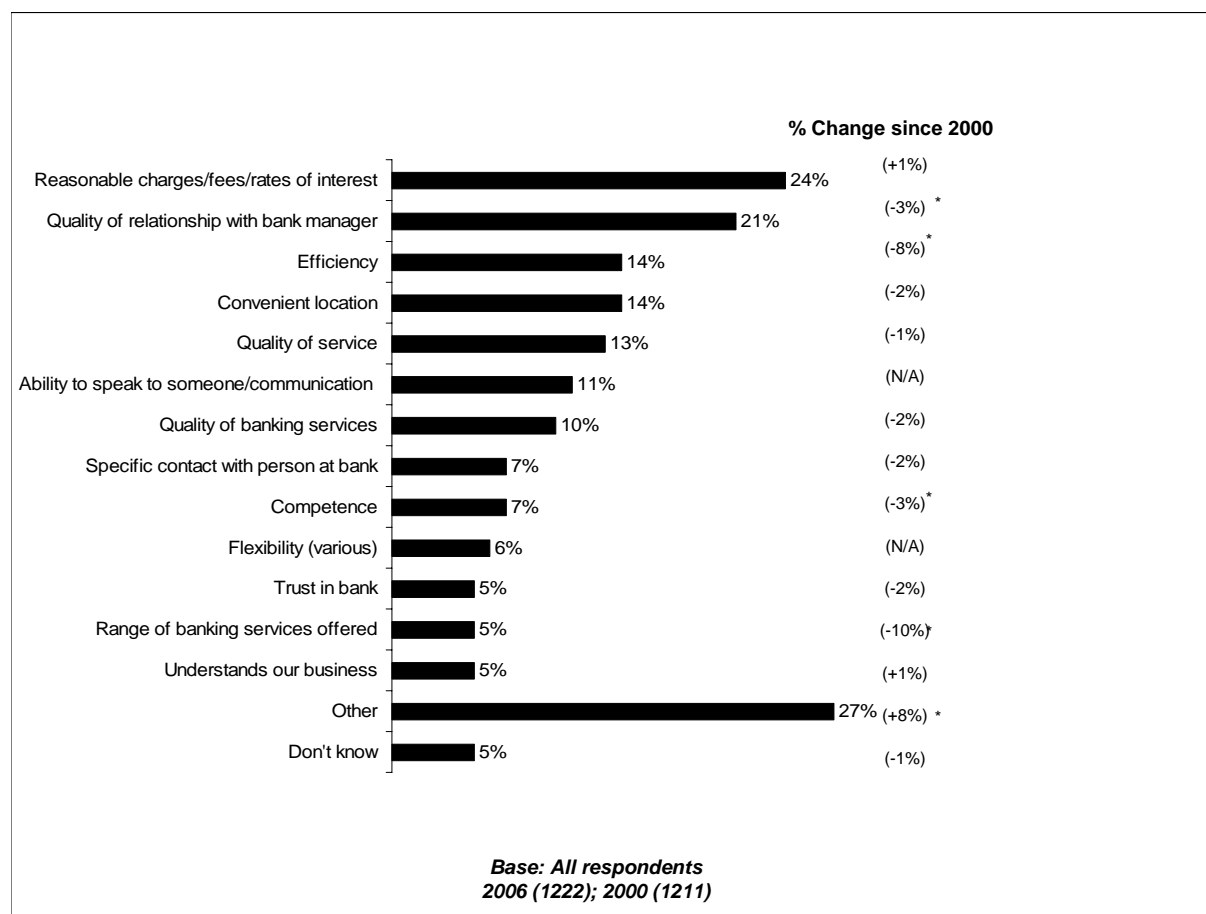
4.32 The importance of price competitiveness of a bank appears to have increased since 2000, with four per cent more SMEs than in 2000 (13 per cent in total) citing price as a reason for choosing their bank.

4.33 On the other hand, as in 2000, a large proportion (34 per cent) of customers chose their main bank because they already had a personal account with them. Customer survey evidence suggested that only 42 per cent of new SMEs (under two years old) claimed to have shopped around in choosing a bank. However, of these, nearly half had considered a non-big four bank, a significant increase since the 2000 survey.

4.34 Similarly, as shown in Figure 4.10, when SMEs were asked about the characteristics that were most important to them in a bank, the largest number (24 per cent) mentioned reasonable charges/fees/rates of

interest. In contrast, the proportion that noted quality of relationship with the bank manager (21 per cent) was lower than in 2000.

**Figure 4.10: Characteristics most important in a bank**



Source: OFT customer survey 2006

4.35 Finally, the OFT survey explored the average length of a customer's relationship with a bank. The value placed by customers on having a long-run relationship with their bank has arguably acted as a key constraint on switching in the past. However, the assumption that customers might benefit from a long-run relationship has been challenged by some commentators. For example, the Warwick survey found that the average length of an SME's financial relationship with its bank was fifteen years. However, it also found no evidence that switching increases the chances of rejection or increases the cost of borrowing.<sup>50</sup> This matches anecdotal evidence gathered by the OFT

<sup>50</sup> Warwick Business School Survey (2004), p.125

which suggested that, particularly for smaller businesses, banks base their lending decisions on standard credit scoring approaches with relatively little local discretion to take account of a long-term banking relationship.

- 4.36 The OFT customer survey found that the proportion agreeing that a long-term relationship means you can obtain more favourable rates has significantly decreased since 2000 from 48 per cent to 32 per cent. The length of the relationship is still seen to be important in securing access to funding, although the proportion of businesses agreeing with this statement has also fallen slightly since the 2000 survey (from 74 per cent to 67 per cent). The OFT believes that this is a positive sign that SME customers are becoming more realistic about the actual benefits of a long-run banking relationship, and that this trend should lead customers to be more willing to switch provider in the future.

### **Price transparency and customer awareness**

- 4.37 The OFT customer survey asked SMEs several questions relating to their awareness of bank charges. When asked about their annual banking costs, 41 per cent of customers did not initially know their annual banking costs. Eighty three per cent of all customers were satisfied that charges relating to the main business account were suitably transparent, but 15 per cent were not satisfied. Of those considering switching, 24 per cent had concerns about transparency. Separately, businesses which had considered switching were asked how easy they found it to compare pricing information between banks. Twenty one per cent said it was not easy. A number of SME representative organisations, including the FSB and FPB argued that the complexity of the charges made it more difficult for consumers to understand their banking charges.
- 4.38 Several banks argued that it was unreasonable to expect consumers to be aware of banking costs when asked, without checking back over old statements. The banks also pointed to their requirement under section 5 of the Business Banking Code to pre-notify customers of account fees and charges. They argued that the requirements of the Business Banking Code meant that banks had to provide customers with a transparent breakdown of charges.

- 4.39 In addition several banks informed us that they provided customers on introductory offers with full information as to the prices they would pay when they are transferred onto standard tariffs. One bank, Lloyds TSB, also referred to a website where customers or prospective customers could see banking charge information after entering certain information about usage or likely usage of banking services.
- 4.40 Most of the banks argued that it is now very easy to compare offers at different banks. The OFT notes that there are several internet-based price comparison services available, including an account-finder sponsored by the British Banking Association, (which has demonstrated significant increases in visits to the website over the last several years), and the website moneysupermarket.com.
- 4.41 The OFT examined sample account statements from each of the four main banks. These showed that the banks already provide information on:
- number of transactions (for example, number of direct debit transfers and number of cheque payments) carried out over the period covered by the statement
  - unit charge per transaction, and
  - sum total of charges for the period.
- 4.42 The OFT considers that this information, particularly on the number of transactions carried out, is very important to ensure that customers could reasonably estimate their banking costs if they were to switch to an alternative provider. The OFT recommends that, where other banks do not already provide this information, they should do so. Banks should also consider including a requirement of this kind in the Business Banking Code.

- 4.43 The findings of a recent study commissioned by Alliance & Leicester challenge the big banks' assurances on price transparency.<sup>51</sup> The study found that it would take three days to properly compare rival offers and switch accounts (including taking account of the potential for negotiation on terms with the banks). The study also notes that 'an important difference between this current study and the report two years ago is that it proved impossible to persuade banks to quote interest charges on borrowings. All the banks stated that interest charges were subject to negotiation'. It was suggested that this might be because banks rely on credit scoring models that calculate the interest to be charged based on the risk profile of businesses, and so are unable to quote interest rates until they have collected the range of data necessary to run their assessment models.
- 4.44 Some banks argue that growing use of brokers has improved price transparency. Lloyds TSB suggested that the use of brokers increases transparency since brokers have a full understanding of the pricing structures of each bank, will actively encourage customers to switch their account to lower banking costs, and can select the lowest price offer to suit their clients' needs.

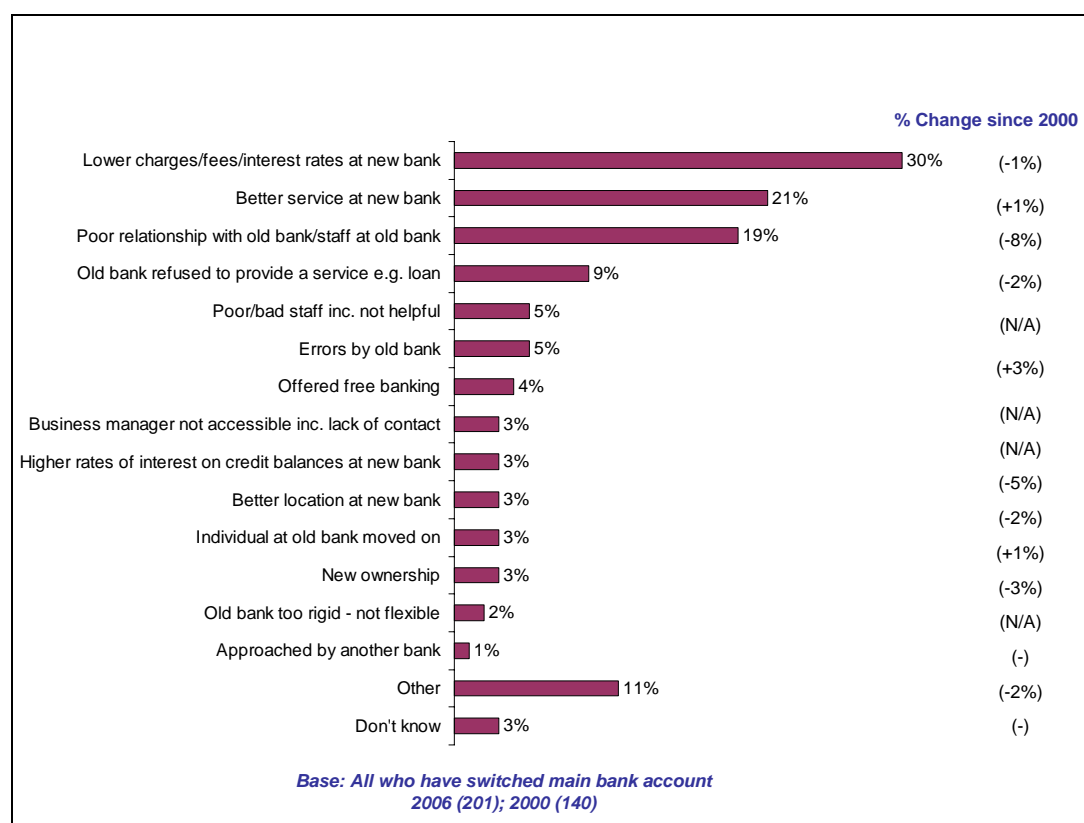
### **Reasons for switching**

- 4.45 The OFT customer survey asked a sample of customers who had switched banks to comment on the reasons why they had switched. The most common reason for switching was to pursue a better deal (be that in the form of lower rate of charges, fees or a higher interest rate at the new bank). Figure 4.11 shows other reasons for switching commonly mentioned by those surveyed.

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<sup>51</sup> F. Chittenden, November 2006, 'How Transparent is the UK Business Banking Market?', Manchester Business School.

**Figure 4.11: Reasons for switching**



Source: OFT Customer Survey 2006

4.46 These results (alongside the evidence discussed in paragraphs 4.30 to 4.34) suggest that customers may have become more sensitive to price, and more willing to switch provider on the basis of price-related factors. Although the results in Figure 4.11 suggest a slight fall in the proportion of customers citing charges/fees, four per cent of customers cited free banking as a reason for switching (which was not included in the 2000 survey). There has also been an apparent marked decline in the proportion of customers stating that a poor relationship with their old bank prompted their switch, along with a slight increase in customers who thought they were getting a better service at their new bank. Further evidence of customers' current sensitivity to price was given by one of the main banks. It stated that its own research in June 2006 suggested that 19 per cent of in-switchers quoted price as the main reason for joining the bank, 'a significant increase compared to levels of around 10 per cent in the preceding three years'. The bank also gave

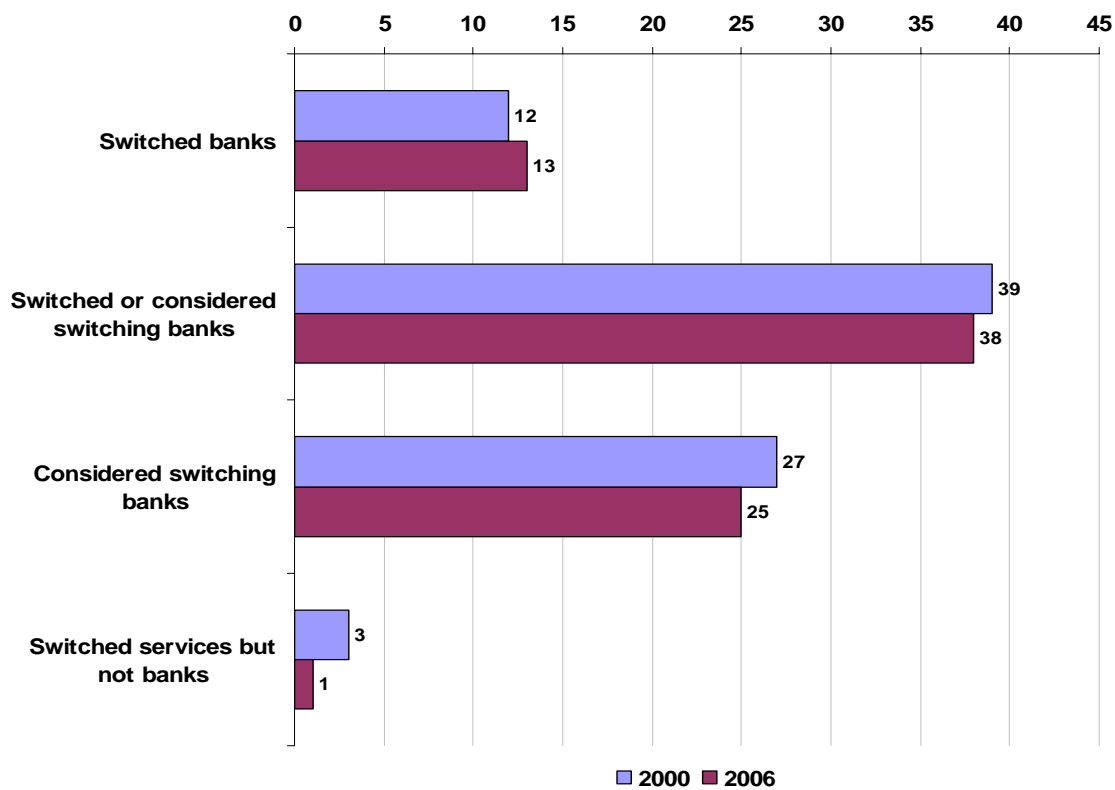
evidence showing that its account 'Sale' promotion had increased switching by 50 per cent and start ups by 11 per cent (compared to non-Sale months).

- 4.47 According to the OFT survey, a fifth of all businesses (19 per cent) said they would definitely switch if charges increased between five per cent and 10 per cent. A further 48 per cent would seriously consider switching if charges increased by this amount and 16 per cent would talk to another bank if approached. Only 13 per cent said they would do nothing as an increase of between 5 and 10 per cent was not enough to warrant switching.

### **Proportion of SMEs considering switching**

- 4.48 The OFT customer survey suggests that there has been little change in the overall number of customers considering switching – as shown in figure 4.12 below.

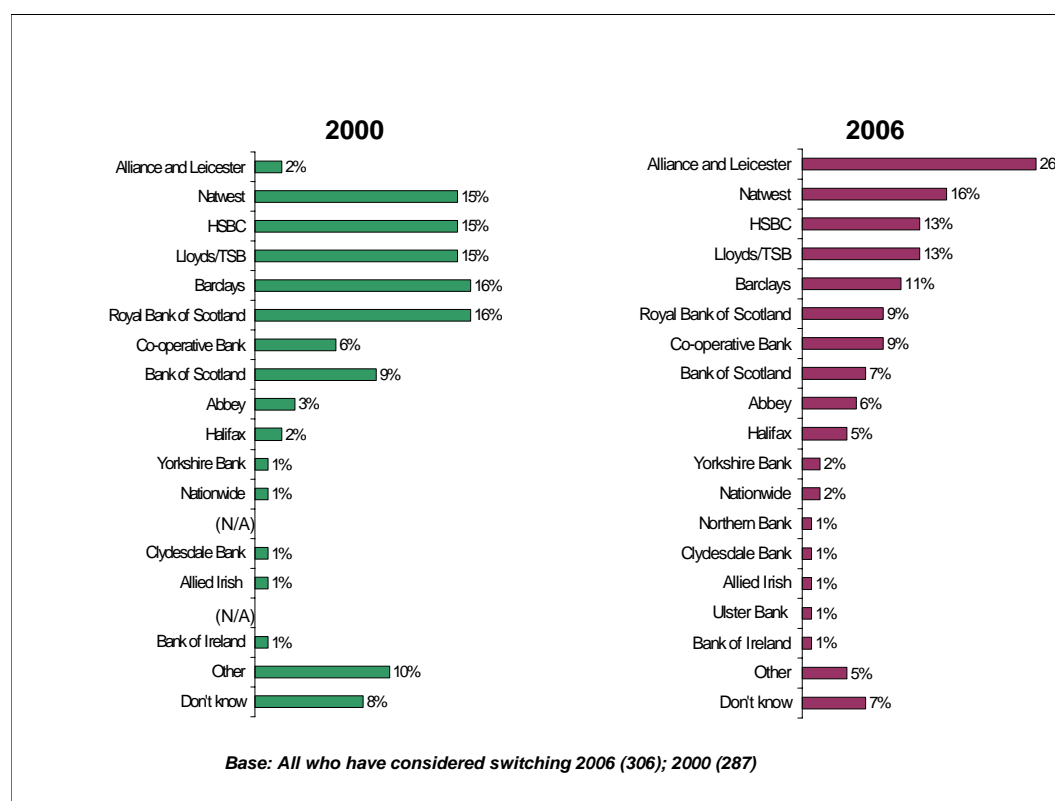
**Figure 4.12: Proportion of SME customers switching or considering switching**



Source: OFT Customer Survey 2006.

4.49 However, SMEs appear increasingly to be considering switching to one of the challenger banks. In the OFT customer survey, all businesses which had considered switching were also asked which banks they had considered switching to. As Figure 4.13 shows, the four main clearing banks accounted for a lower proportion of banks approached in 2006 than it did in 2000 (totalling 62 per cent in 2006 compared with 77 per cent in 2000). The high proportion of SMEs considering switching to Alliance & Leicester is particularly striking. This might reflect marketing by the bank to target switchers, or might also reflect Alliance & Leicester's competitive price offer.

**Figure 4.13: Which banks have SMEs considered switching to?**

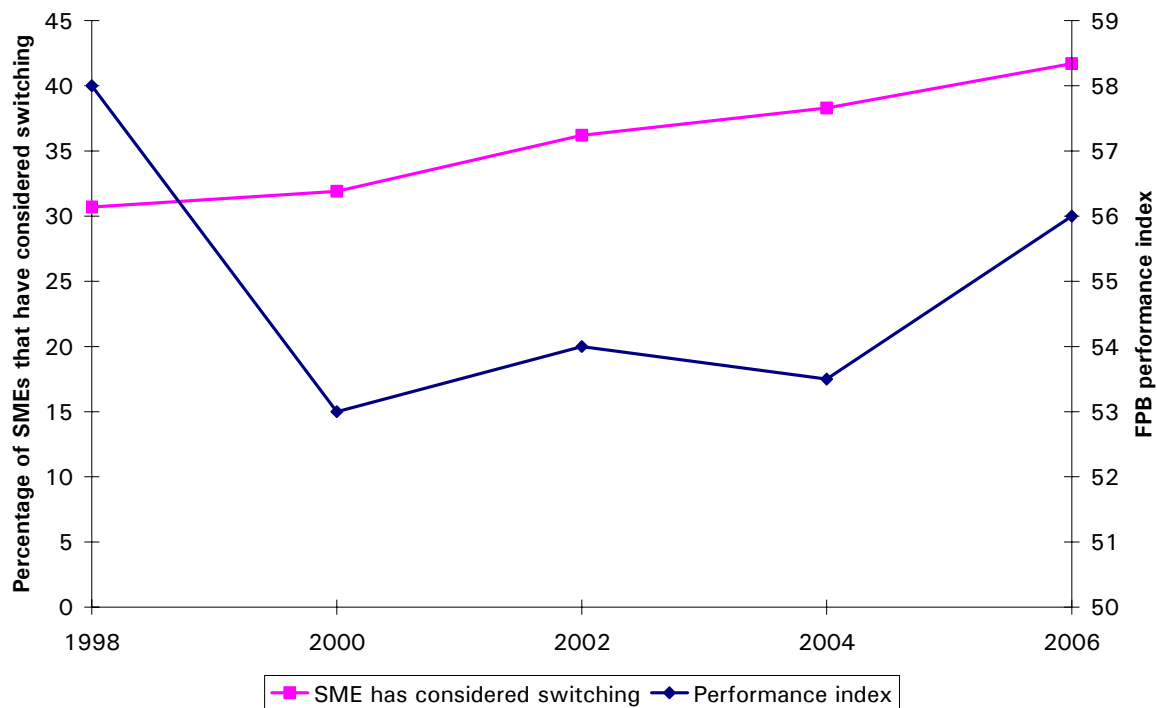


Source: OFT Customer Survey 2006

4.50 Some third party evidence examined by OFT also appears to give a clearer indication that SMEs are now more willing to consider switching. For example, the FPB has registered a fall in the proportion of customers not considering changing bank, from 68.1 per cent in 2000 to 61.7 per cent in 2004 and 58.3 per cent in 2006.<sup>52</sup> As illustrated in Figure 4.14, the FPB found that this increase in willingness to consider switching has come at the same time as the SMEs' perception of banks' overall performance (as measured by the FPB's performance index) appears to have improved. This suggests that switching has not simply been driven by dissatisfaction with the existing bank.

<sup>52</sup> FPB (2006), 'Private Businesses and their banks 2006'.

**Figure 4.14: FPB survey findings on aggregate bank performance and SMEs' willingness to consider switching**



Source: FPB (2006)

4.51 One of the main banks argues that there has been an increase in the sophistication of customers, with SMEs reporting a greater willingness to switch (and TNS data showing the proportion of [...] customers very likely to consider switching increasing from five per cent in 2004 to 11 per cent in 2006). [...] further argues that more customers are actually switching, partly driven by increases in transparency in the market through greater use of the internet. The increasing sophistication of customers has also manifested itself in increased price sensitivity in the market.

### Switching costs

4.52 In terms of time taken to complete a switch, a quarter (24 per cent) of businesses surveyed in 2006 said the process had been completed within seven days. The majority of businesses (76 per cent) perceived it took longer, with a significant proportion (29 per cent) saying the whole

process took longer than six weeks. This question was not asked in the 2000 survey, so there is no comparative data.<sup>53</sup>

- 4.53 Anecdotal evidence provided by a number of parties suggests that the time required to switch can be very long, particularly where the banking requirements are complex. A particular issue relates to customers who have secured lending, where the new bank needs to carry out due diligence on the security before it will take on the loan. It is not clear that this should prevent SMEs from switching their current account, initially retaining the loan with the old bank while due diligence is carried out.
- 4.54 The Warwick survey found that customers who had switched found the process 'relatively easy'<sup>54</sup>. According to the OFT customer survey, of all businesses which switched, a quarter (25 per cent) encountered problems when doing so. This is up significantly since 2000 (14 per cent in 2000). Although this still means for the majority (75 per cent) no problems were encountered, there is a concern that this relatively high reported incidence of switching problems could increase the perception of switching costs in the future. A number of parties commented informally to us that there was an important 'word of mouth' impact, whereby a customer who encounters difficulties in switching telling others, increasing the perceived risk of mistakes or problems during switching.

### **Impact of the switching undertakings**

- 4.55 The switching undertakings set out target times for seven stages of the switching process. Four of these stages are the responsibility of the existing bank, while the rest are the responsibility of the new bank. The banks are committed to meeting these targets in 80 per cent of cases.

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<sup>53</sup> It should also be noted that this reflects SMEs' perceptions of how long the process took and, given the constraints of the questionnaire length, we did not examine this issue further in that forum.

<sup>54</sup> Warwick Business School Survey, page 93.

They are also required to put in place compensation arrangements for cases where the targets are not met by the existing bank.

4.56 Banks have generally argued that the switching undertakings have had a beneficial effect. One bank talked about the undertakings providing a certain 'hygiene factor' in switching. Compliance with the switching undertakings has been high, as shown in Table 4.15.

**Table 4.15: Proportion of account transfers meeting targets in the switching undertakings – averages based on available returns between 2003 and 2006**

Target number	Moving away from bank				Moving to bank		
	1	3	5	7	2	4	6
AIB	91	94	98	100	89	99	100
Barclays	100	100	97	99	90	90	98
HSBC	95	na	85	94	96	97	97
Lloyds TSB	100	99	96	98	100	100	99
Royal Bank of Scotland	100	97	100	100	100	100	100
Nat West Bank	97	99	100	100	99	100	100
Ulster Bank	94	95	94	95	99	92	76
Northern Bank	100	97	98	98	96	100	98
Clydesdale Bank	100	100	100	99	100	100	100
Bank of Scotland	98	97	98	98	94	98	96
Average	97	97	96	98	96	97	96

Notes: Key to switching targets:

- 1: Provide list of Standing Orders and Direct Debits
- 2: Set up Standing Orders and Direct Debits
- 3: Cancel Standing Orders and Direct Debits
- 4: Request credit balance from old bank
- 5: Transfer available credit balance to new bank; Close account following transfer of credit balance to new bank
- 6: Transfer funds to repay o/d at old bank
- 7: Apply cleared funds to clear outstanding o/d; Close account after cleared funds applied

4.57 However, awareness of these undertakings is relatively low. According to the OFT survey, only 26 per cent of businesses are aware of the

switching procedures (undertakings). SMEs who had actually switched accounts were significantly less likely to be aware of the switching procedures (18 per cent). Sixty seven per cent of those who were already considering switching and 42 per cent of those who might switch if approached felt that knowing about the new procedures would encourage them to switch.

4.58 In addition to the switching targets, the switching undertakings require banks to pay compensation in certain circumstances where errors occur. Clause 14 of the switching undertakings states that: 'Subject to clause 12 above, The Bank shall establish a scheme under which an SME can apply (such application may be required in writing) for a payment from The Bank for a failure by The Bank, in respect of the SME's switch from The Bank, to meet any one or more of the relevant targets of the old bank specified in column 4 of the table shown in the Schedule to these undertakings.'

4.59 Overall, it appears that banks do not publicise the compensation arrangements effectively, particularly when a customer is switching away from a bank. For example, the OFT customer survey found that less than one in ten businesses (nine per cent) knew that the bank should pay compensation if the switch is not completed according to the agreed timetable. This is reflected in very low take-up of compensation by SMEs. One bank told OFT that it had made no payments in the past year for switchers-out and 12 payments for switchers-in. Another bank said that it had made payments of £150. The OFT considers these rates of compensation payment to be surprisingly low, even in view of apparent high rates of compliance with the switching targets.

### **Summary of switching costs and attitudes to switching**

4.60 The OFT has found that switching rates remain low, at around four per cent per year. However, there appears to be an increase in the number of SMEs considering switching. There is also evidence that customers are actively considering moving to the challenger banks. Customers generally appear to be more conscious of the price of accounts, and competitiveness of relative price offers. There is also evidence that the perceived importance of having a long-run banking relationship is

declining, reducing one of the most important elements of customer inertia.

4.61 Nevertheless, aside from the fact that switching rates apparently remain low, the OFT also notes other areas in which concerns remain:

- there is evidence that the switching process can take a relatively long time, and that customers report that there have been problems during the switching process in a relatively high proportion of occasions (around one in four according to the OFT Customer Survey)
- customers do not always find it easy to compare charges between banks. The OFT accepts that price comparisons have become easier through, for example, increasing use of price comparison websites. However, it is important that SMEs are given the information that they need in order to use these services – in particular, that they are regularly provided with a breakdown of their current account charges, and that they have a record of the average number of transactions that they carry out in a given period.

4.62 These concerns raise the question of whether more can be done to encourage switching in the future. This issue is addressed at paragraph 6.31 onwards.

## **Pricing behaviour**

4.63 This section considers aspects of the banks' pricing behaviour towards businesses, focusing particularly on the areas that were identified as competition concerns by the CC in 2002.

### **Bundling and cross-selling**

4.64 Bundling relates to selling two or more products together as a package. This practice is common in competitive markets, and can frequently be beneficial to consumers. However, in certain circumstances bundling can raise competition concerns when it is engaged in by players with significant market power. In its 2002 report, the CC raised a particular

concern about 'the requirement of some clearing banks that SMEs wishing to borrow or use business deposit accounts have a business current account' with that particular bank.<sup>55</sup> Behavioural undertakings were recommended to address this concern.

- 4.65 The behavioural undertakings state that a bank 'shall not directly or indirectly require, agree (other than in respect of integrated products) or threaten to require, as a condition of the granting, maintaining or servicing of any business loan to, or the opening, maintaining or servicing of any business deposit account for, any SME that SME should open or maintain any business current account with the Bank.' However, the undertakings explicitly allow for the bank to offer incentives for customers to arrange a business current account at the same time as taking other services. For example, a bank could offer the customer a lower price for purchasing two different products jointly (for example, a current account and a loan).
- 4.66 The OFT customer survey found that, in general, the incidence of bundling has decreased since 2000. The survey recorded a fall from six per cent to three per cent in the proportion of SMEs who claimed that they had been forced to take out a service as a condition of taking out another service. The service that customers were most frequently required to take out to obtain the service they actually wanted was a personal account (41 per cent). Nineteen per cent claimed to have been asked to take out business current accounts as a condition of securing other products. This latter finding might indicate that the behavioural undertakings have not entirely eliminated current account bundling so far. However, the OFT has not found any evidence of cases where the undertakings have been breached, and is satisfied that the overall effect of the undertakings has been to reduce the incidence of bundling to a very low level.
- 4.67 There appears to have been some increase in the incidence of charge reductions resulting from purchasing several services from a single bank.

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<sup>55</sup> CC (2002), paragraph 2.91.

The OFT customer survey indicates that there has been a significant increase (from five per cent to nine per cent) in the proportion of customers who claim to have been offered services at a reduced price as a result of taking out another service. In general, this finding is consistent with information the banks gave us, showing that there is a high degree of cross-selling between different banking products.

- 4.68 The available evidence suggests that bundling is less common in the UK compared with most other European countries. For example, the DG Comp sector inquiry interim report found that 11 per cent of banks required an SME loan customer to open a current account, compared with 51 per cent on average across the EU-15.<sup>56</sup>

### **Similarity in prices**

- 4.69 A similarity of pricing structures offered by different banks might raise competition concerns if it indicates a degree of tacit coordination, reflecting a lack of competitive pressure on prices. It is important to recognise that similarity of pricing structures may also be a legitimate outcome of a highly competitive market, so there can be no presumption of anti-competitive effects. Nevertheless, a range of different pricing offers between banks at the very least might stimulate customers to look more actively at switching provider.
- 4.70 In 2002, the CC's particular concern was the similarity of price structures between the main clearing banks, including in general not paying interest on current accounts while also levying money transmission and other charges, and payment of relatively low rates of interest in relation to the value of funds to the bank on smaller short-term deposit accounts.<sup>57</sup>
- 4.71 Arguably the transitional undertakings might reduce price competition by focusing payment of interest at a certain level (2.5 per cent below base

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<sup>56</sup> DG Comp (2006), p.110.

<sup>57</sup> CC (2002), paragraph 2.107.

rate). The OFT notes that none of the main four banks has provided credit interest at a level above that required by the transitional undertakings. However, at the same time there has been some innovation in available tariffs. In part this has been driven by changes in technology which have made it easier for some companies to rely on automated payments and internet banking. Several of the main banks have introduced direct banking services or tariffs with discounted or free rates for automated payments.<sup>58</sup>

- 4.72 The OFT also notes that, while none of the banks have deviated from the requirement to pay interest at 2.5 per cent below the base rate, other banks not subject to the transitional undertakings have put together alternative interest offers. For example, Abbey offers staged interest rates, which rise as deposit levels increase (similar to some personal bank accounts).

### **Price offers to switchers and start-ups**

- 4.73 In 2002, the CC raised concerns that lower prices, in particular free banking services, are offered to that sector of the market most responsive to price competition and higher prices to that sector that is least price-sensitive. The CC noted that this might prevent the benefits of price competition diffusing through to the majority of customers.<sup>59</sup>
- 4.74 As in 2002, the OFT found that start-ups were typically given a discounted tariff offer. All of the four main banks told us that they provided 'free banking' for start-ups, typically for a period ranging from 12 to 18 months. A number of banks also told us that, at the end of the free banking period, they would not expect businesses to move immediately to the full tariff. They would either have full charges phased in over several months, or would negotiate a specific tariff. This

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<sup>58</sup> For example, Barclays free automated transactions tariff, HSBC Direct.

<sup>59</sup> CC (2002) paragraph 2.112.

evidence appears to support the CC's view that there is stronger competition to attract new start-ups than existing SMEs.<sup>60</sup>

- 4.75 There is also evidence that banks are increasingly offering price discounts to switchers as well as start-ups. For example, HSBC ran an account 'sale' for a limited period, which encouraged a higher level of account switching. To the extent that these offers are open to any SME who chooses to switch, they do not allow banks to price discriminate in the same way as is possible in making an offer to a start-up business.

### **Negotiation of charges**

- 4.76 As with offers to start-ups, in 2002 the CC raised concerns about negotiation of charges, particularly if this came at the point when a customer was threatening to switch. The CC argued that this could be a means of price discrimination, reducing prices to retain the business of more price-sensitive customers and avoiding the need for price reductions to other customers and preventing these other customers from receiving the benefits of competition. The CC also noted that the 'scope for negotiation also exacerbates barriers to entry by pre-empting switching by those considering switching, thus reducing the prospects for new entrants'.<sup>61</sup>
- 4.77 The four main banks provided evidence on the number of their customers who were on negotiated tariffs. Table 4.16 shows the OFT's estimate of rates of tariff negotiation, based on these responses.

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<sup>60</sup> CC (2002), paragraph 2.110.

<sup>61</sup> CC (2002), paragraph 2.117.

## **Table 4.16: Estimated proportion of SME customers on negotiated tariffs**

[...]

- 4.78 Other third party evidence is broadly consistent with these results. For example, the FPB survey found that just under 29 per cent of customers in 2006 were on negotiated tariffs, compared with nearly 32 per cent in 2002. The OFT customer survey found that a third of businesses (32 per cent) had tried to negotiate prices with their main bank, compared with 49 per cent in 2002. Larger businesses were more likely to attempt to negotiate. Only 20 per cent of those with less than £100,000 turnover had tried to do so.
- 4.79 All four main banks accept that there is significant local discretion for relationship managers to negotiate, including if the bank believes that a business is going to switch.
- 4.80 The OFT customer survey asked a sample of switchers or those considering switching what their original bank's response had been when informed of the threat to switch. In 49 per cent of cases the bank did nothing. In 23 per cent of cases the bank reduced its prices and in 13 per cent of cases businesses felt that the bank had improved its service.<sup>62</sup> The larger the business, the more likely the bank was to have taken some action (81 per cent for businesses with turnover above £5 million compared with 51 per cent overall).<sup>63</sup>
- 4.81 Anecdotally, one of the challenger banks argued that it had lost a large number of potential switchers because the existing bank had negotiated better terms once it became aware of the possibility of the account being transferred. It argued that this sometimes happened even once a customer had formally agreed to switch account. The OFT notes that this type of negotiation will benefit customers in the short-term, since

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<sup>62</sup> In other cases, the SME was still in negotiation with its bank, or had changed bank manager.

<sup>63</sup> OFT Customer Survey (2006), Table 7.6.

they can achieve a better deal and avoid switching costs. However, it may also mean that banks will charge a higher average price if they know they can respond individually to specific threats.

### **Difference in terms between personal and business accounts**

- 4.82 In 2002, the CC observed that there were differences in terms between personal and business accounts. Most obviously, personal current accounts tend not to include transaction charges, whereas many business current accounts do include charges.
- 4.83 One of the main banks stated that it would be impossible for incorporated businesses to use a personal account, because the documentation required for customer identification and verification to open the account is different. For non-incorporated businesses, it will encourage a customer to switch to using a business account. The bank reserves the right to close a personal account used to conduct business transactions. In most cases, it argues, there are significant benefits to a business in having a business account – for example, the bank will have a better understanding of the business through regular contact, easier book keeping and reconciliation and access to a relationship manager or business specialist.
- 4.84 Another of the main banks said that it encourages the use of business accounts for business customers because they are more appropriately aligned with business owners' needs. LTSB monitors the usage of personal accounts for business needs but will not generally prevent an SME from using a personal account for business banking.
- 4.85 Another of the main banks said that it relied on local knowledge of staff to determine whether clients were operating businesses through a personal bank account.
- 4.86 Another of the main banks said it is unable to monitor systematically whether or not an SME is using a personal account for business purposes but relies on regular payments information and through high levels of credit/debit transactions. It estimated the number of businesses using personal accounts to be around 1.3 million across all banks.

4.87 Overall, the evidence suggests that some 20 per cent of SMEs might use personal accounts for business purposes. The OFT also observes that some of the free automated transactions or direct banking offers developed since the CC report are more similar to standard personal banking tariffs.

### **Promotion of set-off and sweep facilities**

4.88 Set-off and sweep facilities allow customers to transfer funds between accounts automatically, for example to take advantage of better rates of interest on deposit accounts than on current accounts. The CC in 2002 raised concerns that banks were not doing enough to promote set-off and sweep facilities, and that customers were suffering as a result. However, the CC also noted that 'we would expect adoption of the [transitional pricing remedy] to result in the demand for use of currently expensive set-off and sweep facilities being much reduced',<sup>64</sup> because of the requirement to pay interest on current accounts.

4.89 Of the four largest banks, [...] told us that they have not changed their policies on set-off and sweep facilities since 2002. [...] stated that this particular service is no longer promoted to its sub-£1 million SME customers (although noting that in this period it introduced a market-leading business off-set product). [...] argues that demand for the original service is not significant given the interest payments on current accounts (as recognised by the CC).<sup>65</sup>

### **Summary**

4.90 The evidence on pricing behaviour highlights some trends that might ameliorate some of the CC's concerns in 2002. In particular:

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<sup>64</sup> CC (2002), paragraph 2.595.

<sup>65</sup> The OFT acknowledges that if the transitional undertakings were released and if there were to be a subsequent reduction in payment of credit interest, this could make set-off and sweep facilities more attractive to customers, and it would be important in this context for banks to promote these facilities, as suggested by the CC.

- there appears to have been a slight reduction in levels of tariff negotiation, and there is greater transparency over banks' standard tariffs
- although banks still typically offer different tariffs to start-up businesses, there is also increasing evidence of offers to switchers (which could be taken up by any SME customer)
- new tariffs have emerged since 2002, particularly in connection with direct banking services and free or reduced-price automated transactions.

## **Outcomes of competition – prices and quality of service**

4.91 The following section considers the outcome of the market structure and behaviour discussed above in terms of prices and quality of service.<sup>66</sup> Overall, new tariffs have been introduced and other tariffs phased out, while the main four banks have also had to adapt their tariffs in response to the transitional undertakings.<sup>67</sup> The OFT has collected evidence on prices from two main sources - direct observation of banks' charges,<sup>68</sup> and customer surveys.

### **Published tariff information**

4.92 Banking costs to an SME will depend on a range of factors including the precise mix of transactions that they carry out, and the average balance that they maintain in the account. A number of banks noted that it was

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<sup>66</sup> Banking costs are also discussed in chapter 5 (paragraphs 5.54-5.57) in the context of potential attempts to mitigate the effects of the transitional undertakings.

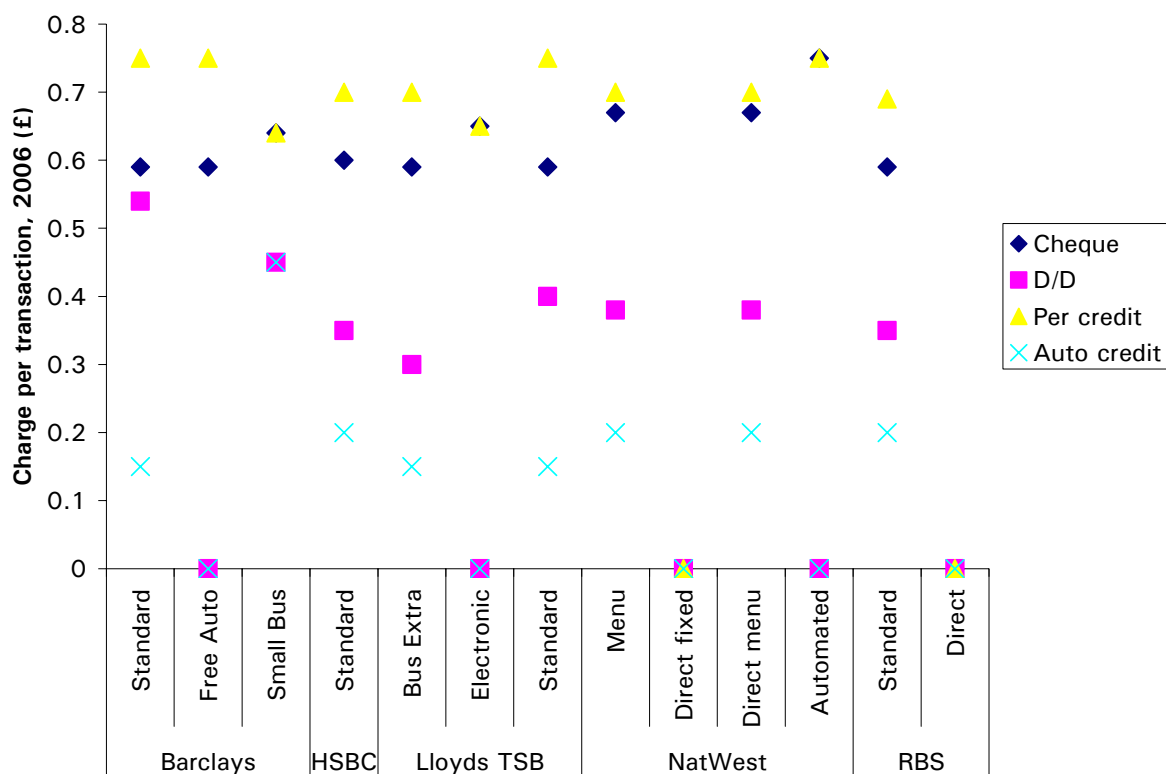
<sup>67</sup> The impact of the transitional undertakings is considered in more detail in chapter 5.

<sup>68</sup> Under the terms of the transitional undertakings, the four main banks are required to provide OFT with information on their standard tariffs every six months. This information is also publicly available as required by the behavioural undertakings, and banks have chosen to do this through their web-sites.

relatively easy for SMEs to compare tariffs based on their own specific characteristics using third party price comparison services.

4.93 Figure 4.17 illustrates some of the money transmission charges offered by the four main banks on their standard tariffs in 2006. It is not intended to be comprehensive. However, it illustrates the range of offers available to customers, and shows the variation in individual charges between banks. Another striking point since 2002 has been the development by all four banks of forms of electronic or 'free automated payment' tariffs which generally offer cheap or free automated credit and debit facilities alongside relatively expensive charges for non-automated transactions (for example, cheque payments).

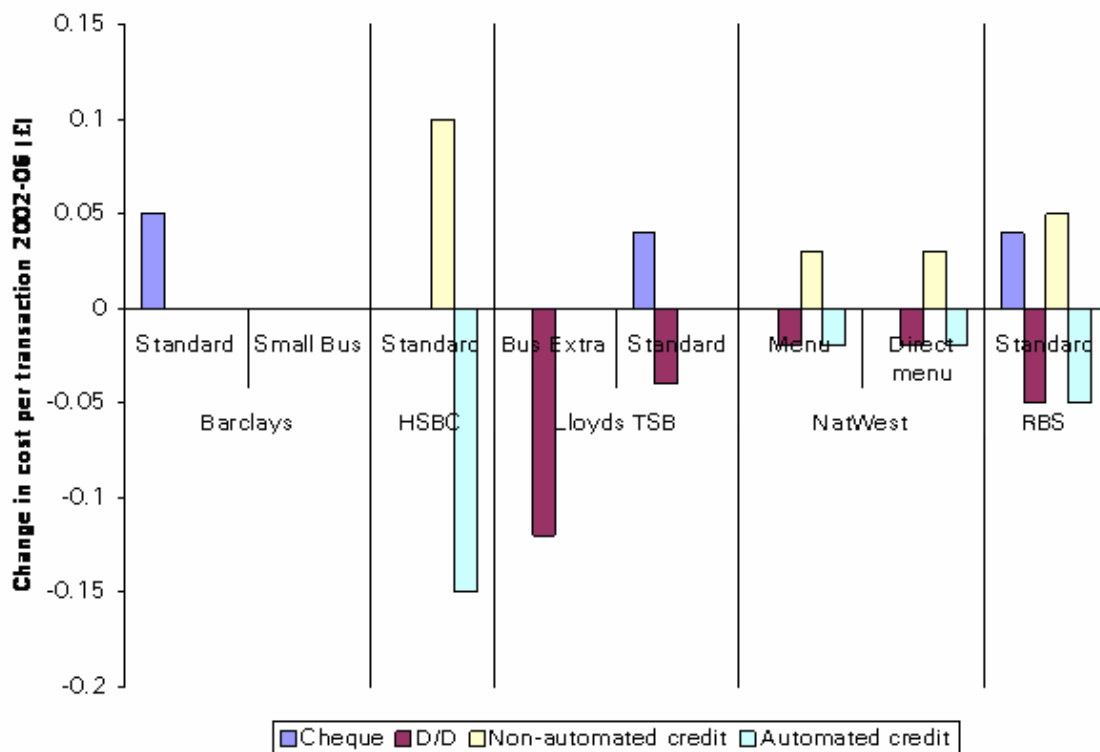
**Figure 4.17: Selecting money transmission charges for the four main banks, March 2006**



4.94 Figure 4.18 illustrates the changes in costs per transaction since 2002 for specific elements of the money transmission charge. Automated payments tariffs were generally not available in 2002, so are excluded

from this comparison. Two points are of particular note. First, there have been movements in all of the tariffs (with the exception of Barclays Small Business Tariff which has now been phased out). Second, there has been a general trend towards lower charges for automated payments and higher charges on non-automated payments, including cash handling.

**Figure 4.18: Change in cost per transaction between 2002 and 2006 for selected charges and tariffs**



4.95 The OFT has conducted its own price comparisons for a limited range of customer types. The OFT would stress that these are not intended to be representative of all consumers – clearly account costs will vary considerably between customers, and different accounts will generate different relative costs and benefits for different customers. Table 4.19 shows the assumptions that have been made (based on SME characteristics used in a previous tariff modelling exercise by Business Moneyfacts 2006). Figures 4.20-4.22 illustrate estimated average

tariffs. It should be noted that these calculations do not take account of interest payments on deposits or overdrafts.

**Table 4.19: Assumptions for bank charge comparisons**

		Business Profile		
		BP1	BP2	BP3
	Average monthly balance (£)	7,500	125	1,250
Non-auto debits	Cheques	24	18	18
	Additional charge for cash at branch (£)	150	0	450
Auto debits	D/D (and card if available)	12	12	12
	S/O (no. transactions)	15	9	3
Non-auto credits	Number of transactions	3	60	96
	Additional cash credits (£)	0	30,000	13,500
	Cheques (£)	24	0	600
Auto credits	Cash exchanging	0	6,000	0

**Figure 4.20: Illustrative tariff comparison: BP1**

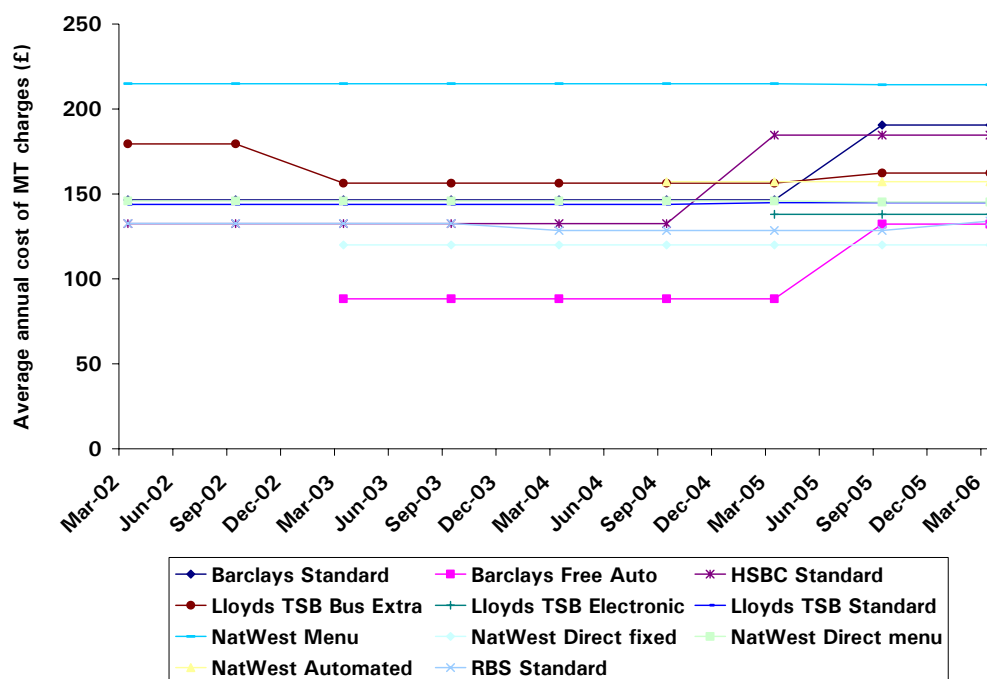


Figure 4.21: Illustrative tariff comparison: BP2

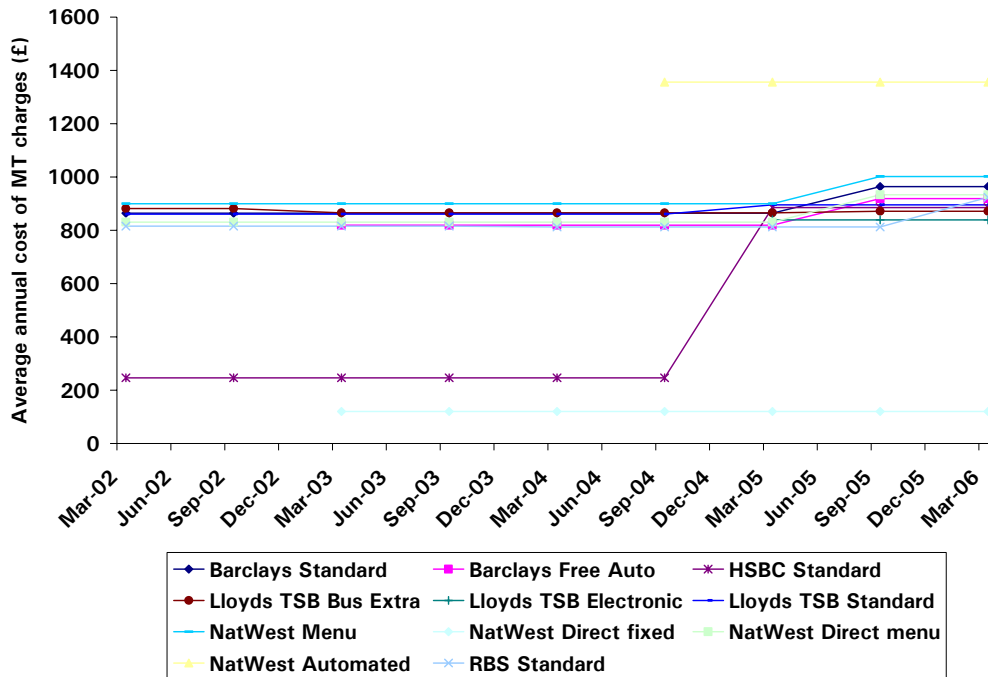
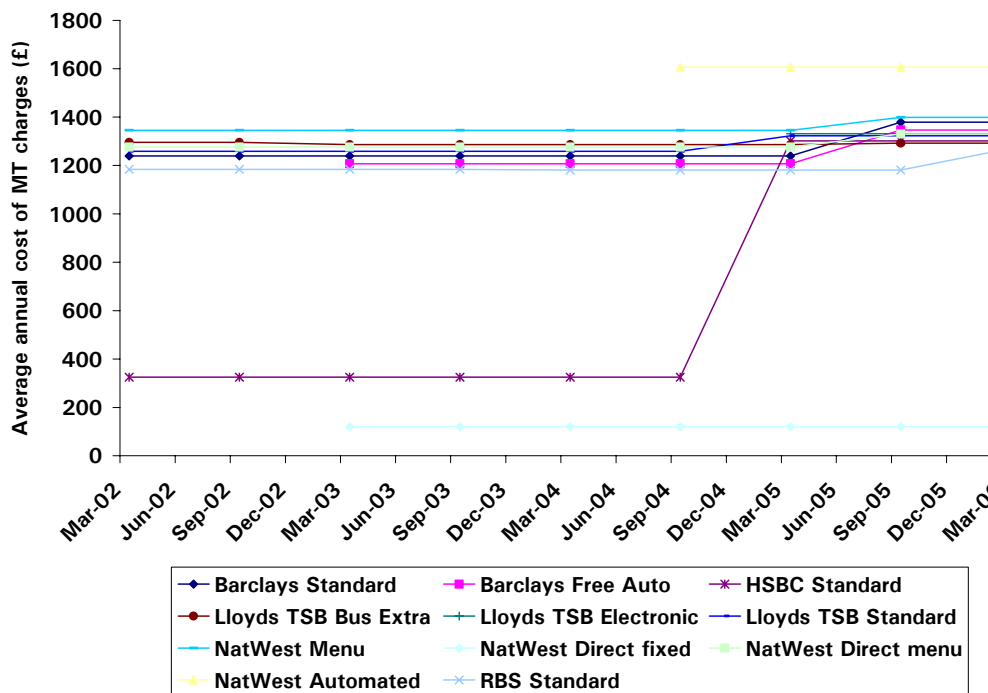


Figure 4.22: Illustrative tariff comparison: BP3



- 4.96 Looking across the publicly available tariff information as a whole for the main four banks, the most notable increases in core charges appear to have been by HSBC and Barclays in 2005. The banks notified OFT of these increases (as required under the terms of the transitional undertakings), and explained that the charges had been part of moves to restructure their offerings, and to better reflect underlying costs.
- 4.97 Several third party sources have attempted to compare bank charges and measures. For example, the trade publication *Business moneyfacts* produces summary price comparison information, and uses this to generate indicative charges for different types of businesses. In its October 2005 survey of charges, Business moneyfacts suggested that business banking has become more expensive since the CC report (although OFT would note that this does not net off the benefit to SMEs of receiving interest on their credit balances). It also suggested that, on average, the big four charge £10 per month more than other banks.
- 4.98 In a separate survey, the Manchester Business School found that 'the 'challengers' are more competitive than the Big Four in four out of five categories examined'. Potential savings on three case studies in switching from the highest cost to the lowest cost provider were between 58 per cent and 145 per cent.

### **Survey evidence on prices**

- 4.99 The OFT customer survey asked customers whether they felt the level of charges paid on their business current account had changed over the last three years relative to their usage of their bank. Businesses' views were split – the same proportion felt charges had increased (43 per cent) as had stayed the same (41 per cent). Only a small minority felt that charges had decreased.
- 4.100 The Warwick study found that SMEs pay, on average, £51 per month in charges. By turnover, charges ranged from under £15 per month, up to £430 per month. The survey also found significant variation between banks, although not between the four main banks (which is likely to be due, in part, to the price restrictions imposed on them by the transitional undertakings).

4.101 The Forum of Private Business survey found that there had been a rise between 2004 and 2006 in the proportion of respondents who perceived that transaction charges had increased.<sup>69</sup> However, the same survey also recorded a sharp increase in customers' perceptions of the competitiveness of charges offered by their bank.<sup>70</sup>

### **Quality of service and customer satisfaction**

4.102 The evidence collected by OFT through its customer survey and in talking to SME representatives is that customer satisfaction remains relatively high. The OFT customer survey suggests that the proportion of customers that are satisfied has decreased slightly from 83 per cent in 2000 to 78 per cent in 2006. Although this represents only a small drop in satisfaction it is still statistically significant and there has been a commensurate increase in the proportion stating they were dissatisfied (up from nine per cent in 2000 to 13 per cent in 2006).

4.103 However, a separate survey carried out by the FPB has reached a different conclusion, finding that satisfaction with bank performance has increased. Its overall performance index suggests an increase from around 53 per cent to 56 per cent between 2000 and 2006. Of other third party sources, Mintel (Continental Research) suggests that 16 per cent of customers were dissatisfied with the service provided by their bank. Lloyds TSB response quotes TNS survey findings that over 75 per cent of SMEs are satisfied with their bank. Lloyds TSB stated that this was mirrored in its own internal surveys.

### **Barriers to entry**

4.104 In 2002, the CC identified a number of other entry barriers for banks attempting to enter or expand in the business banking market. These included:

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<sup>69</sup> FPB (2006), p.32.

<sup>70</sup> FPB (2006), p.25.

- new entrants' lack of an extensive branch network
- poorer information on SMEs available to new entrants than to incumbent suppliers
- the existing personal customer base of the clearing banks, from which new SME customers emerge
- the importance of reputation for providing the required quality of service and being supportive of SMEs, and
- access to relevant skills, such as credit assessment and relationship management; and economies of scope in the provision of a range of services, in particular 'first-port-of-call' advantage.

### **Branch network and new technology**

- 4.105 Evidence collected by the OFT suggests that branch networks remain important both in terms of acquiring new SME customers and in servicing existing customers, although technological changes are gradually altering this position.
- 4.106 In the OFT customer survey, 17 per cent of SMEs stated that one of the reasons for choosing a bank was that it had a conveniently-located branch. The evidence provided by the banks also suggested that a branch network is particularly important in acquiring new customers. Anecdotally, the OFT was told that customers often wanted face-to-face contact with a bank manager before they would 'sign on the dotted line'. It was also suggested that opening an account online was difficult because of money laundering checks, although some banks commented that technology was being developed in an attempt to overcome these difficulties. Finally, the OFT noted that Abbey, which has chosen not to convert its branch network to service business customers, claimed that the personal branch network remained an important channel for acquiring new business customers.
- 4.107 In terms of servicing existing customers, some SMEs continue to make relatively heavy use of branches. The OFT customer survey found that

79 per cent of SMEs were still conducting some or all of their business in person through a branch, with 42 per cent conducting over half their banking by this method. Most obviously, cash handling businesses require convenient local facilities for making transactions. In addition 78 per cent of respondents to the FSB's membership survey in 2006 felt that access to local banking facilities was 'important'.<sup>71</sup> This is supplemented by anecdotal evidence that many SMEs also appear to value regular access to a branch-based bank manager. However, the OFT has noted several trends suggesting that, at least for servicing existing customers, the role of branches is becoming less important.

4.108 First, there is a clear trend towards increased use of computer and internet banking for basic current account services. The OFT customer survey asked businesses which had been trading for two years or more whether they felt their method of banking had changed over the last three years. Almost a quarter (24 per cent) of businesses said their method of banking (that is, relative use of branch, telephone/post or computer) had changed over the last three years. For those businesses who said that their methods of banking had changed, the general trend was that they now conducted considerably more banking by computer (83 per cent) and to a lesser extent by telephone/post (19 per cent) and less banking in person through a branch (63 per cent).

4.109 The OFT asked all the banks to provide information on changes in the use of internet banking. Based on this data, the OFT estimates that there has been nearly a doubling in the use of internet banking over the past four years. A number of banks said that they provided an internet facility automatically with any business current account. BBA statistics suggest that the proportion of small businesses using online facilities has risen from 14 per cent in 2001 to 43 per cent in 2006.<sup>72</sup> However, there are still comparatively few SMEs that conduct all of their banking activities using direct means.

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<sup>71</sup> FSB membership survey (2006), page 42.

<sup>72</sup> <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=145&a=7710>

- 4.110 Second, there is evidence that banks are considering other alternatives to servicing customers through existing branch networks. One bank argued that branches will soon not be necessary for smaller cash business customers. It has recently opened [...] out-of-town commercial centres (and more are planned) where new generation automated deposit machines have been installed. Another bank has a relationship with the Post Office to provide cash handling services for SMEs. [x] Furthermore, a number of banks have decided not to invest in branch networks, but instead to rely on internet and postal transactions. [...].
- 4.111 Finally, to the extent that branches remain important to a significant portion of SME customers, the OFT notes that several of the smaller banks have improved their position since 2002. HBOS in particular has carried out significant investment to convert its Halifax branches to Bank of Scotland Business Banking. HBOS told us that the entire network of some 700 Halifax branches across England and Wales has been dual branded with Bank of Scotland Business Banking's logo. Trained business banking advisors are available in over 370 branches in England and Wales. There are a further 65 Business Banking Managers based in other branches in England and Wales.
- 4.112 Alliance & Leicester has an agreement with the Post Office to service banking customers. AIB has also expanded its number of branches through England and Wales. Among the four main banks there has also been a trend towards retaining or expanding the existing branch network (for personal as well as business banking) rather than closing branches, partly in response to political and consumer pressure. Anecdotally, some parties have suggested that the legacy costs of the existing branch networks could put the four main banks at a competitive disadvantage relative to smaller banks and new entrants.

### **Inter Bank Agency Agreements**

- 4.113 While noting these positive trends, the OFT also has some concerns that the Inter Bank Agency Agreements (IBAAs) for providing third party access to branches by customers of other banks have not developed significantly since 2002.

- 4.114 In 2002, the CC required the banks to 'investigate the feasibility, costs and associated benefits of a national scheme' of providing third parties with access to the branches of the either main clearing groups.<sup>73</sup> The banks' report was published in March 2003.
- 4.115 The banks argued that a scheme of third party access would not be proportionate – the costs would outweigh the potential benefits to consumers. However, the report did make clear that the existing arrangements for IBAs might be improved. The recommendations included that banks should publish key information about IBAs on their websites, and through third parties such as the BBA. In spite of these findings, awareness of the possibility of IBAs appears to remain limited as evidenced by our survey which showed that only 25 per cent of respondents definitely knew that these existed.
- 4.116 The OFT accepts that there is little call for reform of the existing arrangements from new entrants. Smaller banks generally appear to see IBAs as a last resort for servicing a customer because it gives the other bank's branch an opportunity to sell other products to the customer, or ultimately to encourage the customer to switch to them. However, from the customer's perspective, the OFT suspects that there may be many customers who might gain from using an IBA but who currently do not understand the arrangements.

### **Other entry barriers**

- 4.117 There is evidence that some of the other barriers identified by the CC have reduced. For example, discussions with the smaller banks suggested that there was an active market for relationship managers, with the newer banks able to attract relationship managers from rival banks. HBOS, in particular attracted 1,500 staff from the larger banks in 2002 for its SME banking business.<sup>74</sup> In addition other banks such as

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<sup>73</sup> CC (2002), paragraph 2.549.

<sup>74</sup> Referred to in Small Business banking, Financial Intelligence, September 2004, pg. 48

Co-operative, AIB (GB) and Barclays have hired a number of additional relationship managers.

4.118 It is still the case that a significant proportion of customers (34 per cent) choose a business bank because they already have a personal account with the same bank. The OFT customer survey indicated that the 34 per cent of those surveyed chose the bank that they did because they had a personal account with that bank. However, OFT would note the apparent strong competition on price for new entrants, with all banks offering an extended period of free banking. Some banks also noted that a number of customers choose to switch at the point when charges are introduced on their account.

## 5 IMPACT OF THE TRANSITIONAL UNDERTAKINGS

5.1 This chapter examines the impact of the transitional undertakings on prices and competition. It is based on evidence from the OFT's monitoring of the transitional undertakings since 2003 and from information received from the banks subject to the transitional undertakings. The chapter covers:

- the way in which banks have complied with the undertakings
- the effect of the undertakings on prices to SMEs and on banks' revenues
- whether the banks have been able to mitigate the impact of the transitional undertakings
- the impact of the undertakings on competition between banks.

5.2 In summary, the evidence seen by OFT suggests that all of the banks which are subject to the transitional undertakings have complied with the legal requirements set out in them. Overall, the financial impact of the undertakings has been broadly in line with the CC's expectation in 2002. However there have been variations in the methods of compliance with the transitional undertakings and consequently their financial impact, and in some cases this has dampened the intended effects of the undertakings. Aside from the direct impact on prices, several banks have strongly argued that the transitional undertakings have had a dampening effect on competition.

### **Background – CC recommendation and transitional undertakings**

5.3 The CC's investigation in 2002 found that the four main clearing banks were charging excessive prices (including interest forgone on non-interest bearing current accounts) and thereby making excessive profits altogether of about £725 million a year over the period 1998 to 2002. In order to address these adverse effects, the CC recommended the introduction of 'a requirement that the four largest clearing groups offer to all SMEs operating current accounts in England and Wales an account

that pays interest at Bank of England base rate minus 2.5 per cent or a current account free of money transmission charges or a choice between the two'.<sup>75</sup>

5.4 The CC intended that this would give the level of prices 'a decisive and significant shift toward what we considered to be competitive levels'. Over the period 1998 to 2000 the CC estimated that the remedy would have reduced prices to SME customers on average by about £525 million per year at interest rates of around 3.7 per cent.<sup>76</sup> At the time of the CC report, short-term interest rates were lower than the historic average for 1998 to 2000 (at around two per cent), and the CC anticipated that the future reduction in prices could be correspondingly lower.

5.5 Pursuant to the CC's recommendation, the four main clearing banks signed transitional undertakings under the FTA73 to the Secretary of State and the Chancellor of the Exchequer. These undertakings came into effect on 1 January 2003. The transitional undertakings have required each of the main clearing banks to offer its SME customers a business current account which:

- pays interest on cleared credit balances at 2.5 per cent below the Bank of England base rate (Option A), or
- levies no standing charges and provides core money transmission services free of any charge (Option B)<sup>77</sup>, or
- gives the SME a choice between Option A and Option B (Option C).

5.6 The transitional undertakings also state that the bank shall be entitled to choose which one of option A, B or C it offers from time to time to any

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<sup>75</sup> CC (2002), paragraph 2.609.

<sup>76</sup> CC (2002), paragraph 2.589.

<sup>77</sup> Core money transmission charges are defined in Part I of the Schedule to the transitional undertakings – see Annexe C.

particular SME customer. If the SME chooses not to accept the option (A, B or C) offered by the bank, provided such an option is not withdrawn by the bank, the bank shall be under no obligation to offer that SME one of the remaining options. Clause 8 of the transitional undertakings states: '...Provided that the offer made to any particular SME of a business current account with options A, B or C remains available at all times, nothing in these undertakings shall be taken as preventing the bank from also offering to any particular SME a business current account, which the SME can accept as an alternative to a business current account with the option (A, B or C) offered by the bank to it, which offers alternative propositions or features than an account with the options (A, B or C) offered to that SME by the bank'.

## **Banks' approaches to implementing the transitional undertakings**

5.7 The following paragraphs summarise the OFT's understanding of how each of the banks have complied with the transitional undertakings, based on information they provided. The information suggests that each bank has complied with the legal requirement of the transitional undertakings, although the manner of compliance has varied between banks.

### **Barclays**

5.8 Barclays told us that it conducted SME consumer research showing that SME customers favoured free and reduced money transmission tariff structures to interest bearing current accounts.<sup>78</sup> Consequently Barclays offered (and continues to offer) its SME customers one of the following tariffs:

- free money transmission (available mainly to start-up customers; the latter are then migrated onto another tariff after a period of time) (option B), or

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<sup>78</sup> A copy of the research has been provided to the OFT.

- a choice between:
  - interest on current account (option A), applied to the standard business tariff, and
  - reduced or discounted money transmission without credit interest: i) for Barclays Local Business customers with annual turnover typically under £1 million, the Free Automated Transactions Tariffs, and ii) for Barclays Business Banking customers with annual turnover typically over £1 million, a discount to the standard business tariff without credit interest.

5.9 Barclays sent letters and literature to all its SME customers explaining the various options. It sent letters to almost 1 million SME customer accounts and received a 90 per cent response rate back from its customers. Those who failed to respond were given a default option, which in the case of Local Business Customers was to move to the Free Automated Transactions Tariff.

5.10 All Local Business customers opting for the Free Automated Transactions Tariffs can, at any time, switch to the Standard Business Tariff which includes interest on current account balances. The same principle applies to all Business Banking customers who have opted for discounted money transmission in preference to the Business Tariff. This option is regularly brought to the attention of SMEs, for example in their half-yearly statements.

5.11 These tariff offerings formed part of a wider reorganisation of tariffs by Barclays at around the same time that the transitional undertakings came into effect. In October 2002, Barclays closed its Small Business Tariff to new customers.<sup>79</sup> It then gradually transferred existing Small Business Tariff customers onto new tariffs (typically either the Free Automated Transaction Tariff or the Standard Business Tariff with credit interest). Barclays intended to complete this process by the end of 2006. It told us that money transmission charges were broadly similar between the

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<sup>79</sup> The Small Business Tariff had been available to SMEs with an annual turnover of up to £100,000.

old Small Business Tariff and the Standard Business Tariff, with some charges being cheaper on the Standard Business Tariff and other charges being cheaper on the Small Business Tariff. Cash handling over the counter had been free for customers on the Small Business Tariff, whereas it incurred a charge under the standard tariff. Barclays suggested that the Small Business Tariff was in part amended 'to ensure that SME customers contributed to Barclays' SME cash handling costs'. Among other reasons cited by Barclays for the amendment of its Small Business Tariff offering, was that it no longer innovative and competitive and needed simplifying. Furthermore it had originally been designed for customers with a turnover up to £100,000 and was no longer considered appropriate given the large number of larger customers using it.

- 5.12 Barclays told us that it was already in the process of changing its tariffs well before the imposition of the transitional undertakings. However, the CC report and the transitional undertakings accelerated Barclays' modernisation of its tariffs.

## **HSBC**

- 5.13 HSBC Bank Plc opted to implement the transitional undertakings by automatically giving credit interest (option A) on positive balances for all its customers as a matter of course, except where they were receiving free money transmission (option B). All HSBC customers were notified of the change by letter.
- 5.14 All customers are given option A and are generally those SME customers with turnover of less than £500,000.<sup>80</sup> Those SME customers with turnover above this threshold receive negotiated terms on money transmission charges but also receive interest on credit balances in compliance with the undertakings.

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<sup>80</sup> This turnover limit has applied since 2005. Before that time the Small Business Tariff covered customers with a turnover of up to £100,000.

## **Lloyds TSB**

- 5.15 Lloyds TSB responded to the transitional undertakings by agreeing to pay credit interest on its current account offerings except where customers were receiving free money transmission services. Credit interest is applied to all negotiated tariffs as well as discounted tariff offerings and over 99 per cent of Lloyds TSB SMEs have the benefit of either credit interest or free money transmission.
- 5.16 Lloyds TSB confirmed that it had written to each individual SME customer, providing details of the changes made and offering a meeting to discuss the changes with a relationship manager. Lloyds TSB also confirmed that the changes were made regardless of whether the bank received a reply from the customer.

## **Royal Bank of Scotland Group (RBS Group)**

- 5.17 The transitional undertakings apply to both NatWest and Royal Bank of Scotland banks within RBS Group. Different tariffs are offered by these two banks, but the approach to compliance with the transitional undertakings has been broadly the same across the Group.
- 5.18 RBS Group opted to offer its SME customers credit interest on current accounts. Customers will receive credit interest in compliance with the transitional undertakings if they opt for RBS Group's standard tariff. For SME customers on negotiated tariffs the choice is to remain on negotiated terms, (which besides reduced transaction charges may also include credit interest), or transfer onto a current account with the standard tariff to receive credit interest in compliance with the transitional undertakings.
- 5.19 RBS Group also used an 'opt-in' method of implementing the transitional undertakings by writing to all its customers setting out the offer of credit interest. Customers would then receive the offer of interest payments provided they signified their intention by completing a coupon attached to the letter and returning it to RBS Group. In recent years the proportion

of customers opting to receive credit interest has increased since the undertakings came into place.<sup>81</sup>

## **Effect of the transitional undertakings**

5.20 The following paragraphs consider the impact of the banks' method of compliance on prices and tariff offers. First, using the data gathered from the banks, the OFT has estimated the proportion of customers for each bank who are in receipt of interest and/or free money transmission services. Second, using financial information obtained from the banks, the OFT has estimated the financial impact of the transitional undertakings on each of the banks.

### **Direct impact of the undertakings on SMEs**

5.21 Table 5.23 summarises the proportion of customers of each bank who are receiving interest and/or free money transmission.

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<sup>81</sup> RBSG informed us that more than 40 per cent of new UKCB customers took up the credit interest offer in 2005, compared with less than 30 per cent of new UKCB customers in 2003.

**Table 5.23: General outline of which options customers are receiving**

	Percentage of customers receiving interest at 2.5% below base rate <sup>82</sup>	Percentage customers paying no money transmission charges <sup>83</sup>	Percentage of customers receiving both interest and free money transmission services	Percentage of customers receiving neither interest nor free money transmission services
Barclays	3%	43%	0%	54%
HSBC	71%	26%	0%	3%
Lloyds TSB	55%	43%	1%	Less than 1%
RBS Group	33%	32%	0%	35% <sup>84</sup>

Source: OFT estimates based on bank responses

5.22 Table 5.23 suggests that Lloyds TSB and HSBC's method of implementing the transitional undertakings has ensured the highest proportion of customers receiving one of the options of the transitional undertakings. On the other hand Barclays and RBS Group have a significant proportion of its customers who have chosen not to receive interest (option A) or free money transmission services (option B).<sup>85</sup>

### **Financial impact of the transitional undertakings**

5.23 The OFT asked banks to provide a detailed breakdown of their income from SME customers, and attempted to identify from this information the impact of the transitional undertakings. Annex A explains the assumptions made, and provides detailed results for each of the four

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<sup>82</sup> Option A

<sup>83</sup> Option B

<sup>84</sup> This is the combined figure for RBS Group Retail and UK Corporate Banking

<sup>85</sup> This is also confirmed by our customer survey which demonstrates that fewer customers of RBSG and Barclays receive credit interest compared to customers at HSBC and Lloyds TSB.

main banks. This section summarises the key findings of the financial analysis.

- 5.24 The main financial impact of the transitional undertakings has been the cost of paying interest. Assuming that the four main banks would not have paid interest in the absence of the transitional undertakings, the OFT estimates that the total cost to the banks (and benefit to SMEs) over three years was around [...].<sup>86</sup>
- 5.25 All of the banks have also offered free banking to some SMEs – most notably new start-ups and some switchers. For most of the banks this continued a trend which was already evident before the transitional undertakings were introduced, so the OFT has not included this as a direct cost of the undertakings. However, [...] focused its approach on a reduced money transmission tariff, so costs of offering this tariff have been included, amounting to around [...] over three years.
- 5.26 The banks argued that the transitional undertakings have required them to adjust interest rates on deposit accounts. While it might be argued that this is simply a commercial decision rather than a direct impact of the transitional undertakings, the OFT accepts that the increase in interest payments on deposit accounts was likely to have resulted from the transitional undertakings and have included this cost. The OFT estimates that the impact of the transitional undertakings on deposit rates has been around [...] over three years.
- 5.27 In total this suggests that the benefit to SMEs of the transitional undertakings was around £1,070 million over the first three years (2003-05). It is important to reiterate that this figure is based on a number of simplifying assumptions. In particular it assumes banks would not have

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<sup>86</sup> The assumption that banks would not have paid interest is open to challenge. Given the signs of increased competition in the market identified in chapter 4, and also noting the greater availability of interest on personal bank accounts than was the case in 2002, one could argue that banks might have started to pay interest, even without the transitional undertakings. On the other hand, one might also argue that other banks outside the main four subject to the undertakings have also been affected by the general expectation that interest should be paid.

paid interest in the absence of the transitional undertakings. The figure also does not take account of any moves to offset the income effect by raising other charges or reducing quality of service. The possibility of offsetting is discussed in more detail below. For this reason, the figures are more likely to over- rather than under-estimate the true financial impact of the transitional undertakings.

- 5.28 The banks argued that the transitional undertakings imposed additional costs because of changes in internal funding arrangements. For example, a business unit within a bank will aim to eliminate interest risk, as far as possible, to stabilise its interest earnings. This is often achieved by a matched hedging transaction with the bank's treasury department. When a current account becomes interest bearing, it would be necessary to change the funding arrangement to match the interest rate paid. The actual cost would vary according to the balances funded, the level of base rate, and alternative hedged rate. The OFT notes that these internal funding costs have not led to direct benefit for SMEs (although to the extent that banks have to recover their costs from customers then they could ultimately lead to higher charges). Nevertheless, figures provided by banks suggest that internal funding costs could have been around £414 million over three years.
- 5.29 Table 5.24 summarises the estimated financial impact of the transitional undertakings on the four main banks. In broad terms the differences between the banks can be explained by two factors: first, the proportion of customers receiving interest and/or free banking (as set out in table 5.1); and second, different assumptions about internal funding costs.

### **Table 5.24: Estimate of costs of the transitional undertakings over 2002 to 2005**

[...]

- 5.30 Table 5.24 shows that Barclays' implementation has had the least financial impact of the four banks. Nevertheless, the overall impact of the transitional undertakings has been significant, and close to what the CC envisaged at around £525 million per year. The overall effect has been around £1.4 billion over the period 2002 to 2005.

## Assessment of banks' responses to the transitional undertakings

5.31 In broad terms, Lloyds TSB and HSBC appear to have followed a strict application of the transitional undertakings with a high proportion of their customers receiving either credit interest or no charge on money transmission services. Barclays and RBS Group have implemented the undertakings differently, with the result that not all SME customers are in receipt of interest or free money transmission. The approach taken by Barclays and RBS Group is considered in more detail below.

### Barclays

5.32 The monitoring information and evidence provided by Barclays shows that it has offered all customers the option of switching to a tariff paying interest, and has repeated this offer at half-yearly intervals. On the evidence, Barclays has complied with the formal requirement set out in the transitional undertakings.

5.33 Barclays has also followed a transparent approach in its dealings with SMEs. In particular:

- it wrote to all customers setting out the offer
- as a result, it achieved a 90 per cent response rate from its consumers
- it continues to inform SMEs of their various options, including in half-annual statements.

5.34 The OFT's main concern in respect of Barclays' approach is that, by offering payment of interest only on its standard business tariff (take-up of which was relatively low), it has been able to dampen the effect of the undertakings on its income from SMEs.

5.35 The outcome of Barclays' approach is shown in Table 5.25 below. Less than three per cent of its SME customers are receiving the interest remedy (option A) prescribed by the undertakings (although the offer of credit interest remains available to all customers other than those on free

money transmission tariffs). Approximately 43 per cent of Barclays customers are receiving free core money transmission as described in the undertakings (option B). Around 42 per cent of customers are receiving the 'Free Automated Transactions Tariff' (option D) which does not pay credit interest but provides some free core money transmission services.

### **Table 5.25: Summary of Barclays' SME tariffs**

[...]

Source: OFT, Barclays

- 5.36 The OFT accepts that there are some apparent benefits for SMEs in the approach taken by Barclays. In particular, customers are offered a choice between tariffs, and the extent of take-up of the Free Automated Transactions Tariff suggests that customers are attracted by that option. Anecdotal evidence from SME groups also gives support to Barclays' argument that SMEs (including those operating within overdraft limits most of the time) generally prefer to receive free or reduced money

transmission than payment of credit interest. Barclays notes that the tariff is structured to incentivise customers to use cheaper and more efficient automated transaction methods rather than traditional paper based services.

- 5.37 However, the OFT also notes that the introduction of the Free Automated Transactions Tariff coincided with the phasing out of Barclays' Small Business Tariff, which was previously the standard offering for smaller business customers. In moving from the Small Business Tariff to the Free Automated Transactions Tariff, some SMEs could be expected to gain and others to lose, depending on their pattern of transactions and account use. Cash handling over the counter was free for customers on the Small Business Tariff, but incurs a charge on both the Standard Business Tariff and the Free Automated Transaction tariff.
- 5.38 As a result, the net benefit to SMEs from Barclays' tariff changes is uncertain. Barclays' internal strategy documents appear to confirm that its approach has mitigated the impact of the undertakings on profits. To the extent that the CC intended that SMEs should receive either credit interest or free core money transmission services, and that excess profits should be reduced, the OFT believes that Barclays' approach has dampened the intended impact of the undertakings. Nevertheless, SMEs have been given a choice of receiving tariffs as specified by the undertakings, and the OFT is satisfied that Barclays has complied with the legal requirement placed on it.

## **RBS Group**

- 5.39 RBS Group offered its customers the option of receiving credit interest (Option A) but only for those SME customers using a current account with the Standard Tariff. This principle was applied to both Retail and Corporate customers. For those SME customers on negotiated tariffs the choice was to remain on this tariff or to move to an account on the standard tariff that pays the credit interest in compliance with the transitional undertakings. Clubs, Associations, Charities and Societies (CACs) are offered the free banking option, Option B.

- 5.40 However some issues do arise in the method that RBS Group has chosen to comply with the transitional undertakings. The main issue of concern for the OFT was the manner in which RBS Group chose to implement the undertakings once it had decided on which remedy to offer its customers. RBS Group decided to apply an 'opt-in' method of complying with the undertakings.
- 5.41 The 'opt-in' method involved RBS Group sending letters to all its customers inviting those who wished to take up the credit interest option to complete and return a specific coupon attached to the letter. RBS Group stated that for administrative reasons the initial letter to customers indicated a date by which coupons needed to be returned to the bank. RBS Group also stated that whilst the letter did not expressly state that the offer would be available even after the specified date and indeed at any time the customer wished to take up the offer, RBS Group has confirmed this to be the case.
- 5.42 During the monitoring process the OFT raised concerns about RBS Group's method of implementation given the low level of customer take up rates of the interest option at that time. [...] RBS Group said that its customer base had a strong tradition of negotiation of their account arrangements. RBS Group said that the initial take up rates were low because of this tradition.
- 5.43 However it was arguable that first, RBS Group had not done enough to fully communicate the offer properly to their customer base and second, RBS Group had made the receipt of the credit interest remedy only available to those customers who switched onto the standard tariff. This meant that those customers receiving advantageous benefits under negotiated terms were likely to lose such benefits by switching over to the standard tariff. (The same is true of Barclays' approach to implementing the transitional undertakings).
- 5.44 Thus, while RBS Group appears to be compliant with the legal requirements of the transitional undertakings - that is by making the offer to its customers - its method of implementation is less clearly within the spirit of the transitional undertakings. The 'opt-in' policy adopted does not ensure that each customer received one of the

remedies prescribed by the undertakings. In order to receive the credit interest remedy each customer has to do two things; first they have to sign and return a coupon indicating that they wish to receive credit interest and second, they have to be prepared to switch to the standard tariff. RBS Group informs customers periodically about the option of receiving credit interest.

- 5.45 The estimated outcome the RBS Group implementation strategy is shown in Table 5.26.

### **Table 5.26: Impact of RBS Group's implementation policy on customer base**

[...]

- 5.46 It can be seen from Table 5.26 that around one quarter of RBS Group's customer base within the Retail Division is receiving credit interest (Option A). This figure is lower for the customers in the Corporate Banking Division. However, it is worth noting that the proportion of customers opting to receive credit interest has increased since the undertakings came into place as new customers are more likely to take up the offer of credit interest.<sup>92</sup>

### **Summary**

- 5.47 To the extent that the CC considered that, as a result of the transitional undertakings, all customers would receive either interest or free core money transmission services, the approach taken by Barclays and to a lesser extent RBS does not match the spirit of the CC's recommendation. However, the OFT accepts that all four banks have complied with the letter of the transitional undertakings. Furthermore, Barclays and RBS Group have put forward arguments to show the benefits to customers of their approach.

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<sup>92</sup> RBS Group informed us that 41 per cent of new customers took up the credit interest offer in 2005, compared with less than 20 per cent who were customers in 2003. It observed that similar trends in take up over time had occurred amongst its retail customers.

5.48 The OFT notes that [...] and [...], on the basis of the evidence presented in Table 4.3, appear to have lost market share relative to [...] and [...]. While this cannot be directly attributed to the method of implementing the transitional undertakings, the OFT notes that this fits with suggestions discussed in chapter four that customers are becoming more price sensitive and aware of alternative pricing offers.

### **Mitigating the effects of the transitional undertakings**

5.49 In recommending the transitional undertakings, the CC was also concerned that the banks would deploy methods of negating the intended effect of the undertakings on banks' revenues and profits.<sup>93</sup>

5.50 The CC identified a number of ways in which the four main banks could try to off-set the impact of the transitional undertakings on profits, including by:

- increasing money transmission charges
- increasing rates of interest on loans
- reducing lending to some SMEs, and
- reducing quality of service to SMEs.

The OFT obtained evidence from each of the banks as well as from wider market sources. The OFT's objective in this regard was to examine whether the banks had indeed engaged in off-setting the effect of the transitional undertakings, through any of the methods identified by the CC.

### **Increase in money transmission charges**

5.51 The transitional undertakings require the signatory banks to submit tariff data to the OFT at regular intervals for monitoring purposes. The tariff

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<sup>93</sup> CC (2002), paragraph 1.16.

data showed that across most of the banks there has been only a limited change in published tariff rates. As discussed in paragraph 4.96, HSBC and Barclays both increased charges on some accounts in 2005. The banks notified OFT of these increases, and explained that they were aimed at better reflecting underlying costs. There is no clear evidence to demonstrate that this change was made in order to recoup lost revenue from the transitional undertakings.

- 5.52 The Business Moneyfacts 2005 survey also indicated that the average monthly charges for business banking from the main four banks increased by £10.<sup>94</sup> The OFT customer survey was unable to show a clear view as to changes in average banking costs. However, conclusions drawn from the data, based on the number of customers in each turnover band, was that banking charges were unlikely to have changed by any significant amount.
- 5.53 In addition, the OFT customer survey also showed a small but statistically significant increase in the proportion of customers who were satisfied with their business banking charges since 2000. In 2000 around 52 per cent of customers were satisfied with charges whereas in 2006 around 56 per cent were satisfied.
- 5.54 In considering the overall evidence, it seems unlikely that the banks have tried to off-set the effects of the transitional undertakings by increasing money transmission charges, to any significant degree.

### **Increase in interest rate on loans**

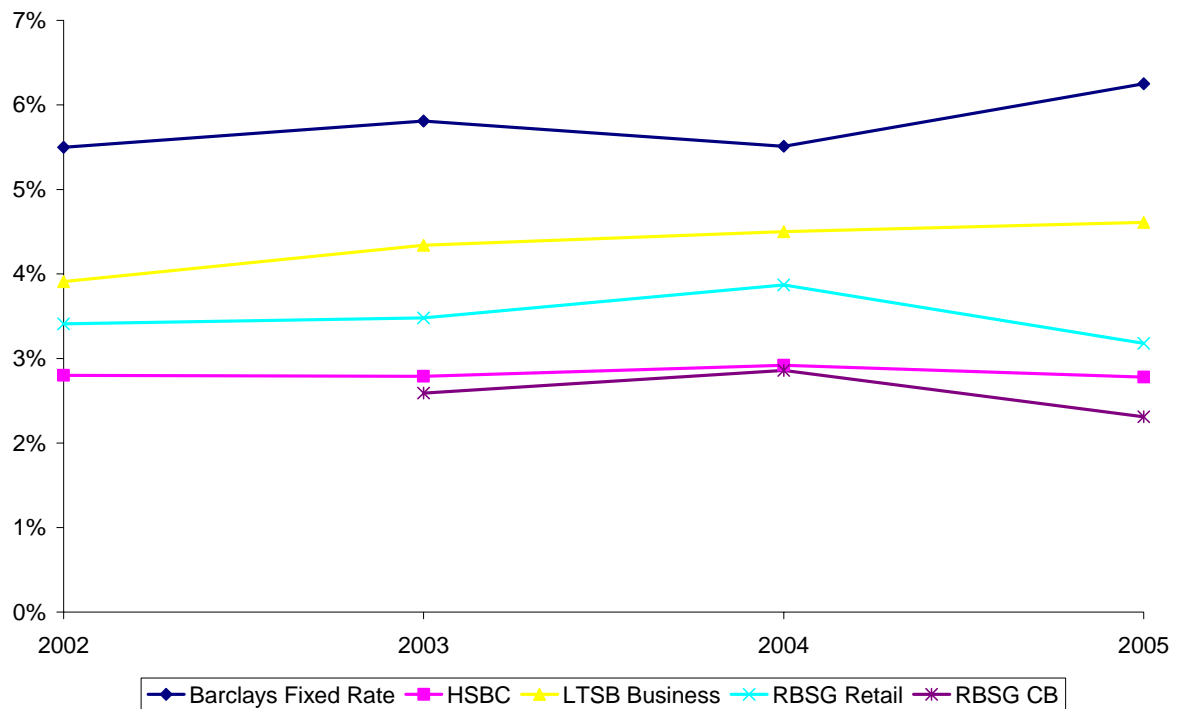
- 5.55 The four main banks provided the OFT with information on interest rates for typical loans to SME customers. Figures 5.27 and 5.28 illustrate estimated interest rate spreads (calculated as the difference between the bank's loan rate and the Bank of England base rate) for two sizes of loans – from £15,000 to £30,000 and from £150,000 to £300,000

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<sup>94</sup> It should be pointed out that a number of banks have raised concerns about the Moneyfacts survey, arguing that the customer profiles were flawed.

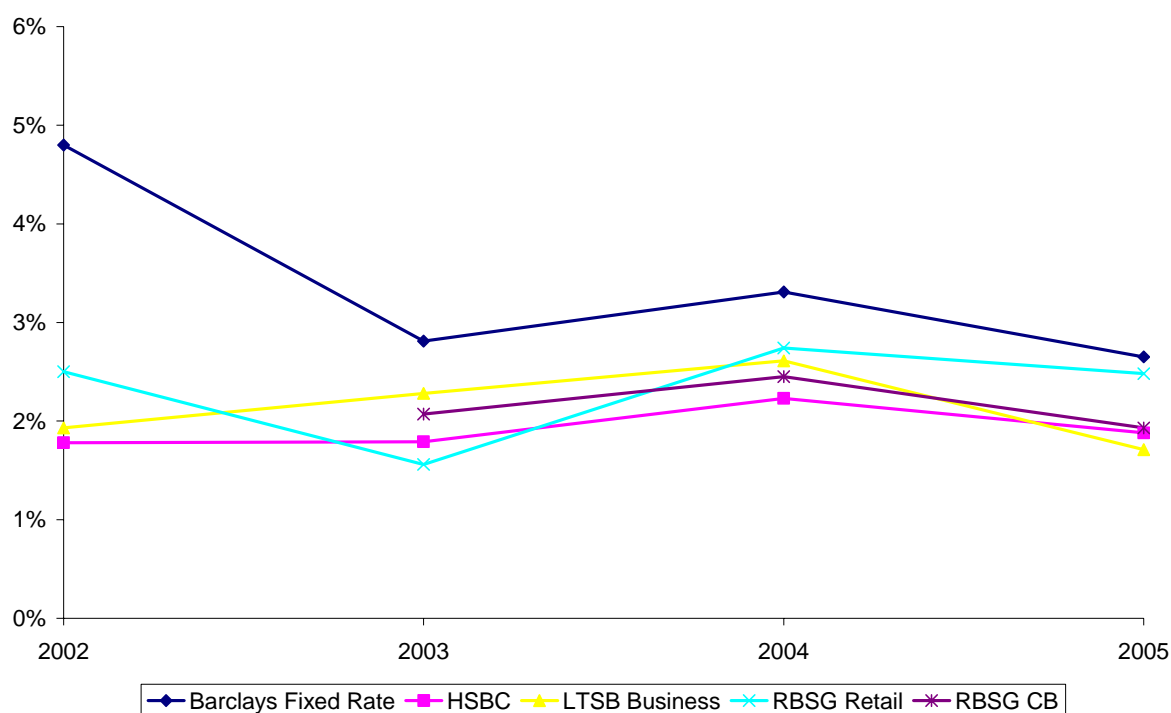
respectively, repayable over a three year period. This data suggests that has not been a significant increase in interest margins earned.

**Figure 5.27: Estimated interest rate spreads for three-year loans of £15,000 to £30,000**



Source: OFT calculations based on information provided by the four main banks on interest rates for SME loans of £15,000 to £30,000, repayable over three years. Interest margin is estimated as spread between the bank's lending rate and the Bank of England base rate. It should be noted that these calculations were based on a relatively small data sample.

**Figure 5.28: Estimated interest rate spreads for three-year loans of £150,000 to £300,000**



Source: OFT calculations based on information provided by the four main banks on interest rates for SME loans of £150,000 to £300,000, repayable over three years. Interest margin is estimated as spread between the bank's lending rate and the Bank of England base rate. It should be noted that these calculations were based on a relatively small data sample.

## Reduced availability of loans

5.56 Evidence gathered from the banks and other market sources shows an overall increase in lending to SMEs. Access to finance is generally good in the UK and the transitional undertakings do not appear to have had a negative effect on the availability of finance for most SMEs. The recent interim report by DG Comp suggests that UK businesses have greater access to finance than other European markets.<sup>95</sup>

<sup>95</sup> DG Comp (2006), 'Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, Interim Report II: current accounts and related services', July 2006.

- 5.57 Certain information taken from the British Banking Association's (BBA) annual abstract of banking statistics showed an overall shift in lending to SMEs from overdraft lending to term loan lending, in particular from variable rate lending and short duration loans to longer term loans.<sup>96</sup> It is likely that this move would indeed be more profitable for the banks and it was considered whether this could have been triggered by the imposition of the transitional undertakings as a method of off-setting the financial impact of the undertakings. However, further analysis showed that these trends were apparent from 1999 to 2001, before the transitional undertakings were implemented.<sup>97</sup>
- 5.58 In the 1990s there was some concern about access to finance to small businesses and the Bank of England investigated and reported regularly on small firm access to finance. The Bank of England's last report was in 2004 where it concluded that access to finance was not a barrier for most SMEs, but there were some specific challenges facing certain types of SME, notably those seeking small amounts of risk capital.<sup>98</sup>
- 5.59 The OFT customer survey showed that a very small number of customers have concerns about banks' willingness to lend. However the numbers were small and likely to be statistically insignificant.<sup>99</sup> Customers were also asked whether they believed that access to finance had become easier, stayed the same or become harder. The results are outlined below in Table 5.29.<sup>100</sup>

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<sup>96</sup> BBA (2005), 'Banking Business – The Annual abstract of banking statistics', p.48

<sup>97</sup> The shift from overdraft lending to term lending was in fact noted by the Cruickshank report in 1999.

<sup>98</sup> Finance for small firms – Bank of England – April 2004, page 2

<sup>99</sup> OFT Customer Survey (2006), p.39.

<sup>100</sup> OFT Customer Survey (2006), paragraph 4.44.

**Table 5.29: Customer survey views on access to finance**

Statements put to customers	Proportion who agreed with that statement
Access to finance had become easier	26%
Access to finance had stayed the same	34%
Access to finance had become harder	16%
Don't know	24%

Source: OFT Customer Survey (2006)

- 5.60 Other evidence considered by the OFT included the Warwick Business School survey (2004) which showed that of all the SMEs surveyed who had applied for finance only 11 per cent had been rejected outright and a further 19 per cent did not get all the finance requested.<sup>101</sup>
- 5.61 An Institute of Directors survey in 2004 concluded that 'generally speaking businesses should not find it too difficult to access capital'. The survey further noted that 23 per cent of directors surveyed in 2004 said that they thought it was difficult to access finance compared to 71 per cent who thought it was not difficult. This was a marginal improvement on the 2003 survey where 25 per cent thought it was difficult and 69 per cent thought it was easy.<sup>102</sup>
- 5.62 In examining the overall evidence, the OFT believe that there is no real evidence that the banks have reduced their willingness to lend as a counter measure to off-set losses made on the transitional undertakings. Generally, access to finance in the UK market appears relatively healthy with only a small proportion facing difficulties and the general SME

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<sup>101</sup> Warwick Business School survey (2004), page 65.

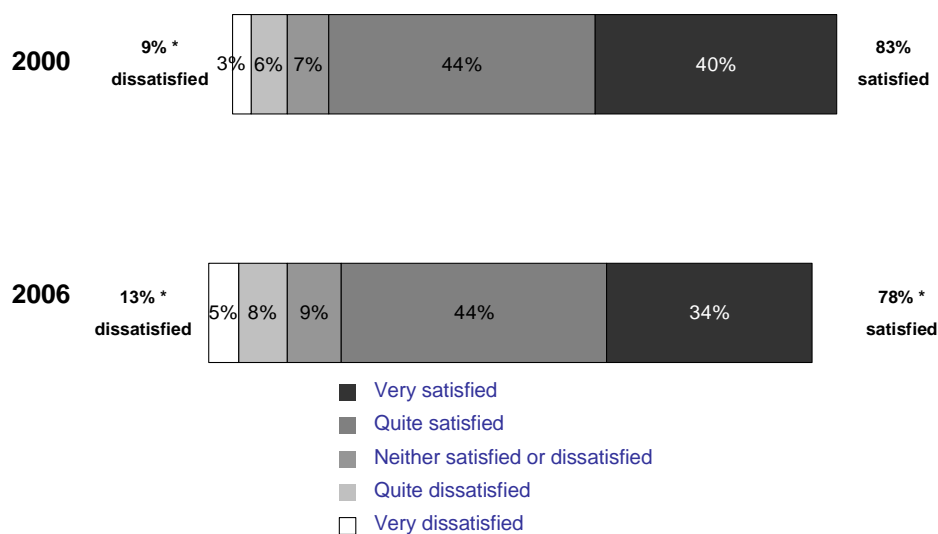
<sup>102</sup> Business Finance (2004), Institute of Directors, page 16.

perception shows an improvement in the view that access to finance has become easier.

### Reduced quality of service to SMEs

5.63 The OFT customer survey provides evidence on the extent to which customers are satisfied with the services provided by the banks. It suggests that the proportion of customers that are satisfied has decreased slightly from 83 per cent in 2000 to 78 per cent in 2006. There has been a commensurate increase in the proportion stating they were dissatisfied (up from nine per cent in 2000 to 13 per cent in 2006). The results of the OFT customer survey are summarised in Figure 5.30 below:

**Figure 5.30: OFT Customer Survey findings on consumer satisfaction**



*Base: All respondents  
2006 (1222); 2000 (1211)*

Source: OFT Customer Survey 2006, Figure 4.8.

5.64 However, a separate survey carried out by the FPB has reached a different conclusion, finding that satisfaction with bank performance has

increased over the last five years. The FPB suggests that there was a fall in SME perception of bank performance between 1998 and 2000, which may have resulted from increased awareness of service issues in the wake of the Cruickshank report. However, the overall index of bank performance increased from 53 per cent in 2000 to 56 per cent in 2006.<sup>103</sup>

- 5.65 The Warwick Business School survey (2004) also showed a generally high level of satisfaction with business banking services. The Warwick survey looked at a range of service issues from availability of finance and competence of staff to efficiency of service and understanding of the customer's business. In all these service ranges the level of customer dissatisfaction, on average around 10 per cent, was small and statistically insignificant.

### **Summary**

- 5.66 The overall evidence suggests that the banks have not attempted to offset the full financial impact of the transitional undertakings through an increase in money transmission charges or interest rates on loans, a reduction in willingness to lend or the quality of banking services provided to SMEs. On balance, the evidence would suggest that these factors have at worst stayed the same with clear indications that there has been an improvement in certain areas and in perceptions.

### **Impact of the Transitional Undertakings on Competition**

- 5.67 A number of parties to the review have argued that the transitional undertakings have held back or distorted competition. The OFT has identified four main sets of arguments made by parties to the review, namely that the transitional undertakings:

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<sup>103</sup> FPB (2006), 'Private Businesses and their banks 2006'.

- increase barriers to entry and expansion, because the business banking sector becomes less attractive to entrants and there is less scope to gain a competitive advantage
- reduce investment and innovation in the market, reducing the dynamic efficiency of the market
- distort the banks' pricing structures, which can reduce allocative efficiency and lead to greater similarity in prices between banks
- create regulatory risk which increases the costs of participating in the market.

5.68 This section sets out the evidence and arguments put to us in the course of our review. It also presents the views of the banks on the potential impact of removing the transitional undertakings.

### **Barriers to entry and expansion**

5.69 The argument made most frequently by parties to the review is that the transitional undertakings have limited the scope of the challenger banks and other new entrants to grow in the market. All three of the main challenger banks (Abbey, Alliance & Leicester and HBOS) argued that they had been hindered by the transitional undertakings:

'The transitional undertakings have hindered Alliance & Leicester's ability to gain market share and compete on price in the market for SME banking services.' – Alliance & Leicester

'Price control has, in our view, hindered new entrants' including HBOS's ability to gain market share.' – HBOS

'The transitional undertakings have not helped Abbey to grow business.' – Abbey

5.70 Other smaller banks have also made similar arguments. For example, AIB argued that 'If anything, the undertaking...has probably hindered our ability to gain market share and/or compete on price/service by removing some of our competitive advantage.'

5.71 There appear to be two main channels by which the transitional undertakings might have increased barriers to entry. First, by lowering banks' prices they have made the sector less attractive for new entrants. Second (and closely related), the transitional undertakings have reduced the scope for new entrants to differentiate themselves. Even if new entrants are able to offer a lower cost proposition to consumers, it is arguably difficult to market their offers as distinctive because the transitional undertakings already cover the two most obvious 'selling points' – free banking and payment of interest on credit balances. For example, Abbey noted that 'The transitional undertakings have not helped Abbey to grow business. They have narrowed the difference in the pricing of the big four banks relative to Abbey. As a consequence, the differential between Abbey and these banks has not been so great resulting in a weakening of the Abbey 'unique selling point' – free banking forever.' Similarly, HBOS told us that 'Price controls reduce essential differentiation between banking providers, reinforce the position of the incumbent banks and reduce the incentive for SMEs to switch.'

5.72 The OFT has seen limited concrete evidence to confirm that expansion by the smaller banks has been held back, partly because it is difficult to prove what may have happened in the absence of the undertakings. The main evidence comes from comparing public statements made before the undertakings were put in place with actual rates of growth achieved by the challenger banks. In 2002, HBOS publicly stated that it had a target of achieving a six per cent market share by 2004.<sup>104</sup> At the time of the CC report, Abbey was aiming to gain a five per cent market share within five years, and Alliance & Leicester was aiming to gain a 10 per cent share of smaller businesses.<sup>105</sup> None of these targets appears yet to have been met.

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<sup>104</sup> HBOS preliminary results, February 2003.

<sup>105</sup> CC (2002), paragraph 2.197.

- 5.73 The OFT notes that some of the smaller banks have still been able to achieve significant growth since the CC report. It is, of course, possible that they may have grown more quickly in the absence of the transitional undertakings. As set out elsewhere in this report, the OFT believes that there has been a strengthening of competition in the market, and consequently an increase in competitive pressure on the main banks. Therefore, the OFT does not believe that releasing the undertakings will necessarily lead to increased prices in the short-term.
- 5.74 However, it is possible that, even if the average level of prices were to remain unchanged in the short term, there might be greater differentiation between banks over the precise charging structure in the absence of the transitional undertakings. In other words, in the absence of a requirement to offer interest or free money transmission, the four main banks would be able to adjust their tariff offerings – for example by changing the balance between different charges or by charging additional prices for particular services. This might then allow competitors greater ability to carve out a particular niche in the market.

### **Reduced innovation and investment**

- 5.75 A second potential impact of the transitional undertakings has been to reduce innovation and investment (either by new entrants or existing banks). This might suggest that dynamic efficiency of the market is held back by the undertakings. Among the comments made by the banks are:

'Through reducing income streams below what they would otherwise have been, the transitional undertakings have inevitably had an impact on the business case supporting reinvestment into [x's] business banking proposition.' – [...]

'The price control distorts competition by making investment in the supply of banking services less attractive to both incumbents and new entrants...At the margin, [the price controls] have reduced the relative attractiveness of the SME banking business as a target for internal investment' – [...]

- 5.76 One of the main banks provided the OFT with further details of its investment in SME banking since 2002. [...]
- 5.77 The OFT customer survey suggested that there has been a small but significant increase in the proportion of respondents indicating that the reason that they did not shop around because 'all banks are the same' (from seven per cent in 2000 to 12 per cent in 2006).<sup>106</sup>
- 5.78 Although the OFT was not able to obtain consistent information on investment across all the banks, it believes that there is some evidence to justify the argument that investment has been distorted.

### **Allocative inefficiency and similarity of pricing**

- 5.79 A third potential concern is that, by imposing constraints on the pricing structure that can be offered by the banks, the transitional undertakings distort allocative efficiency in the market. For example, one of the main banks suggested that 'The price control undertakings effectively provide [...] with only two principal choices...The availability of [free money transmission] makes it very difficult for [...] successfully to promote other tariffs (for example, its Electronic Business Tariff) which are designed to incentivise SMEs to choose more efficient methods of money transmission...This is a serious impediment to improved efficiency.'
- 5.80 These constraints on the pricing structure can have a number of effects. First, some observers have commented that the transitional undertakings lead banks' offerings to be increasingly similar. For example, one bank noted that '[The transitional undertakings have] allowed the four main clearing banks to develop a position that all banks offer the same financial benefits. This, we believe, has reinforced customer switching inertia.' Some banks also suggested that price distortions could also make it uneconomic to serve some customer segments.

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<sup>106</sup> OFT Customer Survey (2006), paragraph 4.20

- 5.81 The OFT recognises that, even with the transitional undertakings in place, there has been an increase over time in the number of tariff offerings. However, in principle the distortion of pricing decisions could have important impacts on the market.

### **Regulatory risk**

- 5.82 Finally, some of the banks have argued that the transitional undertakings and the fact that they have to be reviewed periodically by the OFT adds to regulatory risk, and hence costs of participating in the market:

'Intervention adds to the uncertainty of being involved in this market. The future conditions of competition are difficult to predict as they will depend on whether there will be further regulatory intervention, or whether price controls will be amended in some way.' – Q53

### **Impact of removing the transitional undertakings**

- 5.83 The OFT also asked parties directly to comment on the possible impact of removing the transitional undertakings. The majority of banks argued that removing the undertakings would have little impact on the overall product offering, at least in the short-run. For example:

'We would naturally review our position in light of any change in the dynamics of the market. We consider it unlikely, in itself, however that a removal or reduction of the requirement to pay interest or offer free money transmission charges on business current accounts would result in any significant change in our pricing structures...' – [...]

'The removal of the transitional undertakings would not result in the withdrawal of accounts with free money transmission services, or interest payable on credit balances. Customers' expectations are now that Banks will provide a business account with either free money transmission or interest on credit balances – it would be commercially unattractive to withdraw these products altogether in the face of customer expectations.' – [...]

'In the event of the complete removal of the requirements set out in the transitional undertakings, it would be unlikely that [...] would significantly change its strategy or offerings in the short term. Any variation in [x's] offering would be driven by customer demand, based on SME customers' needs and complexity.' – [...]

'We believe that if the undertakings were removed the four main clearing banks will leave their interest margins unchanged in the short-run. A lack of price disparity would continue to work in their favour as they continue to dampen the appetite for competition. However, should the four main clearing banks offer a lower paid current account, this poorer deal for new customers could create some competitive benefits to new entrants. This would only be achieved if the changes were fully transparent and not simply clouded by the continued availability of the current product with poorer pricing.' - [...]

- 5.84 However, some of the banks did acknowledge that removing the transitional undertakings might prompt an increase in prices. For example,

'In the absence of a price control, [...] would be actively considering a more flexible approach to pricing, taking account of how customers differ by size, money transmission usage and the scope for electronic means of payment.' – [...]

'[...] considers that a removal or reduction in the interest requirement would improve its ability to compete in the business banking marketplace, on the assumption that one or more of the main four clearing banks would revert to their historic pricing propositions.' – [...]

'If the main banks no longer had to pay interest, it is possible they would choose not to do so. If this occurred, it would improve the relative competitive position of price led offerings (for example, currently provided by [...]), and likely increase the opportunity for the bank to compete on price to grow its market share.' – [...]

## Summary

- 5.85 The OFT acknowledges that several of the banks have argued strongly that the transitional undertakings should be released. The OFT believes that there is merit in these arguments. It is reasonable to expect that price restrictions will distort competition, particularly if maintained for an extended period. The lack of firm evidence to substantiate some of the points made reflects, in part, the difficulty in assessing the counterfactual – what would have happened in the absence of the transitional undertakings. However, the OFT believes that the evidence that has been gathered suggests that the transitional undertakings would impose costs on the market going forward and these costs would outweigh the benefits of keeping in place the transitional undertakings. These issues are discussed in more detail in chapter 6.

## 6 ADVICE AND RECOMMENDATIONS

- 6.1 This section sets out the OFT's advice to the CC in relation to the existing undertakings. It draws on the preceding analysis of market developments and assessment of the undertakings. The chapter summarises the effect of the undertakings, notes changes in the market that have occurred since 2002, and advises on how these changes affect the appropriateness of the existing transitional undertakings. It also comments on the behavioural undertakings and remaining competition concerns.

### Effect of the transitional undertakings

- 6.2 As set out in chapter 5, the OFT is satisfied that the four main banks have complied with the requirements set out in the transitional undertakings. The undertakings have generally been effective in reducing banks' interest income, and have also had an impact on money transmission income. Assuming that the banks would not have adjusted their tariffs in the absence of the transitional undertakings, the transfers to SMEs resulting from payment of interest on credit balances and reduced money transmission charges are estimated at just over £1,000 million over three years (2002-05) across the four banks.<sup>107</sup> (This figure does not take account of any attempts by the banks to recoup costs through raising other charges or reducing service levels, discussed in paragraph 6.4).
- 6.3 There have been significant differences in the way that two of the four banks have implemented the undertakings, which has affected the offering to customers at an individual bank level. In particular, the approach taken by Barclays and RBS Group has meant that a relatively high proportion of customers at those banks receive neither interest nor free banking, as described in the transitional undertakings, (around 50

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<sup>107</sup> See paragraphs 5.24-5.31 for details.

per cent and 30 per cent respectively).<sup>108</sup> To the extent that the CC's original intention was that all customers should receive either interest or free banking, the approach taken by Barclays and RBS Group could be argued not to match the spirit of the CC's recommendation, even though it formally complies with the requirements set out in the undertakings and the CC's recommendation.<sup>109</sup> The OFT believes that this is an important consideration in deciding on the outcome of the review, particularly in the light of the CC's stated concerns that banks might attempt to mitigate the effects of the transitional undertakings. However, this needs to be balanced against wider changes in the market and the effect this has had on overall competition, as discussed below.<sup>110</sup>

- 6.4 The OFT has found little evidence of deliberate attempts by the banks to offset the impact of the undertakings in the ways anticipated by the CC. Two banks – Barclays and HSBC – have made significant adjustments to their money transmission charges in the past two years. However, there is no evidence that this was a direct attempt to recover lost revenues. Indicators of quality of service and access to finance have changed little since 2002, as set out in paragraphs 5.52 to 5.69.

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<sup>108</sup> Most significantly, Barclays and RBS Group have made greater use than the other two banks of Clause 8 of the transitional undertakings, which allows banks to offer SMEs other tariffs in addition to those offering either interest on credit balances or free core money transmission. The way in which the banks have implemented the transitional undertakings is set out in more detail in Chapter 5.

<sup>109</sup> The CC report recommended the introduction of 'a requirement to pay interest on current accounts...or to offer SMEs a current account free of money transmission charges or, if they wish, a choice between the two.' (Paragraph 2.585)

<sup>110</sup> As part of its review, the OFT considered whether the behaviour of the banks might give grounds to vary the transitional undertakings, for example to require them to give all customers either credit interest or free money transmission. Given the changes in competition described below, the OFT believes that variation would not have been a proportionate response in this case.

- 6.5 Overall, the transitional undertakings appear to have put downward pressure on prices to more competitive levels in the way that the CC intended. It can be argued that the transitional undertakings have had a positive impact on SMEs' expectations, making them more aware of charges (particularly the payment of interest on current accounts), and more sensitive to price changes.

### **Effect of the behavioural undertakings**

- 6.6 The review raised no significant concerns around compliance with the behavioural undertakings. The OFT's main area of concern relates to the compensation arrangements in the behavioural undertakings. The level of compensation payments made by banks, and observed by the OFT, is not consistent with the banks carrying out their obligations in the undertakings in a proactive way. The OFT would wish to see the banks taking a more proactive approach to compensation alongside efforts to increase transparency, to decrease any perception there may be about the hazards related to switching.
- 6.7 Overall, the review has found that the behavioural undertakings are beginning to have the effect intended by the CC in 2002. There has been a reduction in the degree of bundling of business current accounts with other services. The requirements relating to price transparency and switching have generally made the switching process easier (albeit that concerns remain, as discussed below).

### **Changes in the market since 2002**

- 6.8 Aside from the direct effect of the undertakings, the OFT has found a number of changes in the market since the CC report in 2002, discussed in chapter 4. The share of the market in England and Wales held by the four main banks has declined gradually but steadily. HBOS, Abbey and Alliance & Leicester have expanded relatively rapidly, albeit from a low base, and have focused on different areas of the SME market. Other smaller banks such as Co-op and Northern have maintained their market positions, and there has been new entry particularly in related markets for lending and savings. There has been some customer churn among

the four main banks themselves, indicating that the four main banks are now competing more effectively between each other.

- 6.9 Alongside this shift in market positions, there is evidence that some customers are becoming more sensitive to changes in banking costs. Part of this might reflect the impact of the behavioural undertakings in ensuring a degree of price transparency, and improved access to price comparison services. The emergence of banks such as Alliance & Leicester and Abbey focusing on low cost provision of core current account services may also have contributed to the change in customer perception. This growing price sensitivity should reduce the market power of the main banks, making it more likely that a charge increase will lead customers to consider moving to another bank. It points towards increasing competitive constraints on the behaviour of the four main banks.
- 6.10 The OFT is satisfied that switching banks has become easier as a result of the switching undertakings put in place following the 2002 report. In almost all cases the banks appear to have met the targets on switching set out in the undertakings. However, the OFT continues to have concerns about the relatively low rates of actual switching, and has received anecdotal evidence about the difficulties that can be encountered during switching, particularly where the switcher has a secured loan. The OFT is also concerned about the low rate of payment of compensation for failures of the switching process, as required under the switching undertakings.
- 6.11 There appears to be a growing trend towards unbundling of business banking relationships, with SMEs increasingly banking with more than one provider. The behavioural undertakings appear to have had a positive impact in preventing banks from forcing an SME to take out a business current account as a condition for purchasing other banking services. Overall, the reduction in bundling and increase in multi-banking should reduce the ability of the main banks to leverage their share of the current account market to distort other banking services markets.
- 6.12 The OFT has also observed that new technology is playing an increasingly important role in the business banking market (as in other

banking markets). Growing proportions of customers are using internet technology, reducing the importance of branch access as a barrier to servicing customers (at least for some parts of the market). Similarly, greater use of automated payments technology has encouraged banks to develop new tariffs offering cheaper rates for use of automated payments. This has contributed to a greater variation in tariffs now than was the case in 2002, providing SMEs with greater choice – even though the transitional undertakings have in some ways encouraged banks to offer similar rates of interest on credit balances.

6.13 Finally, the OFT would note that the behavioural undertakings and Business Banking Code (introduced in December 2001) have put in place important safeguards for small businesses, in particular around price transparency, bundling and the switching process. The OFT is encouraged that awareness, particularly of the Business Banking Code, appears to be relatively high.<sup>111</sup>

6.14 Alongside these generally positive developments, the OFT continues to have some concerns about elements of the SME banking market, most notably around the persistent low levels of switching, and an apparent lack of awareness of pricing. In particular:

- while there has been an apparent increase in SMEs' willingness to consider switching, there does not appear to have been a significant increase in actual switching activity since 2002
- customers appear not always to be aware of their banking costs. The OFT survey suggested that 41 per cent of customers did not initially know their annual banking costs. Even when they were sufficiently aware, 24 per cent had concerns about transparency. Of businesses which had switched or considered switching, 21 per cent said comparing prices was not very easy or not at all easy

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<sup>111</sup> The most recent FPB membership survey indicated that 78.4 per cent of respondents were aware of the business banking code. The OFT is aware that the Banking Code Standards Board has been increasingly active in promoting the Code over the last two years.

- there also appears to be a lack of confidence in the switching process among some consumers. The OFT survey found that 25 per cent of businesses had encountered problems during switching. There was also a lack of awareness about the safeguards set out in the behavioural undertakings. Sixty seven per cent of those already considering switching and 42 per cent of those who might switch if approached felt that knowing about the new procedures would encourage them to switch.

6.15 These issues are addressed further in paragraphs 6.33 to 6.40.

### **Advice in relation to the transitional undertakings**

6.16 In its 2002 report, the Competition Commission made clear that the price remedy could be temporary, saying, 'If effective competition does emerge, the need for regulation would, in our view, prove temporary: hence we would envisage a review after three years of whether the requirement to pay market-related rates of interest on current accounts continued to be appropriate.'<sup>112</sup>

6.17 It is reasonable to expect that price restrictions will distort competition, particularly if maintained for an extended period. Price regulation can affect the competitive incentives for firms to invest in the market, to attempt to gain market share, and to produce innovative products and services. In assessing the transitional undertakings, the OFT has considered how the balance of costs and benefits has changed since 2002.

6.18 The transitional undertakings have delivered important benefits to SMEs since 2002. As noted in paragraphs 5.24 to 5.31, the OFT estimates that the requirement to offer interest or free money transmission has produced a direct transfer to SMEs in excess of £1,000 million over three years. While some of this transfer may have been recovered by the banks through other charges or service changes, the OFT has not found

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<sup>112</sup> CC (2002), paragraph 2.578.

evidence of widespread price increases or a general decline in quality of service. The transitional undertakings have arguably also altered customers' expectations. The majority of consumers now receive interest at the rate specified in the transitional undertakings. Combined with the fact that customers appear now to be more aware of price competitiveness, this might suggest a general shift in expectations.

- 6.19 To the extent that there is greater competition now than was the case in 2002, this will have reduced the direct benefit of the transitional undertakings. This is because stronger competitive constraints on the four main banks should limit the degree to which they can raise prices in the absence of price regulation. In particular, the OFT has considered what would happen if the banks were to be released from their undertakings. A number of the challenger banks felt that any bank attempting to raise its prices immediately in the light of release of the undertakings would lose customers to its rivals. The OFT considers that this belief is justified by the growth of smaller banks providing a competitive price offer since 2002, along with an apparent increase in consumers' responsiveness to price signals and willingness to switch.
- 6.20 Evidence of this is found in the way some of the challenger banks have been able to increase market share even with the transitional undertakings in place. The three challenger banks have been able to increase their combined market share from around three per cent to nine per cent. In particular, both have now geared themselves up to compete more effectively with the main banks in the event that prices are increased by the main banks.<sup>113</sup>

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<sup>113</sup> In 2002, the CC commented that, 'if we were confident that each of the above three clearing banks could achieve a market share of 5 to 10 per cent, or 20 to 25 per cent overall, we could foresee a change in the competitive environment' (2.240). The OFT notes that none of the challenger banks have yet been able to achieve these levels of growth. However, the OFT believes that the changes that have been observed are material in terms of change in circumstance, and that this needs to be considered alongside the possibility that the transitional undertakings have held back growth of the challenger banks since 2002.

6.21 In relation to costs of the transitional undertakings, several parties – including all of the main challenger banks not subject to the undertakings – have suggested that the transitional undertakings might distort competition. Three main arguments have been made:

- first, it has been argued that the transitional undertakings limit new entry and expansion by smaller banks because there is less scope to differentiate on price (or identify a 'unique selling point')
- second, it has been argued that innovation and investment is dampened by the undertakings
- third, it has been argued that the undertakings distort banks' pricing decisions, ultimately leading to allocative inefficiency.

6.22 The OFT believes that there is evidence in support of each of these arguments. While it is impossible to state with certainty what would have happened in the absence of the undertakings, the challenger banks have made strong representations that their growth has been hindered. (The challenger banks made similar representations to the CC in 2002. However, at the time, the CC felt that the challengers were not quite in a position to exert sufficient constraint on the main banks and needed to take more decisive action to bring immediate benefits to consumers – hence the transitional undertakings). Similarly, the OFT has seen some evidence that investment in innovation has been reduced by some of the main banks.

6.23 The OFT recognises that the welfare implications of some of the arguments that have been put to us are ambiguous (at least in the short term). Most notably, if the challenger banks are arguing that they can only expand if the main four banks increase their charges (and by implication their profits), then the immediate net impact on SMEs of removing the transitional undertakings might be negative. This is, of course, assuming that the four main banks pay less interest on business current accounts.

6.24 On the other hand, the OFT believes that more rapid expansion by the smaller banks is likely to have important dynamic benefits, ultimately

putting greater downward pressure on prices and stimulating innovation. Furthermore, to the extent that the transitional undertakings are already holding back investment and innovation in the market, removing the undertakings should have a positive impact for SMEs even in the short term.

- 6.25 To the extent that competition is developing even with a price control in place (as appears to have been the case with SME banking over the last four years), there will remain a case for retaining the safeguards to ensure that consumers are not exposed to anti-competitive behaviour. However, the OFT has also borne in mind that the transitional undertakings have now been in place for more than four years. The OFT considers that this period has been sufficient for the behavioural undertakings to begin to change customer expectations.
- 6.26 On balance therefore, the OFT recommends that the costs of the transitional undertakings are now beginning to outweigh the benefits, and the transitional undertakings should be lifted. The evidence shows that already some investment and innovation has been impacted by the transitional undertakings, and more and more banks may focus investment and innovation in other more profitable sectors. This could lead to a lower level of investment and innovation in the SME sector generally than would otherwise be the case, particularly if the transitional undertakings appear to be a longer term feature of the sector than the transitional term envisaged by the CC.
- 6.27 In reaching this conclusion, the OFT also considered whether the existing transitional undertakings might be varied in some way rather than be released in its entirety. First, the OFT considered whether there would be grounds to vary the transitional undertakings in response to the banks' different approaches to implementation. For example, if the transitional undertakings were to specify that all SME customers would have to receive interest at the specified rate or free core money transmission services (rather than that all customers must be offered one of these options), this would reduce the difference between the banks. However, the OFT considers that the flexibility allowed by the undertakings has encouraged greater choice for consumers, and that

there would be costs of such a variation. The variation would also not be proportionate, given the positive developments in competition that have occurred since 2002.

- 6.28 Second, the OFT considered whether the transitional undertakings might, alternatively, be varied to reduce the distortion of competition in the market but nevertheless retain a degree of price protection for SMEs. For example, in principle the specified rate of credit interest could be reduced from the current level of 2.5 per cent below the base rate. However, the OFT considered that such a variation would not mitigate the costs of the undertakings, since there would still be constraints on banks' pricing. The OFT has concluded that there are sufficient grounds in terms of change in circumstance to advise releasing the transitional undertakings, and that this would be preferable to a temporary easing of the price control.

### **Advice in relation to the behavioural undertakings**

- 6.29 While there are still some specific concerns, the OFT is satisfied that overall the behavioural undertakings (and Business Banking Code) are starting to make the market effective. Where customers want to switch account, there are safeguards in place to ensure that it is relatively easy to do this.<sup>114</sup> SMEs are actively considering switching to smaller challenger banks, and the smaller banks are gaining a disproportionate share of account switchers.
- 6.30 The OFT has concluded that the behavioural undertakings should be retained. The OFT believes that the behavioural undertakings have contributed to the development of competition in the market as described above, but that competition has not developed sufficiently to warrant removing the undertakings. Furthermore, the OFT notes that the

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<sup>114</sup> The switching process can be slow if customers are transferring a bundle of different banking services, and particularly if they have secured lending. However, the OFT accepts that these kind of transfers require the new banks to carry out lengthy due diligence, and to the extent that this is being carried out by the receiving bank it should be in their interests to carry out switching quickly.

behavioural undertakings are generally directed at areas where there continue to be competition concerns – particularly around price transparency and switching. If anything, these are areas where banks might do more to protect consumers and promote competition, as discussed in the following section.

## Other recommendations

6.31 Although it is advising that the transitional undertakings be released, the OFT still has some concerns about the way in which the market is operating.<sup>115</sup> As noted above, the OFT remains concerned about low levels of switching in the market. While this is due in part to SMEs' attitudes to the market, it is incumbent on banks to ensure that customers are aware of their banking costs, have ready access to the information required to compare alternative offers, and have confidence in the switching process should they decide to move bank. It is important in this context that the behavioural undertakings remain in place, providing a vital safeguard for consumers. OFT would intend to monitor this closely in the period following release of the undertakings to gauge the effect.

6.32 The OFT believes that action might be taken to address some of these concerns. As the CC found in 2002, a number of the concerns about the market relate to consumer behaviour, rather than behaviour by firms. There are a number of key messages that might be given to SMEs, including:

- customers should be aware of their current banking costs, and alert to the potential benefits of switching bank

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<sup>115</sup> Also note that the OFT's analysis has focused on the core banking services, particularly current accounts, because that was the market in which the CC imposed undertakings. The OFT has not explored wider issues such as access to finance, which were not directly related to the undertakings put in place by the CC.

- customers should consider negotiating price or service issues – in a large number of cases this is successful (based on evidence from the OFT customer survey and CC report)
- there is a range of different business bank accounts available, some significantly lower priced than others
- there are safeguards in place to ensure that switching goes smoothly – generally the switching process works
- customers should not assume that having long-run relationship with their bank will increase their chances of getting a good deal in the future.

6.33 Second, if the transitional undertakings are removed, the OFT would continue to monitor the behavioural undertakings (including the switching undertakings). As part of the review, the OFT has considered whether it could improve the effectiveness of its monitoring of the behavioural undertakings, balancing the benefits of different approaches against the resource costs that these might entail. Based on this assessment, the OFT suggests that, in future, its monitoring work could include:

- publishing an annual factual summary of switching performance. The OFT already receives monitoring data on switching performance twice a year, as set out in Table 4.15. The OFT believes that releasing this information publicly would provide an important degree of transparency for SMEs, and ensure that the banks continue actively to improve their performance
- continuing to collect information on prices. Under the behavioural undertakings all signatories have to publish certain information on prices, and to provide this in a form that can be used by the OFT for monitoring purposes. This would provide continuity with the OFT's previous monitoring of prices of the four main banks based on information provided under the transitional undertakings

- ask for specific information on compliance with the switching compensation undertakings – for example, annual information on level of compensation payments and percentage of cases where compensation has not been paid when a switching target is missed. This would address a particular concern raised by this review about the current low levels of payment of compensation for errors that occasionally occur during the switching process.

6.34 Third, the OFT believes that there are a number of steps that banks might take to further improve the operation of the market in response to remaining concerns, including:

- providing clearer information to customers about the switching process on bank websites. Existing advice is easier to find on some websites than on others, and banks should ensure that the information covers the process for switching out as well as switching in
- giving SMEs access to account information (including volumes of transactions) on demand. Customers should not have to wait for a regular statement in order to access this information, which is very important in considering the potential benefits of switching
- providing more detail of compensation arrangements relating to switching. This could include informing customers of their rights at the time of switching, given that very few currently appear to take advantage of the compensation arrangements
- nominating a single identified individual to be responsible for overseeing the switching process within each bank. The undertakings already specify that each bank should have a liaison for compliance issues with the OFT.

6.35 The OFT notes that the Business Banking Code is currently being reviewed, with any amendments due to come into effect in 2008. The OFT proposes to pursue the potential behavioural measures indicated above through the Banking Code review in the first instance. This

provides a useful framework for reaching agreement across the market as a whole.

- 6.36 Alliance & Leicester argued that banks should be prevented from negotiating charges once a customer has agreed to switch to another bank. In response, the OFT would reiterate the importance of the 'old bank' not impeding the switching of an account. The recommendations around payment of compensation for example, discussed above, go to this issue. However, the OFT would be wary of imposing absolute restrictions on the negotiation process. To the extent that customers can benefit from negotiations, it is generally preferable to increase customers' awareness of the options available to them, and encourage them to explore switching and negotiation pro-actively.
- 6.37 There are also practical issues that would need to be considered. For example, several banks argued that, when a customer had switched, they often made attempts to win the customer back. Even if negotiation were prevented at the time when a switch was taking place, the OFT does not believe it would be possible (or desirable) to prevent the old bank from offering alternative terms to a customer once the switch has occurred.
- 6.38 Ultimately a further market reference remains a possibility. The OFT has determined that, given the apparent improvements in competition since 2002 and the absence of significant new issues in the market, a reference would not be appropriate at this point. However, the OFT will continue to remain actively focused on the market through its role in monitoring the remaining undertakings on the banks, and on its wider role in monitoring markets.

## **A FINANCIAL ANALYSIS OF THE TRANSITIONAL UNDERTAKINGS<sup>116</sup>**

A.1 A financial questionnaire was submitted to each of the major banks and a number of follow-up questions were sent following their initial submissions. Details were also reviewed at meetings held with the banks. Following these exchanges a basis was determined to estimate the impact of the undertakings on the banks' income on a broadly consistent basis. As significant estimation was required by the banks to derive the figures shown, it would be more appropriate to interpret the figures as being within a range than as precise estimates.

### **Data provided by the banks and estimation required**

A.2 To simplify the data collection and analysis task for the banks, income rather than cost data was collected. This was expected to be suggestive as to profit movement, while avoiding the more onerous requirement for detailed collection and analysis of costs.

A.3 The data collected was for SME companies with turnover up to £25 million. This did not exactly match the banks' internal reporting of business segments and some estimation was required. Analysis by subsidiary turnover group was not consistently available from the banks, so analysis has concentrated on the full £0 to £25 million turnover band. In general the banks used debit turnover from customers' current accounts to determine whether customers should be included within the band.

A.4 Two banks faced particular problems in providing the data:

- RBS experienced difficulty in providing data for 2001 and 2002 due to the integration of RBS and National Westminster Bank systems in 2002

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<sup>116</sup> This section contains commercially sensitive information provided by the four main banks. The OFT intends that this section will be redacted in the published version.

- Lloyds/TSB's business structure only allowed customers with up to £25 million turnover to be identified from 2004; their Commercial Banking division covered businesses with turnover between £2 million and £75 million between 2001 and 2003 and some high level estimation was required for SMEs in a £2 million to £25 million turnover range.

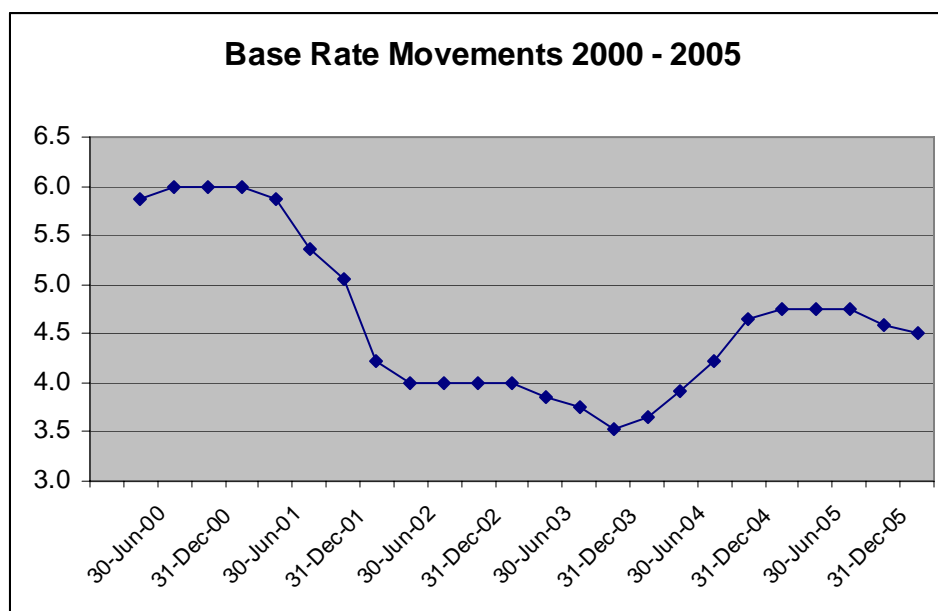
## Interest rate movements

A.5 Over the 2000-05 period, the average base rate declined from its peak in 2000 to a low point close to 3.5 per cent in the third quarter of 2003, and then increased through 2004 to early 2005. Rates were on average lower than for the period considered by the Competition Commission. Movements in the annual average base rate are summarised below.

**Table A.1: Annual average base rate (per cent)**

2000	2001	2002	2003	2004	2005
5.97	5.12	4.00	3.69	4.39	4.65

**Figure A.2: Movement in base rates 2000-2005**



## Financial consequences of the undertakings

A.6 There are four main areas where the financial undertakings are considered to have impacted on banks' profitability and we have used information provided by the banks to estimate these areas. There are two direct effects and two related areas.

A.7 The direct effects are:

- interest paid on current accounts, where not paid previously
- money transmission income foregone, where money transmission services were provided free.

A.8 The less direct effects are:

- lower funding benefit from current accounts, as the interest benefit earned by banks from current account credit balances was reduced when the accounts became interest-bearing<sup>117</sup>
- higher deposit interest paid, where necessary to maintain the interest differential relative to interest bearing current accounts.

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<sup>117</sup> A business unit within a bank will aim to eliminate interest risk, as far as possible, to stabilise its interest earnings. This is often achieved by a matched hedging transaction with the bank's Treasury department e.g. in simple terms a 1 year customer deposit will be 'lent' to Treasury in exchange for a 1 year return. Matching interest risk is more complicated when a deposit is not interest bearing. Instead a behavioural assumption can be made, usually based on the expected life of the product. Typically non interest bearing current accounts would be hedged by rolling 3-5 year funding arrangements, e.g. swaps, which would usually earn higher interest income than from shorter term rates. When a current account becomes interest bearing, it will instead be necessary to change the funding arrangement to match the interest rate paid – in this case base rate. As base rate was lower than the 3-5 year funding benefit when accounts were non-interest earning, the banks incurred a recurring loss from a lower funding benefit. The actual cost from a reduced interest margin earned would vary according to the balances funded and the level of base rate and the rolling rate ruling at the time.

A.9 Some possible effects were excluded as they did not appear to be sufficiently closely related to the introduction of the undertakings. These include:

- the cost of free money transmission offered specifically to new customers and switchers, as it is assumed that this would have been offered in the absence of the undertakings
- profit or loss from any one-off unwinding of some rolling hedge arrangements previously made by their treasury department. Although treasury may have had to change their funding arrangements, any profit or loss arising would be a part of the broader corporate funding activities and the benefit or cost would not have been passed to the business area.

### **Quantification of the cost of the undertakings**

A.10 It should be noted that there were differences in the approaches used by the banks in estimating the effect of the undertakings. While this means that the estimates are not exactly comparable, the estimates used are felt to represent a reasonable estimate of the impact in the four areas identified.

A.11 The financial undertakings are estimated to have cost the banks circa £400 million in 2003 and almost £1,500 million for the three years 2002-05. By far the main cost comes from lower interest margins earned on current accounts (over £1 billion 2002-05, reflecting both interest paid and a reduced funding benefit from the balances). There was also a cost from deposit interest rates being raised to maintain a positive interest differential and Barclays' response incurred lower money transmission income. Customers should have benefited from the higher interest rates and lower money transmission charges (£1.07 billion 2002-05), but not from the reduced funding benefit.

**Table A.3: Summary position 2002-03**

<b>£m</b>	<b>Barclays</b>	<b>HSBC</b>	<b>Lloyds TSB</b>	<b>RBS</b>	<b>Total</b>
Interest paid on current accounts	[...]	[...]	[...]	[...]	[...]
Money transmission income	[...]	-	-	-	[...]
Funding benefit on current accounts	-	[...]	[...]	[...]	[...]
Deposit interest paid	[...]	[...]	[...]	[...]	[...]
<b>Total cost</b>	[...]	[...]	[...]	[...]	<b>403</b>

**Table A.4: Summary position 2002-05**

<b>£m</b>	<b>Barclays</b>	<b>HSBC</b>	<b>Lloyds TSB</b>	<b>RBS</b>	<b>Total</b>
Interest paid on current accounts	[...]	[...]	[...]	[...]	[...]
Money transmission income	[...]	-	-	-	[...]
Funding benefit on current accounts	-	[...]	[...]	[...]	[...]
Deposit interest paid	[...]	[...]	[...]	[...]	[...]
<b>Total cost</b>	[...]	[...]	[...]	[...]	<b>1483</b>

## **Assumptions**

A.12 A number of assumptions have been made to produce an estimate of the impact of the undertakings. Given the difficulty in precisely defining our

counterfactual in the absence of the undertakings, assumptions were kept straightforward wherever possible.

- banks were asked to follow the same approach and assumptions they used for their submission to the CC wherever possible
- debit turnover of current accounts was generally used by the banks to determine customers to be included within turnover bands
- it is assumed that banks would not have chosen to pay interest in the absence of the undertakings
- variances due to movements in margins earned on current account and deposit products are assumed be driven by the undertakings. In effect margin movements from 2002 were attributed to the undertakings. Margin movements for other products and volume growth for the above products are assumed to be attributable to other factors including competitive behaviour
- the change in funding arrangements required by a move from non-interest bearing accounts to interest bearing is included as a cost of the undertakings, although customers were not a beneficiary. The funding benefit from a non-interest bearing account was usually based on 3 or 5-year swap rates. This benefit changed to being base rate related earnings when interest was paid. The cost of this change in arrangement has been estimated using the reduction in funding rate between years.

A.13 Under the new arrangements, with interest paid and funding benefit earned both being related to base rate, the interest margin was not sensitive to movement in interest rates. However when no interest was paid, the margin (equal to the gross funding benefit) was sensitive to movements in the rolling funding rate. Consequently, our assumption of attributing all margin movements to the undertakings may over- or under-estimate the true effect, to an extent determined by how the funding rate would have moved.

- A.14 However as the funding rate for non interest bearing accounts is determined on a rolling basis, for example new contracts taken every three months depending on the balances to be hedged, it would be very difficult to accurately produce alternative funding rates. One bank advised that their five-year rates declined in 2004 and 2005, despite the increase in base rate, suggesting that the effect of the change in funding rates may be overstated. However this may not have been typical of all the banks.
- A.15 Estimates made by the banks were used to quantify the effect of the undertakings wherever possible. Some of these estimates were revised following discussions with the banks.

### **Barclays**

[...]

### **HSBC**

[...].

### **Lloyds TSB**

[...]

### **RBS**

[...]

## **B      OFT CUSTOMER SURVEY**

B.1    See separate attachment.

## C THE UNDERTAKINGS

### 1) Transitional Undertakings

**1. Title of report:** The supply of banking services by clearing banks to small and medium-sized enterprises (MMC – Cmnd 5319)

**2. Published:** 14 March 2002

**3. Orders:** N/A

**4. Date of original undertakings:** 18 July 2002      **Date of undertakings coming into force:** 1 January 2003      **Press release:** DTI, 18 July 2002

**5. Companies giving undertakings:** Barclays Bank Plc, HSBC Bank Plc, Lloyds TSB Bank Plc and the Royal Bank of Scotland Group Plc

### 6. Undertakings:

WHEREAS on 20 March 2000 the Secretary of State and the Chancellor referred to the Commission under sections 47(1), 49(1) and 51(1) of the Act the matter of the existence or possible existence of a monopoly situation in relation to the supply of banking services by clearing banks to SMEs;

WHEREAS the Report sets out adverse public interest findings in connection with the supply of banking services to SMEs within the United Kingdom by certain clearing banks;

WHEREAS the Commission recommended in the Report remedies relating to the prices charged for the provision of business current accounts in England and Wales and further recommended that the effect of such remedies be reviewed by the Director after a period of three years;

AND WHEREAS pursuant to a request by the Secretary of State and the Chancellor, the Director has consulted with the Bank with a view to obtaining from it undertakings to take certain action to implement such remedies;

NOW THEREFORE the Bank gives to the Secretary of State and the Chancellor under section 88(2) of the Act the undertakings below to take action requisite

for the purpose of remedying certain of the adverse effects specified in the Report:

## **Interpretation**

1.- The Interpretation Act 1978 shall apply to these undertakings as it does to Acts of Parliament.

2.- Compliance with these undertakings does not affect the duty on the Bank to comply with nor restrict the application of:

(1) the Competition Act 1998; or

(2) any other law.

3.- In these undertakings:

'the Act' means the Fair Trading Act 1973;

'BACS' means the bulk inter-bank electronic funds transfer processing of direct debits, direct credits and standing orders in the UK, as carried out through BACS Limited;

'the Bank' means Barclays Bank Plc/ HSBC Bank Plc/ Lloyds TSB Bank Plc/ the Royal Bank of Scotland Group Plc;

'business' means a business of any kind and includes sole traders, partnerships, limited liability partnerships, limited companies, other bodies corporate, unincorporated associations and clubs and charities;

'business current account' means a current account denominated in sterling intended for use by businesses and excludes any current account (even if used by the SME for the purpose of its business) which is offered by the Bank as a current account intended for personal use by a natural person;

'the Chancellor' means the Chancellor of the Exchequer;

'CHAPS' or 'Clearing House Automated Payments System' means the electronic transfer system for real-time gross settlement, same-day value, inter-bank payments in the UK, as operated by CHAPS Clearing Company Limited;

'the Commission' means the Competition Commission;

'core money transmission services' means the money transmission services, relating to the transfer of sterling through a business current account, listed in Part I of the Schedule to these undertakings;

'current account' means a current account denominated in sterling, under whatever name, including a current account maintained via the internet, telephone or post, features of which include instant access to money, the availability of a wide range of money transmission services, and may include the provision of credit through overdraft facilities, but excludes:

- (i) any credit card account;
- (ii) any account designed for businesses, other than unincorporated associations, clubs and charities, to hold monies on behalf of third parties; and,
- (iii) for the avoidance of doubt, any deposit account;

'the Director' means the Director General of Fair Trading;

'deposit account' means an account denominated in sterling, under whatever name, designed for depositing money generally not required for immediate use, and which is generally interest bearing and which account may or may not impose terms as to the minimum or maximum amounts required or permitted to be deposited and as to the term for which such sums should be deposited, and which may impose varying restrictions on deposit and withdrawal instruments, but for the avoidance of doubt any current account, any account on which the customer may borrow funds from the Bank, or any accounts where the monies are held specifically for the purposes of Treasury Money Market deals shall not be treated as a deposit account;

'group' means (i) two or more businesses that are members of a 'group of interconnected bodies corporate' as defined in section 137(5) of the Act; and (ii) any business which owns or controls one or more other businesses, together with those other businesses which such business owns or controls, and for these purposes control shall be deemed to arise where a business is owned as to 25% or more of its share capital or where 25% or more of the voting rights are held by another business or jointly by two or more other businesses, except where such interests are held by public investment corporations, venture capital companies or institutional investors who exercise, whether individually or jointly, any rights they have in the business only to maintain the full value of those investments and not to determine directly or indirectly the competitive conduct of the business;

'money transmission services' means services relating to the transfer of money to or from a business current account and relating only to transactions exclusively in sterling, whether by the SME or a third party, (whether on paper or electronically or by any other means) and includes those services which are listed in the Schedule to these undertakings;

'net cleared credit balance' means the cleared credit balance outstanding at the end of any particular day on a business current account after the operation of any set-off or sweep arrangements which exist between that account and other current accounts maintained by the same SME, or the group of which it is a member, with the Bank;

'the Report' means the report of the Commission on the supply of banking services by clearing banks to small and medium-sized enterprises within the United Kingdom presented to Parliament in March 2002 (Cm 5319);

'the Secretary of State' means the Secretary of State for Trade and Industry;

'SME' (small or medium-sized enterprise) means a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) of no more than £25 million. For the purposes of applying this definition, the sales revenues of a business in any given year shall be determined as follows:

- (a) where the Bank has, or has provided to it by the SME, evidence showing to the reasonable satisfaction of the Bank the level of its sales revenues in the previous year, such evidence shall be treated as determinative of the sales revenues of the business in respect of the current year; or
- (b) if the Bank does not have, or does not have provided to it, evidence showing to the reasonable satisfaction of the Bank the level of an SME's sales revenues in the previous year, then the business may be categorised as an SME in respect of a given year if:
  - (i) it holds a business current account with the Bank which current account generated in aggregate, in the previous complete year, either debit turnover or credit turnover (inclusive of VAT and other turnover-related taxes) of no more than £25 million (or, where the current account was opened during the previous year, such proportion of £25 million as shall equate to the proportion of the year for which the account was maintained); or
  - (ii) it is a business which opens a business current account with the Bank during the year, which business the Bank reasonably expects after discussion with the business, at the time the account is opened, to generate during the year sales revenues of no more than such proportion of £25 million as shall equate to the proportion of the year remaining from the date when the account is opened;

and provided that, in deciding whether a business is an SME, the Bank shall be entitled to treat as a single business all businesses forming part of a group; and

provided that, where a business or group holds business current accounts with the Bank and with another bank and has failed to respond to a request from the Bank to provide evidence of its or the group's annual

sales revenues in a given year, the Bank shall be entitled, in deciding pursuant to subparagraph (i) above whether the business' or the group's debit or credit turnover exceeds £25 million, to take into account not only the debit or credit turnover on any current account maintained with the Bank but also the Bank's reasonable estimate of the debit or credit turnover on any current account maintained by such business or group with any other such bank.

For the avoidance of doubt the reference above to 'debit turnover' shall mean the funds paid out of the business current account of the SME and 'credit turnover' shall mean the funds paid into such business current account.

'specified rate' means a percentage rate equal to Bank of England base rate for the time being minus 2.5. For so long as Bank of England base rate is 2.5% or less, then the specified rate shall be zero;

'standing charge' (sometimes referred to as an account maintenance fee) means any fee or charge for the provision or maintenance of a business current account and does not include proposition or relationship management charges or charges for the provision of electronic cash management packages;

'year' means, for the purposes of paragraph (a) of the definition of 'SME', the latest financial year of the business concerned and, for the purpose of paragraph (b) of the definition of 'SME', a year running from 1 January to 31 December.

4.- Subject to clauses 1 and 3 above, all expressions used in these undertakings shall be interpreted in accordance with the Business Banking Code (March 2002) and with generally accepted banking practice.

## **Application**

5.- Except as otherwise provided in clause 6 below, these undertakings shall apply-

(a) with effect from the date of the giving of these undertakings; and

- (b) in respect of all SMEs which the Bank-
  - (i) supplies (for so long as it continues to supply), and
  - (ii) approves for the purpose of opening

a business current account with the Bank at, or through, a branch or office of the Bank situated in England and Wales.

6.- Clauses 7 to 10 below shall apply with effect from no later than 1 January 2003.

### **Requirement to offer an account which either pays interest or does not levy charges for core money transmission services**

7.- Subject to clause 9 below, the Bank shall, in respect of each of its SME customers, offer that SME a business current account which:

- (a) pays interest (net of tax where appropriate), calculated on a daily basis and payable quarterly or more frequently, at a rate which is equal to or exceeds the specified rate on cleared credit balances from time to time maintained by the SME, provided that where set-off or sweep arrangements are in place the Bank shall be entitled, if it so chooses, to pay interest on net cleared credit balances (hereinafter referred to as 'Option A'); or
- (b) which levies no standing charges and provides core money transmission services, conducted via such account, free of any charge for the use of any such service or for the use of the business current account in the provision of such service, with the exception that any third party costs arising and payable by the Bank in relation to the provision of any core money transmission service may be recovered by the Bank from the SME (hereinafter referred to as 'Option B'); or
- (c) gives the SME a choice between Option A and Option B (hereinafter referred to as 'Option C'),

and the Bank shall be entitled to choose which one of Option A, Option B or Option C it offers from time to time to any particular SME. If an SME chooses

not to accept the Option (A, B or C) offered by the Bank, provided such Option is not withdrawn by the Bank, the Bank shall be under no obligation to offer that SME one of the remaining Options (A, B or C).

8.- The Bank shall communicate to each SME, in a clear and effective manner, which one of Options A, B and C is being offered by the Bank to it. The Bank shall not withdraw such offer, or where such offer has been accepted by an SME the Option (A or B) accepted, from an SME without offering to that SME one of the remaining Options (A, B or C). Provided that the offer made to any particular SME of a business current account with Option A, B or C remains available to it at all times, nothing in these undertakings shall be taken as preventing the Bank from also offering to any particular SME a business current account, which the SME can accept as an alternative to a business current account with the Option (A, B or C) offered by the bank to it, which offers alternative propositions or features than an account with the Option (A, B or C) offered to that SME by the Bank.

9.- Where an SME falls into a category of business to which the Bank would normally offer Option A, and the Bank is satisfied that the SME is unable to accept a business current account with Option A for reasons based on religious beliefs, the Bank shall use reasonable endeavours to explore with such SME alternative means by which the SME could benefit to the same or similar extent as if it had accepted a business current account with Option A. Should the Bank, as such an alternative, agree with such SME to offset any amount which would have been payable had Option A been accepted against any standing charges and any money transmission charges levied in relation to that SME's business current account, the Bank shall be entitled to limit any such offsetting payment to the extent of any such charges levied.

10.- For the avoidance of doubt, and without prejudice to clauses 7 to 9 above, the Bank may make the offer to any particular SME of a business current account with Option A or with Option B subject to the meeting of certain conditions which have been communicated to that SME, provided that, if such conditions are not met by an SME, the Bank shall offer that SME free of any conditions (other than such conditions that apply to all business current accounts offered by the Bank) a business current account offering an

alternative, from Options A, B and C, to the Option (A or B) made subject to such conditions.

### **Increases in, or adoption of, tariff-based charges for money transmission services**

11.- The Bank shall notify to the Director and publish in a manner and within such period of time as is approved by the Director:

- (a) each and every increase in any-
  - (i) tariff-based charge for any of the money transmission services listed in the Schedule to these undertakings, and
  - (ii) standing charges,

taking effect as from 18 March 2002 or thereafter; and

- (b) each and every-
  - (i) new charge for any new money transmission service,
  - (ii) new charge for any of the money transmission services listed in the Schedule to these undertakings, and
  - (iii) standing charge,

not levied before 18 March 2002.

### **Compliance with these undertakings**

12.- The Bank shall, at the request of the Director, furnish promptly to the Director such information as is reasonably necessary from time to time to enable him to monitor compliance with these undertakings.

13.- If the Director is of the reasonable view that the Bank has failed to comply with any of its obligations under these undertakings, he may from time to time, in respect of such obligations, give reasonable written directions to the Bank:

(a) to take such steps within the Bank's competence as may be specified or described in the directions for the purpose of carrying out or securing compliance with these undertakings; or

(b) to do or refrain from doing anything so specified or described which it is required by these undertakings to do or to refrain from doing,

and the Bank shall comply promptly with such written directions.

### **Additional clause for The Royal Bank of Scotland Group plc only**

14.- The Bank shall procure that both National Westminster Bank plc ('NatWest') and The Royal Bank of Scotland plc ('RBS') shall comply with these undertakings as if NatWest and RBS had each given these undertakings and as if the undertakings referred to NatWest and RBS respectively, instead of to the Bank.

## **SCHEDULE**

### **Money Transmission Services**

#### *Part I: Core money transmission services*

- Cash in over the counter or received by post
- Cash out over the counter
- Cheque deposits and cheque withdrawals
- The establishment of direct debit instructions (but excluding any direct debit services, other than auto-credit, relating to direct debits in respect of which the SME is the originator) and the payment of direct debits
- The establishment and payment of standing orders
- Non-auto credit services
- Auto-credit services (including deposits received via BACS and CHAPS)

- The transfer of funds between the business current account and other accounts denominated in sterling held by the customer with the Bank in the UK
- The provision of a debit card for the withdrawal of cash from a business current account at ATMs operated by the Bank
- The withdrawal of cash from a business current account using such a debit card

#### Part II: Non-core money transmission services

- The exchange of cash (sterling) for other denominations of cash (sterling)
- Dealing with stopped, returned, unpaid or recalled payments
- The provision of bank drafts
- Special presentations of cheques
- Withdrawals other than direct debits made via BACS and withdrawals made via CHAPS
- The provision of sweep (also known as auto transfers) and set-off facilities
- Copy statements
- Dealing with status enquiries
- The provision of audit letters

## 2) Behavioural Undertakings - Switching

**1. Title of report:** The supply of banking services by clearing banks to small and medium-sized enterprises (MMC – Cmnd 5319)

**2. Published:** 14 March 2002

**3. Orders:** N/A

**4. Date of original undertakings:** 27 October 2003 **Date of undertakings coming into force:** 31 of December 2003 **Press release:** DTI, 27 October 2003

**5. Companies giving undertakings:** AIB Group (UK) Plc, Bank of Ireland, Barclays Bank Plc, Clydesdale Bank Plc, HBOS Plc, HSBC Bank Plc, Lloyds TSB Bank Plc, Northern Bank Limited, The Royal Bank of Scotland Group Plc.

WHEREAS on 20 March 2000 the Secretary of State and the Chancellor referred to the Commission under sections 47(1),49(1) and 51(1) of the Act the matter of the existence or possible existence of a monopoly situation in relation to the supply of banking services by clearing banks to SMEs;

WHEREAS the Report sets out adverse public interest findings in connection with the supply of banking services to SMEs within the United Kingdom by certain clearing banks;

AND WHEREAS the Bank gave undertakings, accepted on 31 October 2002, to the Secretary of State and the Chancellor to take certain action to implement the remedies recommended by the Commission to address certain of the adverse effects identified in the Report;

AND WHEREAS pursuant to clause 10 of the undertakings accepted on 31 October 2002, the OFT has consulted with the Bank with a view to obtaining from it further undertakings to take certain action to implement the remedies recommended by the Commission to address certain of the adverse affects identified in the Report in relation to switching of business current accounts;

NOW THEREFORE the Bank gives the Secretary of State and the Chancellor under section 88 of the Act the undertakings below to take action requisite for the purpose of remedying certain of the adverse effects specified in the Report:

## Interpretation

1. - The interpretation Act 1978 shall apply to these undertakings as is does to Acts of Parliament.
2. - Compliance with these undertakings does not affect the duty on the Bank to comply with nor restrict the application of the Competition Act 1998 or any other law.
3. - In there undertakings:

'the Act' means the Fair Trading Act 1973;

'at the relevant time' means, for the purposes of clauses 6 and 7 below, the time immediately prior to the carrying out of the particular task identified;

'available balance' means the credit balance of monies, taking account of any interest, charges, or benefit accrued thereon which has yet to be credited or debited, as the case may be, to the account, held by an SME in a business current account which are cleared funds, but shall not include any monies which The Bank has agreed with the SME shall be withheld by The Bank, or in respect of which The Bank has a fixed charge or a right to a set off, or which The Bank is otherwise reasonably entitled to withhold, for example to meet any interest charges, uncleared cheques, any contingent liabilities (including bonds, guarantees and indemnities), or other forms of unmet or future exposure (for example, any accrued charges for money transmission or other account activity) of The Bank in relation to the SME;

'BACS' means the bulk inter-bank electronic funds transfer processing of direct debits, direct credits and standing orders in the UK, as carried out through BACS Limited;

'The Bank' means; either AIB Group (UK) Plc, Bank of Ireland, Barclays Bank Plc, Clydesdale Bank Plc, HBOS Plc, HSBC Bank Plc, Lloyds TSB Bank Plc, Northern Bank Limited, The Royal Bank of Scotland Group Plc

'business' means a business of any kind and includes sole traders, partnerships, limited liability partnerships, limited companies, other bodies corporate, unincorporated associations and clubs and charities;

'business current account' means a current account denominated in sterling intended for use for a business and excluding any current account (even it is used by the SME for the purpose of its business) which is offered by the Bank as a current account intended for personal use by a natural person;

'the Chancellor' means the Chancellor of the Exchequer;

'the Commission' means the Competition Commission;

'current account' means a current account denominated in sterling, under whatever name, including a current account maintained via the internet, telephone or post, features of which include access to money, the availability of a wide range of money transmission services, and may include the provision of credit through overdraft facilities, but excludes:

- (a) any credit card account;
- (b) any account designed for businesses, other than unincorporated associations, clubs and charities, to hold monies on behalf of third parties
- (c) any feeder account; and,
- (d) for the avoidance of doubt, any deposit account;

'deposit account' means an account denominated in sterling, under whatever name, designed for depositing money generally not required for immediate use, and which is generally interest bearing and which account may or may not impose terms as to the minimum or maximum amounts required or permitted to be deposited and as to the term for which sums should be deposited, and which may impose varying restrictions on the timing, the number of and the manner of making deposits and withdrawals, but for the avoidance of doubt any current account, any account on which the customer may borrow funds from the Bank, any

account where the monies are held specifically for the purposes of Treasury Money Market deals, or any account held within the Hong Kong Universal Banking System shall not be treated as a deposit account;

'feeder account' means an account-

- (a) which has as its only functions:
  - (i) the advancing by The Bank of funds to the SME pursuant to any agreement between the Bank and the SME, other than an agreement to provide an overdraft on a business current account;
  - (ii) the collection of funds and remittance of those funds towards discharge of the periodic interest payments and/or capital reductions or other repayments agreed under the terms of any such agreement; and
  - (iii) the adjustment of any balances between The Bank and the SME in respect of such agreement
- (b) in respect of which no cheque book or debit card is issued and in respect of which no credit is provided (save for any overdraft which The Bank advances to meet payments due by the SME under such agreement, for the sole purpose of avoiding an event of default under such agreement); and
- (c) against which no interest or charges are levied other than in respect of any overdraft of the kind described in paragraph (b) above;

'group' means (a) two or more businesses that are members of a 'group of interconnected bodies corporate' as defined in section 137(5) of the Act; and (b) any business which owns or controls one or more other businesses, together with those other businesses which such business owns or controls, and for these purposes control shall be deemed to arise where a business is owned as to 25% or more of its share capital or where 25% or more of the voting rights are held by another business or

jointly by two or more other businesses, except where such interests are held by public investment corporations, venture capital companies or institutional investors who exercise, whether individually or jointly, any rights they have in the business only to maintain the full value of those investments and not to determine directly or indirectly the competitive conduct of the business;

'new bank' means, in respect of an SME, the supplier of banking services to which such SME is switching and which has approved such SME application to set up a business current account

'OFT' means the Office of Fair Trading

'old bank' means, in respect of an SME, the supplier of banking services from which an SME is switching;

'overdraft' means an overdraft facility provided to an SME by The Bank;

'the Report' means the report of the Commission on the supply of banking services by clearing banks to small and medium-sized enterprises within the United Kingdom presented to Parliament in March 2002 (Cm 5319);

'The Secretary of State' means the Secretary of State for Trade and Industry;

'secured overdraft' means an overdraft on a business account provided to an SME by The Bank in respect of which The Bank holds security;

'security' means (except for the purposes of clause 13 below) any guarantee or indemnity, or any fixed or floating charge, mortgage, assignment or other charge under which assets, whether tangible or intangible, or any interests in them are held by or given to the Bank and to which or in respect of which The Bank has recourse (which includes, without limitation, the right to sell all or any of such assets or appoint an administrator or receiver of them to take any other action to enforce the obligations accepted) in satisfaction of the balance of any lending outstanding (including all costs and interest) which the SME fails for whatever reason to repay; but, for the avoidance of doubt, excludes any items held by or given to The Bank for safe-keeping;

'SME' (small or medium-sized enterprise) means a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) of no more than £25 million. For the purposes of applying this definition, the sales revenue of a business in any given year shall be determined as follows:

- (a) where The Bank has, or has provided to it by the SME, evidence showing to the reasonable satisfaction of The Bank the level of its sales revenues in its previous financial year, such evidence shall be treated as determinative of the sales revenues of the business in respect of the current year; or
- (b) if The Bank does not have, or does not have provided to it, evidence showing to the reasonable satisfaction of The Bank the level of an SME's sales revenues in its previous financial year, then the business may be categorised as an SME in respect of a given year if:
  - (i) it holds a business current account with The Bank which current account generated, in the previous complete year, either debit turnover in aggregate or credit turnover in aggregate (inclusive of VAT and other turnover-related taxes) of no more than £25 million (or, where the current account was opened during the previous year, such proportion of £25 million as shall equate to the proportion of the year for which the account was maintained); or
  - (ii) it is a business which opens a business current account with the Bank during the year, which business The Bank reasonably expects after discussion with the business, at the time the account is opened, to generate during the year sales revenues of no more than such proportion of £25 million as shall equate to the proportion of the year

remaining from the date when the account is opened.

And provided that, in deciding whether a business is an SME, The Bank shall be entitled to treat as a single business all businesses forming part of a group; and providing that, where a business or group holds business current accounts with The Bank and with another bank and has failed to respond to a request from The Bank to provide evidence of its or the group's annual sales revenues in a given financial year, The Bank shall be entitled, in deciding pursuant to subparagraph (i) above whether the business' or the group's debit or credit turnover on any current turnover exceeds £25 million, to take into account not only the debit or credit turnover on any current account maintained with The Bank but also The Bank's reasonable estimate of the debit or credit turnover on any current account maintained by such business or group with any such bank. For the avoidance of doubt the reference above to the 'debit turnover' shall mean the funds paid out of the business current account of the SME and 'credit turnover' shall mean the funds paid into such business current account

'substantial percentage' means a minimum of 80 per cent of the business current accounts being switched to or from the Bank as the case may be within each calendar year after these undertakings take effect;

'switching' means the transfer by an SME of the operations or functions associated with its business current account, and/or the holding of such account, with an old bank, whether or not such account with the old bank is closed, to a business current account with a new bank and 'switch' and 'switched' shall be constructed accordingly; provided that, if, when an SME requests The Bank perform any one or more of the tasks listed in the Schedule and does not indicate or has not indicated it is switching, The Bank asks the SME to indicate whether it is switching, the case shall be treated as one of switching (and these undertakings shall apply to the case) only if the SME indicates to The Bank that it is switching;

'working day' means a day which is not Saturday, Sunday or any other day on which The Bank is closed for business;

'year' means, unless otherwise stated, for the purpose of paragraph (a) of the definition of 'SME', the latest financial year of the business concerned and, for the purpose of paragraph (b) of the definition of 'SME', a year running from 1 January to 31 December.

4. Subject to clauses 1 and 3 above, all expressions used in these undertakings shall be interpreted in accordance with the Business Banking Code (March 2003) and with generally accepted banking practice.

### **Application**

5. - These undertakings shall apply-

- (a) in relation to the supply of banking services in [...] <sup>118</sup> by The Bank to SMEs; and
- (b) with effect from no later than 31 December 2003.

### **Switching targets where there is no secured overdraft**

6.- In respect of switches of business current accounts which do not have a secured overdraft, where The Bank is in the position of the old bank, it shall, in respect of a substantial percentage of such switches, successfully complete the tasks numbered 1,3 and-

- (a) where the account has a credit or zero balance at the relevant time, 5, or
- (b) where the account has a debit balance at the relevant time, 7

in the table shown in the Schedule to these undertakings within the targets specified in column 4 of such table in relation to such tasks.

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<sup>118</sup> Barclays Bank, HSBC Bank, Royal Bank of Scotland (English branches), National Westminster Bank and Lloyds TSB in England and Wales; AIB Group, Bank of Ireland and Northern Bank, and Ulster Bank in Northern Ireland. Clydesdale, HBOS and the Royal Bank of Scotland (Scottish branches) in Scotland.

7.- In respect of switches of business current accounts which do not have a secured overdraft, where The Bank is in the position of the new bank, it shall, in respect of a substantial percentage of such switches, successfully complete the tasks numbered 2 and-

- (a) where the account with the old bank has a credit balance at the relevant time 4, or
- (c) where the account with the old bank has a debit balance at the relevant time, 6

in the table shown in the Schedule to these undertakings within the targets specified in column 4 of such table in relation to such tasks; provided that, where the bank has agreed to provide the SME switching with a secured overdraft, the new bank shall only be required to perform such task within such target-

- (i) where such secured overdraft needs to be available to enable the SME to operate the account, once the agreed security has been put in place; or
- (ii) otherwise, where agreed with the SME, for the purpose of providing an operational business current account without (until such time as the agreed security has been put in place) an overdraft.

### **Switching targets where secured overdraft is involved**

8. - In respect of switches of business current accounts which have a secured overdraft, where The Bank is in the position of the old bank, it shall, in respect of a substantial percentage of such switches, successfully complete the tasks numbered 1 and 3 in the table shown in the Schedule to these undertakings within the targets specified in column 4 of such table in relation to such tasks.

9. - In respect of switches of business current accounts which have a secured overdraft, where the bank is in the position of the new bank, it shall, in respect of a substantial percentage of such switches, successfully complete the task numbered 2 in the table shown in column 4 of such table in relation to such task; provided that, where The Bank has agreed to provide the SME switching

with a secured overdraft, the new bank shall only be required to perform such task within such target-

- (a) where such secured overdraft needs to be available to enable the SME to operate the account, once the agreed security has been put into place; or
- (b) otherwise, where agreed with the SME, for the purpose of providing an operational business account without (until such time as the agreed security has been put in place) an overdraft

### **Necessary information, etc., closing accounts and third parties**

10. The targets to be met by The Bank in accordance with clauses 6 to 9 above shall only apply once The Bank, whether acting as the old bank or the new bank, has been provided with adequate authorisation, which the bank may require to be in writing, from the SME and all necessary and/or required information (for example, account details, outstanding balance and method of payment) and materials (for example, unused cheques and payment cards) to enable it to deal with the relevant request.

11. The target to be met by The Bank in respect of closing accounts under the tasks numbered 5 and 7 in the table shown in the Schedule to these undertakings shall not apply where The Bank has, either by agreement with the SME or where it is otherwise reasonably entitled to do so, withheld monies to meet any uncleared cheques and any contingent liabilities (including bonds, guarantees and indemnities) and other forms of unmet or future exposure of The Bank in relation to the SME.

12. The Bank shall not be considered to have failed to meet a switching target incumbent upon it as either the old bank or the new bank if the cause of the target not being met, whether wholly or partly, is the act or omission on the part of any person other than The Bank; provided that The Bank shall remain liable for the failure to meet such switching target where such act or omission is on the part of a third party supplier that The Bank has generally, in respect of switches, sub-contracted to perform on its behalf the whole or part of the task to which the switching targets applies.

## **Communication**

13. Throughout each switch in which The Bank is in the position of either the old bank or the new bank, The Bank shall use the most expedient means of communication (including first class post, telephone or electronic means) available to it at the relevant time with the other supplier of banking services to SMEs involved; provided that such means of communication shall be appropriate and proportionate, taking into account the confidential nature of any communication and the level of security offered by the different means of communication available.

## **Failure to meet switching targets**

14. - Subject to clause 12 above, The Bank shall establish a scheme under which an SME can apply (such application may be required in writing) for a payment from The Bank for a failure by The Bank, in respect of the SME's switch from The Bank, to meet any one or more of the relevant targets of the old bank specified in column 4 of the table shown in the Schedule to these undertakings.

15.- By December 31 2003, and at the time any subsequent change in the scheme to which the clause takes account, The Bank shall publish on its website and make available in its branches details of the scheme established by it in accordance with clause 14 above.

16. - Where The Bank, acting as either the old bank or the new bank in respect of a particular switch, imposes any charge (including interest) on the SME customer concerned in circumstances where such charge has only been incurred because of a failure on the part of The Bank to meet a relevant switching target, it shall cancel such charge and, where the SME has already paid any such charge, reimburse the SME with the total amount of such charge.

## **Publication of performance objectives**

17. - The Bank shall publish details of each of the targets which is applicable to it in its capacity as the old bank, or as the case may be, the new bank in accordance with the targets specified in column 4 of the table shown in the

schedule to these undertakings, in literature which is available to SME's explaining the process of switching to or from The Bank.

18. The Bank shall compile information showing its performance objectives in relation to successfully completing all of the old bank's targets and, as the case may be, all of the new bank's targets, as specified in column 4 of the table shown in the schedule to these undertakings, and its success in achieving such performance objectives, measured either by exception based reporting, sampling, or any other appropriate means.

19. - The information to be compiled under clause 18 above shall be compiled every six months and published on The Bank's website.

## Compliance with these Undertakings

20. - The Bank shall at the request of the OFT, furnish promptly to the OFT such information as is reasonably necessary from time to time to enable it to monitor these undertakings.

21.- If the OFT is of the reasonable view that The Bank has failed to comply with any of it's obligations under these undertakings, it may from time to time, in respect of such obligations, give reasonable written directions to The Bank:

(a) to take such steps within the Bank's competence as may be specified or described in the directions for the purpose of carrying out or securing compliance with these undertakings; or

(b) to do or refrain from doing anything so specified or described which it might be required by these undertakings to do or refrain from doing.

22. - The Bank shall provide to the OFT the name and contact details of a person within the bank with whom the OFT may liaise in relation to the Bank's compliance with and obligations under these undertakings. Such person shall have access to all relevant information relating to the Bank's compliance with and obligations under these undertakings. The Bank shall inform the OFT of any change in the identity or contact details of such person.

## SCHEDULE

### Switching targets

<b>Column 1 Task Number</b>	<b>Column 2 Tasks of old bank</b>	<b>Column 3 Tasks of new bank</b>	<b>Column 4 Target</b>
1.	Forward new bank, and/or SME as requested, details of SME's existing direct debits('DDs')		By close of business on the second working day following the working day of receipt of the

	and standing orders ('SOs') following receipt of request to do so from SME or new bank(authorised by SME).		request.
2.		Following receipt of details of regular payments (DDs and SOs) from old bank or SME set up, in accordance with any instructions from SME, new SO's and DD's, in relation to the latter by sending a transfer advice to DD originators advising them of details of both the old bank and the new bank.	By close of business on the third working day following the working day of receipt of details of such regular payments or, where a later date for action is specified by, or agreed with, SME, by such date.
3.	Action request by new bank (authorised by SME to cancel DDs and SOs.		By close of business on the second working day following the working day of receipt of the request or, where a later date for action is specified by, or agreed with, new bank or SME, by such later date
4.		Where applicable and requested by SME, send request to old	By close of business on the second working day

		bank to transfer it to the available balance remaining in SME's account with old bank.	following the working day of receipt of the request to do so by SME or, where a later target date for the transfer has been agreed with SME, in sufficient time to enable the transfer to take place by such later date.
5.	Where applicable, action request by new bank (authorised by SME) or by SME to transfer, in the manner requested, the available balance remaining in SME's account with it to new bank or to SME. If requested by SME or by new bank (authorised by SME), close account.		By close of business on the third working day following the working day of receipt of the request.  An additional working day is applicable where the SME or new bank (authorised by SME) has requested closure of the account (i.e. a total of four working days to close the account whether it has a credit or zero balance).
6.		Where applicable, and provided SME has put new bank in a position to do so, action request to transfer to old bank funds, in accordance	By close of business on the second working day following the working day of receipt of the request or, where a later date for the

		with SME's instructions, to clear balance of SME's overdraft (including interest and costs) remaining in SME's account with old bank	transfer has been agreed with SME, by such later date.
7.	Where applicable, on receipt of sufficient cleared funds from new bank or SME to clear balance of SME's overdraft (including interests and costs), level off SME's account (showing the balance as zero) and, if, in addition, requested by SME or new bank (authorised by SME), close account		<p>Within 3 working days following the working day of receipt of the funds from SME or new bank.</p> <p>An additional working day is applicable where the SME or new bank (authorised by SME) has requested closure of the account.</p>

### 3) Behavioural Undertakings - others

**1. Title of report:** The supply of banking services by clearing banks to small and medium-sized enterprises (MMC – Cmnd 5319)

**2. Published:** 14 March 2002

**3. Orders:** N/A

**4. Date of original undertakings:** 31 October 2002 **Date of undertakings coming into force:** See date that undertakings came into effect table<sup>119</sup> **Press release:** DTI, 31 October 2002

**5. Companies giving undertakings:** AIB Group (UK) Plc, Bank of Ireland, Barclays Bank Plc, Clydesdale Bank Plc, HBOS Plc, HSBC Bank Plc, Lloyds TSB Bank Plc, Northern Bank Ltd and The Royal Bank of Scotland Group Plc

#### 6. Undertakings:

WHEREAS on 20 March 2000 the Secretary of State and the chancellor referred to the Commission under section 47(1), 49(1) and 51(1) of the Act the matter of the existence or possible existence of a monopoly situation in relation to the supply of banking services by clearing banks to SMEs;

WHEREAS the Report sets out adverse public interest findings in connection with the supply of banking services to SMEs within the United Kingdom by certain clearing banks;

AND WHEREAS pursuant to a request by the Secretary of the State and the Chancellor, the Director has consulted with the Bank with a view to obtaining from it undertakings to take certain action to implement the remedies recommended by the Commission to address certain of the adverse effects identified in the Report;

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<sup>119</sup> Available at: <http://www.ofc.gov.uk/Business/Register+of+Orders/monopoly.htm>. It should be noted that different clauses of the undertakings came into effect on different dates (see clause 5 of the undertakings for details).

NOW THEREFORE the Bank gives the Secretary of the State and the Chancellor under section 88 of the Act the undertakings below to take action requisite for the purpose of remedying certain of the adverse effects specified in the Report:

### **Interpretation**

- 1.- The Interpretation Act 1978 shall apply to these undertakings as it does to Acts of Parliament.
- 2.- Compliance with these undertakings does not affect the duty on the Bank to comply with not restrict the application of:
  - a. The Competition Act 1998: or
  - b. Any other law.

3(1).- In these undertakings;

'the Act' means the Fair Trading Act 1973;

'BACS' means the bulk inter-bank electronic funds transfer processing of direct debits, direct credits and standing orders in the UK, as carried out through BACS Limited;

'the Bank' means either AIB Group (UK) Plc, Bank of Ireland, Barclays Bank Plc, Clydesdale Bank Plc, HBOS Plc, HSBC Bank Plc, Lloyds TSB Bank Plc, Northern Bank Limited, The Royal Bank of Scotland Group Plc;

'business' means a business of any kind and includes sole traders, partnerships, limited liability partnerships, limited companies, other bodies corporate, unincorporated associations and clubs and charities;

'business current account', 'business deposit account' and 'business loan' means respectively, a current account, deposit, deposit account or loan denominated in sterling intended for use by businesses and excluding any current account, deposit account or loan (even if used by the SME for the purpose of its business) which is offered by the Bank as a current account, deposit account or loan intended for personal use by a natural person;

'the Chancellor' means the Chancellor of the Exchequer;

'CHAPS' or 'Clearing House Automated Payments System' means the electronic transfer system for real-time gross settlement, same-day value, inter-bank payments in the UK, as operated by CHAPS Clearing Company Limited;

'commercial mortgage' means a commercial loan used to finance or re-finance the acquisition by an SME of property, plant or equipment and which is secured over such property, plant or equipment as the case maybe;

'the Commission' means the Competition Commission;

'credit history' means a statement of an SME customer's credit performance over the most recent 12 month period (or over such lesser period as it shall have maintained a business current account with the Bank), where the most recent month is the last month for which compilation of the relevant information has been completed, which , in particular, enables an SME to demonstrate to any potential supplier of banking services the extent to which is has adhered to facility limits in respect of loans and overdrafts and which, unless otherwise agreed in writing by the Director that a particular category of information may be omitted until a date which is to be no later than 31 October 2003, contains, at least, the information identified in the credit history shown, by way of example, in Schedule 1 to these undertakings;

'current account' means a current account denominated in sterling, under whatever name, including a current account maintained via the internet, telephone or post, features of which include instant access to money and the availability of a wide range of money transmission services and may include the provision of credit through overdraft facilities, but excludes:

- a. any credit card account;
- b. any account designed for businesses, other than unincorporated associations, clubs and charities to hold monies on behalf of third parties;

- c. any feeder account; and,
- d. for the avoidance of doubt, any deposit account;

'the date of the Report' means 14 March 2002;

'deposit account' means an account denominated in sterling, under whatever name, designed for depositing money generally not required for immediate use, and which is generally interest bearing and which account may or may not impose terms as to the minimum or maximum amounts required or permitted to be deposited and as to the term for which such sums should be deposited, and which may impose varying restrictions on the timing of, the number of and the manner of making deposits withdrawals, but for the avoidance of doubt any current account, any account on which the customer may borrow funds from the Bank, any account where the monies are held specifically for the purposes of Treasury Money Market deals, or any account held within the Hong Kong Universal Banking System shall not be treated as a deposit account;

'the Director' means the Director General of Fair Trading;

'feeder account' means an account –

- a. which has sole functions;
  - (i). the advancing by the Bank of funds to the SME pursuant to any loan agreement between the Bank and the SME, remittance of those funds from an associated business loan account;
  - (ii). the collection of funds and remittance of those funds to an associated business loan account towards discharge of the periodic interest payments and/or capital reductions agreed under the terms of the associated business loan; and
  - (iii). the adjustment of any balances between the Bank and the SME in respect of such business loan;
- b. in respect of which no cheque book or debit card is issued and in respect of which no credit is provided (save for any overdraft which

the Bank advances to meet payments due by the SME under any business loan agreement, for the sole purpose of avoiding an event of default under such loan agreement); and

- c. against which no interest or charges are levied other than in respect of any overdraft of the kind described in paragraph (b) above;

'group' means (a) two or more businesses that are members of a 'group of interconnected bodies corporate' as defined in section 137(5) of the Act; and (b) any business which owns or controls one or more other businesses, together with those other businesses which such business owns or controls, and for these purposes control shall be deemed to arise where a business is owned as to 25% or more of its share capital or where 25 % or more of the voting rights are held by another business jointly by two or more other businesses, except where such interests are held by public investment corporations, venture capital companies or institutional investors who exercise, whether individually or jointly, any rights they have in the business only to maintain the full value of those investments and not to determine directly or indirectly the competitive conduct of the business;

'loan' means a loan or lending facility denominated in sterling other than: (a) an overdraft or overdraft facility; (b) a factoring arrangement, invoice discounting arrangement, trade finance arrangement, asset finance arrangement, hire purchase arrangement or leasing arrangement; (c) a commercial mortgage; (d) credit provided through credit cards; and (e) foreign currency lending;

'money transmission services' means services relating to the transfer of money to or from a business current account and relating only to transactions exclusively in sterling, whether by the SME or a third party, (whether on paper or electronically or by any other means) and includes those services which are listed in Schedule 2 to these undertakings;

'the Report' means the report of the Commission on the supply of banking services by clearing banks to small and medium-sized enterprises within the United Kingdom presented to Parliament in March 2002 (Cm 5319);

'the Secretary of the State' means the Secretary of the State for Trade and Industry;

'short-term deposit account' means a sterling business deposit account from which the customer may withdraw funds, without paying any penalty (including loss of interest), on the giving of 'no more than 30 days' notice or which has a term of no more than 30 days;

'SME' (small or medium-sized enterprise) means a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) of no more than £25 million. For the purposes of applying this definition, the sales revenues of a business in any given year shall be determined as follows:

- a. Where the Bank has, or has provided to it by the SME, evidence showing to the reasonable satisfaction of the Bank the level of its sales revenues to the previous year, such evidence shall be treated as determinative of the sales revenues of the business in respect of the current year; or
- b. If the Bank does not have, or does not have provided to it, evidence showing to the reasonable satisfaction of the Bank the level of an SME's sales revenues in its previous financial year, then the business may be categorised as an SME in respect of a given year if:
  - i. It holds a business current account with the Bank which current account generated in aggregate, in the previous complete year, either debit turnover or credit turnover (inclusive of VAT and other turnover-related taxes) of no more than £25 million (or, where the current account was opened during the previous year, such proportion of £25 million as shall equate to the proportion of the year for which the account was maintained); or
  - ii. it is a business which opens a business current account with the Bank during the year, which business the Bank reasonably expects after discussion with the business, at the time the account is opened, to generate during the year sales revenues of no more than such proportion of £25 million as shall equate to the

proportion of the year remaining from the date when the account is opened;

and provided that in deciding whether a business is an SME, the Bank shall be entitled to treat as a single business all businesses forming part of a group; and provided that, where a business or group holds business current accounts with the Bank and with another bank and has failed to respond to a request from the Bank to provide evidence of its or the group's annual sales revenues in a given financial year, the Bank shall be entitled, in deciding pursuant to subparagraph (i) above whether the business' or the group's debit or credit turnover exceeds £25 million, to take into account not only the debit or credit turnover on any current account maintained with the Bank but also the Bank's reasonable estimate of the debit or credit turnover on any current account maintained by such business or group with any other such bank. For the avoidance of doubt the reference above to 'debit turnover' shall mean the funds paid out of the business current account of the SME and 'credit turnover' shall mean the funds paid into such business current account.

'switching' means the transfer by an SME of its business current account to another supplier of banking services to SMEs and 'switch', 'switching' and 'switched' shall be construed accordingly;

'technical constraint' means a constraint arising from the Bank's computer, accounting operating systems and existing at the date of the giving of these undertakings which makes the holding of a current account with the Bank a prerequisite for obtaining, maintaining or servicing a business loan or a business deposit account from it;

'working day' means a day which is not Saturday, Sunday or any other day which the Bank is closed for business;

'year' means, unless otherwise stated, for the purpose of paragraph (a) of the definition of 'SME', the latest financial year of the business concerned and, for the purpose of paragraph (b) of the definition of 'SME', a year running from 1 January to 31 December.

- (2) Nothing in clauses 6, 8 and 25 below shall require the Bank to disclose any confidential information to any of the other banks listed in Schedule 3 to these undertakings.
4. Subject to clauses 1 and 3 above, all expressions used in these undertakings shall be interpreted in accordance with the Business Banking Code (March 2002) and with generally accepted banking practice

### **Application**

5(1). - These undertakings shall apply –

- a. In relation to the supply of banking services in [...] <sup>120</sup> by the bank to SMEs; and
- b. Except as otherwise provided, with effect from the day after the day of acceptance of these undertakings by the Secretary of the State and the Chancellor.

(2) Clauses 12, 13, 15 and 24 below shall apply with effect from 1 January 2003.

### **Closing or Switching Accounts**

- 6.- The Bank shall use all reasonable endeavours to co-operate with the other banks listed in Schedule 3 to these undertakings to:
- a. investigate whether there are any measures which it might be reasonable and proportionate for the Bank to implement, either alone or with such other banks, which would –

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<sup>120</sup> Barclays Bank, HSBC Bank, Royal Bank of Scotland (English branches), National Westminster Bank and Lloyds TSB in England and Wales; AIB Group, Bank of Ireland and Northern Bank, and Ulster Bank in Northern Ireland. Clydesdale, HBOS and the Royal Bank of Scotland (Scottish branches) in Scotland.

- (i) facilitate the transfer of direct debit arrangements from one bank to another when an SME chooses to switch from one bank to another; and
  - (ii) assist in resolving the problem of delays in such transfers which result from the need for the originator of direct debits to redirect direct debits from one bank to another; and
- b. examine such measures as have been identified and, with 12 months of the date of the Report, produce and publish a report on the investigation and the examination of any such measures, or, if no such measures have been identified, describing the investigations made and giving the reasons why no such measures were identified.

7. The investigation to be carried out in accordance with clause 6 above shall be carried out in accordance with terms of reference approved by the Director.

8.- The bank shall use all reasonable endeavours to co-operate with the other banks listed in Schedule 3 to these undertakings to:

- a. investigate whether there are any measures which it might be reasonable and proportionate for the Bank to implement, either alone or with such other banks, to allow more rapid:
  - (i) release by the Bank of any security given to the Bank by an SME which chooses to switch; and
  - (ii) transfer by the Bank of such security as it may have taken from an SME to another supplier of banking services to whom the SME chooses to switch; and
- b. examine such measures as have been identified and, with 12 months of the date of the report, produce and publish a report on the investigations and the examinations of any such measures, or, if no such measures have been identified, describing the investigations made and giving the reasons why no such measures were identified.

9. The investigation to be carried out in accordance with clause 8 above shall be carried out in accordance with terms of reference approved by the Director.

10- As soon as reasonably practicable after both of the reports required by clauses 6 and 8 above have been published, the Bank shall enter into discussions with the Director with a view to agreeing:

- a. reasonable and proportionate timescales (which may be different depending on whether a business current account is being switched to or from the Bank, whether borrowing is or is not involved and whether any borrowing is secured or unsecured) within which a substantial percentage of switching is to be completed as well as a target for the percentage of such switching which should be completed within the agreed timescales;
- b. circumstances, which are in the control of the banks, in which compensation will be payable to SMEs switching to or from the Bank whose accounts have not been successfully switched within the agreed timescales, the identity of the organisation liable to pay such compensation and the manner of such compensation; and
- c. publication of the Bank's performance objectives in relation to the agreed timescales and its efficiency in achieving them.

11.- The Bank shall not levy any charges in relation to the closing or switching of any business current account held by an SME where such charges are levied only when such accounts are closed or switched.

12. Where a new loan facility is to be provided by the supplier of banking services to which any of the Bank's SME customers is switching a business current account held with the Bank, the Bank shall not levy any charges in relation to the early termination of any business loan held by that SME at the same time as it closes or switches such business current account where such charges:

- a. are levied only when such loans are subject to early termination by the SME; and

b. are a form of penalty for the early termination of business loans.

13.- Whenever the Bank levies, or seeks to levy, on any SME any charges on, or relating to, the early termination of business loans, when terminated at the same time as that SME closes or switches a business current account held with the bank, it shall provide that SME with details on writing of:

- a. each different type of charge including, where these charges relate to the recovery of fees or costs incurred, or to be incurred, by the Bank details of each such fee or cost;
- b. the amount of each such type of charge; and
- c. when requested by an SME, a summary of the basis on which the calculations of any such fees or costs have been determined.

For the avoidance of doubt, nothing in this clause shall require the Bank to disclose any of its confidential cost information to an SME.

14.- By 1 January 2003, and within one month of any subsequent change in the Bank's policy in relation to the matters to which this clause relates, the Bank shall publish, in a manner approved by the Director, its general policy in relation to its willingness to pay, or not to pay (as the case may be), in whole or in part, legal and valuation charges arising from the transfer of security to the Bank when an SME switches to it; and if its general policy is that it is willing to make any such payment:

- a. the circumstances in which it is willing to do so; and
- b. any limits on the amounts it is willing to pay.

15.- Subject to clause 16 below, the Bank shall on request (which the Bank may require to be in writing) from any of its existing SME customers provide, free of charge, an up-to-date credit history to such suppliers of banking services within the United Kingdom as the SME shall nominate and supply a copy of such credit history to the SME. For requests received on or before 31 October 2003, all such credit histories shall be provided within 7 working days from, but not including, the date of receipt of the request. For requests received on or after 1

November 2003, all such credit histories shall be provided within 5 working days from, but not including, the date of receipt of the request.

16.- The Bank shall not be required to provide a credit history, in accordance with clause 15 above, free of charge in response to more than two requests from an SME within any 12 month period; provided that there shall be no limit on the number of suppliers of banking services to which a credit history is to be provided free of charge in response to a particular request by an SME; and provided that a request for a credit history which provides information as at the same date as a credit history provided earlier shall not be treated as a separate request.

### **Limitation on bundling**

17(1).- Subject to clause 18 below, the Bank shall not directly or indirectly require, agree (other than in respect of integrated products) or threaten to require, as a condition of the granting, maintaining or servicing of any business loan to, or the opening, maintaining or servicing of any business deposit account for, any SME that SME should open or maintain any business current account with the Bank.

(2) For the purpose of paragraph (1) above, 'integrated product' means a product (offered via any channel) made up of different types of business accounts and/or business loans which is offered as a single product to SMEs, which is generally available to SMEs and which is offered as an alternative to having a number of separate business accounts and/or business loans.

18(1).- Clause 17 above shall not apply to the extent that the holding by the SME of any business current account with the Bank as a condition of the granting of a business loan or a business deposit account is required –

- a. in order to comply with any requirement of law having effect in the United Kingdom; or
- b. subject to clause 19 below, by virtue of any technical constraint; or
- c. in respect of any business loan to any particular SME, to enable the Bank to take effectively and enjoy a fixed charge over the book and other debts of that SME.

(2).- For the avoidance of doubt, nothing in clause 17 above shall preclude the Bank from offering incentives to any SME to agree to open a business current account with the Bank when that SME is granted a business loan by, or opens a business deposit account with, the Bank; such incentives may include levying lower charges (including a lower rate of interest) for the provision of a business loan to an SME which chooses to maintain its main business current account with the Bank than the Bank would charge for a similar business loan to the same SME for so long as that SME chose not to maintain its main business current account with the Bank to the extent that the difference reflects the Bank's reasonable assessment of the different credit risk arising in the two situations.

19.- Where the holding by the SME of any current account with the Bank as a condition of the granting of a business loan or a business deposit account is required due to a technical constraint, the Bank shall –

- a. use all reasonable endeavours to overcome or remedy such technical constraint within 12 months of the publication of the Report and notify the Director as soon as it has overcome or remedied it; and
- b. until such time as the technical constraint has been so overcome or remedied, specify clearly in the terms and conditions of such loan or deposit account that the requirement to hold a current account is a temporary requirement applying only as a result of a technical constraint and specify, in summary, what that technical constraint is; and
- c. not levy any direct or indirect charges for transferring funds, in either direction, between such loan or deposit account held with the Bank and such current account.

20.- The Bank shall notify the Director of all technical constraints of which it is aware within 10 working days from, and including, the day after the day of acceptance of these undertakings by the Secretary of the State and the Chancellor.

## **Price information**

21.- By 1 January 2003, and following any subsequent change in the information to which this clause relates, the Bank shall compile information showing:

- a. the Bank's standard tariff charges payable by SMEs for the money transmission services listed in Schedule 2 to these undertakings;
- b. standard rates of interest paid by it on business current accounts held by SMEs; and
- c. standard rates of interest paid by it on short-term deposit accounts held by SMEs.

22.- The information to be compiled under clause 21 above shall, unless otherwise state, be:

- a. compiled within a time and in a form approved by the Director; and
- b. published within a time and in a manner approved by the Director; and
- c. made available to the public without charge by the Bank.

23.- The Bank shall ensure that the availability of the information compiled in accordance with clause 21 above is brought to the attention of its SME customers. The steps to be taken, and the time and manner in which these are taken, by the Bank to draw the availability of such information to the attention of such customers shall be approved by the Director.

24(1).- The Bank shall either –

- (a) on the first occasion in any charging period that any SME incurs an unauthorised overdraft on a business current account and also incurs any charge, or a higher rate of interest, specifically for incurring such an unauthorised overdraft, inform that SME –
  - (i) that it has incurred such a charge or higher rate of interest; and

- (ii) in respect of tariff based charges, of the amount of that charge and, where a higher rate of interest is applied, the higher rate applied; or
- (b) where an SME incurs an unauthorised overdraft, specify on that SME's statements for that account (or in a separate notice which accompanies that SME's statement for that account) or in a pre-notification notice:
  - (i) in a case where a charge (excluding interest and charges for items returned unpaid by the Bank) has been , or is to be, levied specifically for the incurring or use of an unauthorised overdraft, the amount of any such charge, in total, levied, or to be levied, in respect of the charging period in question;
  - (ii) in a case where interest has been or is to be, levied in respect of the overdraft, the total amount of interest charged, or to be charged, for the charging period in question (where part only of an overdraft is unauthorised it shall be necessary to show separately the amount of interest charged, or to be charged, in respect of the unauthorised part of the overdraft); and
  - (iii) in a case where a higher rate of interest applies to any part of the overdraft as a result of its being unauthorised (in whole or in part), the higher rate applied and the amount of the overdraft above which such higher rate of interest applies.

Provided that, for the purpose of complying with sub-paragraph (iii), where the whole of an overdraft is unauthorised and is subject to interest at a rate charged on unauthorised overdrafts, then it shall be sufficient for the Bank to show, on each relevant statement of account (or in a separate note accompanying each such statement) or pre-notification notice, the rate of interest applicable to such unauthorised overdraft and the total amount of interest charged.

- (2) For the purpose of paragraph (1) above, 'pre-notification notice' means a notice of interest and/or charges incurred during a charging period which

are to be deducted from an SME's business current account and which is given at least 14 days before any such deductions are made.

## **Investigation of the feasibility of sharing branch facilities**

25.- Subject to clause 26 below, the Bank shall use all reasonable endeavours to co-operate with the other banks listed in Schedule 3 to these undertakings to –

- a. Carry out an investigation into the feasibility, costs and associated benefits of participation by the Bank and the other banking groups listed in Schedule 3 in a United Kingdom wide scheme in which the Bank and such banking groups are required to enter into arrangements (not necessarily reciprocal) with other suppliers of banking services to SMEs without a local branch presence in a particular area for use of branches on fair, reasonable and non-discriminatory terms which have been approved by the Director; and
- b. within 12 months of the date of the Report, produce and publish a report recording the results of such investigation.

26.- The investigation to be carried out in accordance with clause 25 above shall be carried out in accordance with terms of reference approved by the Director.

## **Compliance with these undertakings**

27.- The Bank shall, at the request of the Director, furnish promptly to the Director such information as is reasonably necessary from time to time to enable him to monitor these undertakings.

28.- If the Director is of the reasonable view that the Bank has failed to comply with any of its obligations under these undertakings, he may from time to time, in respect of such obligations, give reasonable written directions to the Bank:

- a. to take such steps within the Bank's competence as may be specified or described in the directions for the purpose of carrying out or securing compliance with these undertakings; or

- b. to do or refrain from doing anything so specified or described which it might be required by these undertakings to do or to refrain from doing.

29.- The Bank shall provide to the Director the name and contact details of a person within the Bank with whom the Director may liaise in relation the Bank's compliance with and obligations under –

- a. these undertakings, and
- b. the undertakings given by the Bank to, and accepted on 17 July 2002, by, the Secretary of State and the Chancellor.<sup>121</sup>

Such person shall have access to all relevant information relating to the Bank's compliance with and obligations under both such undertakings. The Bank shall inform the Director of any change in the identity or contact details of such person.

**Additional clause for HBOS plc only**

29.- The bank shall procure that, to the extent that these undertakings apply to and require any act or omission by Bank of Scotland, Bank of Scotland shall comply with these undertakings as it if had given these undertakings and as if these undertakings referred where appropriate to the Bank of Scotland instead of the Bank.

**Additional clause for The Royal Bank of Scotland group plc only**

29.- The Bank shall procure that, to the extend that these undertakings apply to and require any act or omission by any one or more Bank subsidiary, that Bank subsidiary shall comply with these undertakings as it if had given these

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<sup>121</sup> Barclays Bank plc, HSBC Bank plc, Lloyds TSB Bank plc and The Royal Bank of Scotland Group plc only

undertakings and as if these undertakings referred where appropriate to Bank subsidiary, instead of the Bank.

## SCHEDULE 1

### Credit History

Business Name: ..... [legal Form].....

Business Address:.....

Customer Since:.....

Facility agreements existing with (Name of Bank)

#### LOAN AGREEMENTS

Facility Type	Initial Facility Amount £s	Date Drawn	Amount Outstanding £s	Repayment £s	Repayment Frequency	Maturity Date	Security (Y or N)	Have payments Been made as agreed? * (Y or N)

\* Over the most recent 12 month period.

\* \* Indicate whether including /excluding transfers between accounts maintained by the same SME

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OVERDRAFT AGREEMENTS (other than for main current account)		
Expiry Date	Limit £s	Security (Y or N)

MAIN CURRENT ACCOUNT ONLY:

Sorting Code:

Account No:

Month	Min. Ledger Bal. £s	Max. Ledger Bal. £s	Av Ledger Bal. £s	Credit Turnover**	Overdraft Limit £s
Jan XX					
Feb XX					
Mar XX					
Apr XX					

\* Over the most recent 12 month period.

\*\* Indicate whether including /excluding transfers between accounts maintained by the same SME

May XX					
Jun XX					
Jul XX					
Aug XX					
Sep XX					
Oct XX					
Nov XX					
Dec XX					

Have any cheques, standing orders or direct debits been returned unpaid for lack of funds on the main Current Account in the last 12 months ? YES / NO

If yes, how many? .....

\* Over the most recent 12 month period.

\* Indicate whether including /excluding transfers between accounts maintained by the same SME

## **SCHEDULE 2**

### **Money Transmission Services**

- Cash on over the counter or received by post
- Cash out over the counter
- Cheques deposits and cheques withdrawals
- The establishment of direct debit instructions (but excluding any direct debit services, other than auto-credit, relating to direct debits in respect of which the SME is the originator) and the payment of direct debits
- The establishment and payment of standing orders
- Non-auto credit services
- Auto-credit services (including deposits received via BACS and CHAPS)
- The transfer of funds between the business current account and other accounts denominated in sterling held by the customer with the Bank in the UK
- The provision of a debit card for the withdrawal of cash from a business current account at ATMs operated by the Bank
- The withdrawal of cash from a business current account using such a debit card
- The exchange of cash (sterling) for other denominations of cash (sterling)
- Dealing with stopped, returned, unpaid or recalled payments
- The provision of bank drafts
- Special presentation of cheques

- Withdrawals other than direct debits made via BACS and withdrawals made via CHAPS
- The provision of sweep (also known as auto transfers) and set-off facilities
- Copy statements
- Dealing with status enquiries
- The provision of audit letters

### SCHEDULE 3

AIB Group (UK) plc, in respect of First Trust Bank's SME business and branches in Northern Ireland.

Bank of Ireland, in respect of its SME business and branches in Northern Ireland.

Barclays Bank plc, in respect of its SME business and branches in England and Wales.

Clydesdale Bank (a subsidiary of National Australia Bank Ltd), in respect of its SME business and branches in Scotland.

HBOS plc, in respect of Bank of Scotland's SME business and branches in Scotland.

HSBC Bank plc, in respect of its SME business and branches in England and Wales.

Northern Bank Limited (a subsidiary of National Australia Bank Ltd), in respect of its SME business and branches in Northern Ireland.

The Royal Bank of Scotland Group PLC, in respect of The Royal Bank of Scotland Group plc's SME business and branches in England and Wales and Scotland, National Westminster Bank plc's SME business and branches in England and Wales and Ulster bank Ltd's SME business and branches in Northern Ireland.

## **D LETTER TO THE COMPETITION COMMISSION OF 14 MAY 2007 CLARIFYING THE OFT'S FINDINGS AND RECOMMENDATIONS**

Dear [...]

Thank you for your letter of 20 April setting out your requests for additional information in relation to the OFT's review of SME banking undertakings, following the Remedies Standing Group (RSG) meeting on 26 March. We are happy to clarify the evidence gathered during our review where this is not clear in our advice document.

Before addressing your specific questions, I wanted to make a brief comment on the advice that we have presented for releasing the banks from the transitional undertakings. As you identify in some of your questions, the developments in competition that we observed during our review of the SME banking market have been evolutionary, rather than radical. There is naturally then a question about whether the changes are sufficient to justify release of undertakings put in place following the 2002 CC inquiry.

The scale of the changes needs to be set against the costs of the distortions to competition caused by the transitional undertakings. We have argued that the market has changed sufficiently that, if the transitional undertakings were to remain unchanged, these costs would outweigh the benefits. With the smaller banks now in a stronger position to compete with the established four main banks, with technology reducing some of the previous barriers to entry, and with signs that consumers are becoming more active in considering switching their account, we have argued that now is the right time to allow the market to develop more freely without the transitional price controls.

As we made clear in our advice, this does not mean that we consider that this is necessarily an effectively functioning market. We continue to have a number of significant concerns, particularly around lack of price transparency, and the costs (and perceived costs) of switching. As you will be aware, many of these concerns are evident in wider banking markets. Separately from the SME

banking review, the OFT is carrying out a substantial amount of work in the banking sector, looking at these problems in detail in the personal banking sector, and contributing to the current review of the Banking Codes. We believe that further measures may be taken to address the underlying problems – whether this is lack of clear information, the need for better consumer education, or putting in place regulations around the switching process. For these reasons we believe that the behavioural undertakings should remain in place, and we are encouraging banks to go further through their own self-regulation.

In summary, in recommending that the CC release the banks from the transitional undertakings, the OFT was fully aware that there was no evidence to suggest a major step change in the level of competition in the SME banking market since 2002. However, we believe that there is sufficient evidence to meet the test of change of circumstance required by the legislation, and that releasing the transitional undertakings would benefit the long-run development of competition in the sector, and be in the interests of SME customers.

The remainder of this document responds to the specific questions in your letter.

**4a. What are the SME products currently offered by the four clearers bound by the transitional undertakings and the three challenger banks referred to in your advice? How have they changed since 2002? Have the four large clearers introduced new, improved or lower priced products? If so, in what ways are they an improvement on the products offered in 2002? Have there been any offsetting price rises? Overall what has been the impact on SMEs and on competition?**

The following paragraphs present details of changes in products and prices since 2002, before drawing some overall conclusions on the impact on SMEs and competition.

### **The four main clearers**

The OFT receives monitoring data twice a year as a requirement of the transitional undertakings. The four main banks are required to provide data on all of the current account tariffs available to SMEs. As part of its review, the OFT also sent detailed questionnaires to the four main banks. These included

questions about products, particularly with a view to understanding how the banks had complied with the transitional undertakings.

The following table summarises the SME current account products currently offered by the four main banks. It also gives the main changes in products since 2002, and summarises the changes in prices within the tariffs.

**Table D.1: Summary of products offered by the four main groups**

	Current SME products	Main changes in products since 2002	Main changes in prices since 2002
Barclays	<ul style="list-style-type: none"> <li>• Standard Business Tariff/Business tariff (including interest on current account and offered to all SMEs)</li> <li>• Free Automated Transactions tariff (for businesses with turnover under £1m)</li> <li>• Discount to standard tariff without credit interest (for businesses with turnover over £1m)</li> <li>• Free money transmission</li> <li>• Community account (tariff fro CACS which offers free money transmission)</li> </ul>	<ul style="list-style-type: none"> <li>• Most customers have since 2003 been offered a choice between receiving interest and an alternative offering (e.g. Free Automated Transactions tariff/discounts to standard tariff)</li> <li>• Free automated transaction tariff introduced in 2003</li> <li>• Small Business Tariff for businesses with turnover up to £500k was closed to new businesses from Mar 03 and phased out by end 2006.</li> <li>• Business Direct Tariff was closed to new business from Feb04 (this</li> </ul>	<ul style="list-style-type: none"> <li>• Interest at 2.5% below base rate was introduced on Standard Business Tariff/Business tariff following transitional undertakings</li> <li>• Standard Business and Free Automated Tariffs adjusted in 2005 – fixed standing charge introduced; some changes to money transmission charges.</li> </ul>

	<ul style="list-style-type: none"> <li>• Other negotiated tariffs (for businesses with turnover over £1m)</li> </ul>	was replaced by a telephone banking service)	
HSBC	<ul style="list-style-type: none"> <li>• Small Business Tariff (turnover up to £500k)</li> <li>• Business Direct</li> <li>• Treasurer</li> <li>• Schools and colleges</li> <li>• Negotiated tariffs for larger businesses</li> </ul>	<ul style="list-style-type: none"> <li>• Business Direct launched in April 2006</li> </ul>	<ul style="list-style-type: none"> <li>• Interest at 2.5% below base rate paid on small business tariff and negotiated tariffs.</li> <li>• Pricing structure of Small Business Tariff revised in 2005</li> </ul>
LTSB	<ul style="list-style-type: none"> <li>• Business Extra</li> <li>• Corporate</li> </ul>	<ul style="list-style-type: none"> <li>• Electronic payments tariff introduced as an option on business extra from Mar05, providing discounted charges for automated payments.</li> </ul>	<ul style="list-style-type: none"> <li>• Interest at 2.5% below base rate introduced on Business Extra tariff.</li> <li>• Tariffs on Business Extra simplified in 2004</li> </ul>
Natwest	<ul style="list-style-type: none"> <li>• Menu</li> <li>• Direct fixed from Mar03</li> <li>• Direct Menu</li> <li>• Natwest Auto</li> </ul>	<ul style="list-style-type: none"> <li>• Direct fixed tariff introduced in March 03</li> <li>• Natwest auto tariff introduced in Sep04</li> </ul>	<ul style="list-style-type: none"> <li>• Interest paid on standard tariff</li> <li>• Minor changes to money transmission tariffs</li> </ul>
RBS	<ul style="list-style-type: none"> <li>• RBS Standard</li> <li>• RBS Direct</li> <li>• Treasurer</li> </ul>	<ul style="list-style-type: none"> <li>• RBS Auto Free Tariff introduced in September 2004</li> </ul>	<ul style="list-style-type: none"> <li>• Interest paid on standard tariff</li> <li>• Minor changes to money transmission tariffs</li> </ul>

As shown in the table, the four main banks have all changed their product offerings and prices since 2002. Among the key trends that can be observed are:

- Barclays, Lloyds TSB and Natwest have all introduced tariffs offering free or reduced charges for automated payments
- HSBC and Natwest have launched 'direct' tariffs, although it should be noted that Barclays withdrew its Direct tariff in 2004.

There have also been changes in charges on some of the accounts:

- Barclays, HSBC and Lloyds TSB all revised their tariffs in 2004/05. The OFT's tariff modelling results suggest that, for typical customer profiles, the tariff changes made by HSBC and Barclays mean that banking is likely to be slightly more expensive.<sup>122</sup>
- the transitional undertakings have seen all four of the main banks introduce payment of credit interest at 2.5% below the base rate on their standard business tariffs. As discussed in detail in our advice, the impact in terms of take-up has varied markedly between banks because of the way in which the offer was made, and the relative attractiveness of alternative tariffs offered by each bank.

In addition, the four clearers gave us details of other offers to consumers, beyond the standard tariffs outlined above. (As noted in the advice document and observed by the CC in 2002, negotiation of charges and services plays an important role in the SME banking market, particularly for larger businesses, e.g. with turnover over £1m). [...] appears to have been particularly active in seeking to attract customers from the other banks. For example:

- in January 2006 it ran a business banking sale, where it offered 18 months free banking, six months free transactions via internet and telephone banking, and 12 months fee-free business card use. [...]

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<sup>122</sup> The modelling results do not factor in the impact of changes in credit interest

- other campaigns included [...]

All of the banks, to varying degrees, told us that they were willing to negotiate with individual SME customers in relation to price and service.

### Challengers and other smaller banks

The OFT asked several of the smaller banks to provide information on the products they offered SME customers. We did not ask the smaller banks about their tariffs (either currently or in comparison with 2002), but for the standard tariffs this information is available publicly, e.g. through Business Moneyfacts. We conducted some initial modelling of the tariffs offered by some of the challenger banks. We also saw modelling work from [...] indicating the savings that might be made by customers switching to them from one of the four main banks.

The following table summarises the information on products and prices (the latter being sourced from Business Moneyfacts):

**Table D.2: Summary of products offered by the challenger banks**

	Current SME products	Main changes in products since 2002	Main changes in prices since 2002
Abbey	<ul style="list-style-type: none"> <li>• Free banking forever</li> </ul>	<ul style="list-style-type: none"> <li>• Previously had two tariffs: Business free banking forever and Business fixed rate banking</li> </ul>	<ul style="list-style-type: none"> <li>• Increase in number of free debits and credits on the account</li> <li>• Removal of charge for non-automated credit (from 50p)</li> </ul>
Alliance & Leicester	<ul style="list-style-type: none"> <li>• Free Business current account (turnover up to £1 million)</li> <li>• Business Centre current account (turnover over £1 million)</li> </ul>	<ul style="list-style-type: none"> <li>• Overhaul of tariffs carried out in 2003 with relaunch of A&amp;L business banking.</li> <li>• Previously had business current account (up to £500k), Flat fee</li> </ul>	<ul style="list-style-type: none"> <li>• Changes to free business current account tariff in Nov04 and Aug 05</li> <li>• Included removal of charges on automated debits and credits</li> </ul>

	<ul style="list-style-type: none"> <li>• Business Builder account (turnover up to £500k, trading less than 6 months)</li> </ul>	<p>current account (up to £100k), and free direct account.</p> <ul style="list-style-type: none"> <li>• Free Business Current account product launched Dec 03</li> <li>• New Business Centre Current Account product launched Jan04</li> <li>• New Business Builder account launched May04</li> </ul>	<p>(previously 65p), and removal of £1.75 standing charge. Increase in additional charges for cash.</p>
HBOS	<ul style="list-style-type: none"> <li>• Business current (turnover up to £1m)</li> <li>• Corporate current account (turnover over £1m)</li> </ul>	<ul style="list-style-type: none"> <li>• No major change in products</li> </ul>	<ul style="list-style-type: none"> <li>• Small price increases on business current account - mainly on non-automated credits and debits.</li> <li>• HBOS offers £500 to customers whose current terms it cannot beat</li> </ul>

As shown in the table, the three challenger banks have all revised their product offerings since 2002. [...] and [...] in particular appear to have developed their strategy for competing in the market.

One of the challenger banks told us that:

- it has recently made the commitment to give all switchers a one to one relationship with a relationship manager (an example of product innovation)
- [...] offers £500 to customers whose current terms it cannot beat and is focussed upon switcher customers
- [...] now provides a full range of services which are likely to be required by SMEs

- [...]

Another bank noted that:

- it has developed its SME banking business with a focus on a simplified product portfolio. This has been delivered through direct product offerings, using internet and telephone banking. However, more recently this has been supplemented by a growing network of business banking centres across the UK
- the bank introduced a new business banking strategy in 2003, which involved a rationalisation of the product range for new customer acquisition and the introduction of new business centres through out the UK to serve customer needs
- [...]

One of the banks noted that its SME banking proposition has not changed significantly since 2002. [...]

We also asked what services had been provided by the various banks to SME customers. We wanted to know whether the smaller banks provided a full range of services to challenge the four main banks, or whether they were relying on niche services. As noted in our advice document, [...] told us that it provides a wide range of services and products to its SME customers. [...] and [...] provide a less complete service than [...] – most notably because they lack extensive branch networks. However, these banks have developed their services since 2002, for example through recruitment of relationship managers for larger business customers.

In terms of price, the table above indicates that Abbey and Alliance & Leicester have reduced their prices since 2002. HBOS has increased some of its prices, although it still claims to be cheaper than the standard tariffs of the four main banks. The overall impact on price competition is considered below.

Apart from the three main 'challengers', the OFT also requested information from a number of other smaller banks in the market. This indicated that products

have also been introduced and modified by other banks in the market. For example:

- Co-operative Bank launched a new current account product, Clarity business banking, in March 2004
- Co-operative Bank also launched the FSB Business Banking specifically designed for FSB members.

Finally, as noted in our advice, there has been a degree of new entry to the market.

## Overall impact on SME customers and competition

In our advice paper, we explained that 'a combination of general trends in the market and the impact of the behavioural undertakings have increased the level of competition in the market.' (1.5).

One of the factors identified to support this conclusion was that product variety had increased. In particular, we said that 'greater use of automated payments technology has encouraged banks to develop new tariffs offering cheaper rates for use of automated payments.' (1.5). As described above, three of the four main banks have introduced reduced-fee tariffs for automated payments. Along with the expansion of the smaller banks in the market, we believe that SME consumers now have more choice of current account products than was the case in 2002.

The degree of price competition is more difficult to measure, because it is hard to estimate an exact like-for-like comparison of average charges. (This in itself raised concerns about transparency of tariffs, something that we made clear in the report and have pursued in a wider context through the ongoing Banking Code review and our retail banking strategy work). First, within the core tariffs offered by the main banks, some charges have fallen and others increased, so some SMEs would have gained and others lost, depending on their usage of the account. Second, with new tariffs being introduced (and in some cases others being withdrawn), the options for switching between tariffs would have changed since 2002.

In the customer survey we asked respondents to give a direct estimate of their annual banking costs. A direct comparison with the results obtained by the CC in its previous survey suggested that average costs had fallen. However we did not place high weight on this evidence, as we were also aware of claims from consumer groups that SMEs perceive charges to be higher now than they were in 2002.

As a result of this lack of firm evidence, we carried out some simple tariff modelling, using customer profiles taken from a similar study by Business Moneyfacts (outlined in paragraphs 4.92 to 4.98 of the advice). This suggested that core charges for the four main banks have been relatively steady (in

nominal terms), with the main exceptions being Barclays and HSBC, both of which increased tariffs during 2005. Aggregate prices for the three customer profiles modelled appeared to converge between 2002 and 2006 (pp64-65). We are aware that this could be consistent both with highly competitive outcomes and with uncompetitive outcomes characterised by tacit co-ordination. However, the variation between banks in individual charges (Fig 4.17) and in charges since 2002 (Fig 4.18) provided some comfort that there was no clear evidence of price following.

It is important to note that this tariff modelling (and the questions in the customer survey about bank charges) did not take account of the payment of interest on credit balances offered on some of the tariffs. As shown in 5.21, compared with 2002 we estimate that between 30% and 50% of consumers are now receiving interest at 2.5% below Bank of England base rate on their credit balances. The impact on consumers will again clearly depend on how they use the account, but the financial modelling we carried out indicated that the overall impact on banks' revenues has been substantial.

## Conclusions

Overall then, in terms of products and prices in the market, we would reiterate our judgement in the advice document that:

- compared with 2002, product range has increased; for example, SMEs can take advantage of reduced fee charges for automated payments across a number of banks
- there are now cheaper tariffs available for SMEs wanting a basic current account service, provided both by the four main banks and by several of the smaller banks, particularly [...] and [...]
- SMEs on a standard account operated by one of the four main banks have benefited from the payment of interest on credit balances as a result of the transitional undertakings; in most cases core charges have not increased significantly on these accounts.

**4b. What evidence is there for developments in competition between the four large clearers? What form has this competition taken? We would be particularly**

**interested in evidence from the challenger banks or customers regarding their perceptions of changes, if any, in the nature and intensity of competition between the four large clearers.**

The OFT advice noted that there has also been a marked movement in relative shares between the four main banks over a relatively short time period. [...] and [...] have seen their market share fall, while [...] has gained market share. For example, the market share of the three largest banks has reduced by more than seven per cent from 74 per cent to 67 per cent. This contrasts, to some extent, with the stability of market shares amongst the four largest banks reported by the CC in 2002.<sup>123</sup>

As outlined in our response to question 4a, there have been changes in products and prices which resulted from this competition between the main four banks and the smaller challengers. In our advice document, we also outlined increases in levels of switching away from the four large banks (e.g. see paragraph 4.20). In paragraph 4.75 we outlined the increasing evidence that banks are offering price discounts to attract switchers as well as start-ups.

In their comments about the state of competition in the market, the four main banks (perhaps unsurprisingly) pointed to indications of what they saw as strong competition. For example,

- one of the four main banks told us that [...] recently ran an SME banking campaign with clear service quality message, backed up with willingness to compete aggressively on price for business of larger customers. As result [...]
- another of the main banks told us that competition varies over time and by sector and geography. However, [...] has tended to provide the greatest threat on money transmission charges, with [...] latterly proving particularly competitive also. It said that there had been price

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<sup>123</sup> CC (2002), paragraph 2.65. The CC reported some changes amongst market shares of the major providers between 1990 and 2000, however these changes occurred over a longer period than those found by the OFT.

competition, with a decline in prices in real terms. Customers have increased their pressure in tariff negotiations, helped by online price comparison services such as Business Money's business bank charge checker

- [...] noted that market shares of start-ups of [...] and [...] in England & Wales have declined. In aggregate [...].

### **Views of challenger banks**

In contrast, the challenger banks generally said that they had not seen great progress in competition, either overall or between the big four. They argued that the transitional undertakings had been an important constraint on their ability to compete (see also our response to questions 4d and 4e below).

- [...] stated that 'behavioural remedies aimed at promoting greater competition look largely to have failed, whilst it has been estimated that the four main clearing banks have made more than double the excess profits from SME banking than earned in 2002.' [...] also noted that 'price controls reduce essential differentiation between banking providers, reinforce the position of the incumbent banks and reduce the incentive for SMEs to switch...[The price control] has withdrawn any incentive for the four main clearing banks to actively compete for switchers amongst themselves, allowing them to flex their growth and risk appetite only in the start-up market'
- [...] said that it had seen little change in the market place compared to three years ago when the undertakings came into effect. The markets were still perceived to be dominated by the big four clearing banks. [...] also said that it had to change the nature of its proposition as a result of the Competition Commission remedies.

## Views of consumer and business groups

Consumer and business groups were divided about the degree of competition in the market.

- [...], FSB indicated that their survey (launched in February 2007) suggested that there was little competition when compared to competition on the continent
- in contrast, the FPB noted positive signs, including a significant increase in the proportion of SMEs considering switching bank
- the ACCA SME finance user group suggested that banks are risk averse when lending to small businesses. The group suggested that there has been little development in competition for lending products.

Further views of SME groups are discussed in the response to question 4c.

### Summary

Overall, the OFT found that there was a mixed picture of competition among the four main banks (and in the wider market). The challenger banks were clearly frustrated that they had not been able to make greater inroads into the market. However, they saw the transitional undertakings as an important factor in this, alongside the more general reluctance of consumers to switch, and perceived costs of switching.

**4c. What views and evidence have been provided by customers, or groups representing customers, regarding both the impact of the undertakings and of their removal (or possible revision)? How did the OFT seek input from these customers and with what results?**

The OFT sought views of SME customers in two main ways:

- through a customer survey of around 1,000 SMEs, carried out by IFF
- through discussions with and written submissions from a range of groups representing SME interests.

Results from the customer survey are discussed in detail throughout our advice, and are not repeated here. The following paragraphs summarise the views of the groups we met with during the course of our review:

### **Federation of Small Business**

- the FSB said that its members were concerned about increases in charges which the banks have been imposing over the last 4 years, although they noted that they had limited evidence to back up these views
- they felt that all the banks are offering basically the same sort of service at the same sort of prices. They did not feel that the challenger banks offered anything significantly different to the small business customer
- the FSB said that interest payments on current accounts do not benefit the small business customer and free banking would be more beneficial to them.

### **Forum of Private Business**

- the FPB survey showed that the propensity to consider switching has increased steadily and that satisfaction with bank performance has increased
- the FPB noted that its survey revealed that only a small proportion of businesses were aware of the undertakings (around 26.7 per cent). This compares with a much greater awareness of the Business Banking Code
- the FPB identified that there remains a very low proportion of switching, although it noted that its survey revealed that a greater proportion of customers have considered switching in recent years. It noted that the propensity to consider switching appears to be correlated with bank performance and the wider economic climate.

### **Small Business Council (SBC)**

- a key concern was how businesses in financial difficulty are treated by banks, particularly when they try to switch
- the SBC felt compliance with the transitional undertaking was 'patchy'
- they noted that banks are increasingly forcing businesses to take out term loans instead of overdrafts
- the SBC noted that the manner in which pricing information was available to consumers was often a bar on switching; this is because the information is presented as a large set of all the different individual charges which an SME pays. It believes that the average SME will not have sufficient time to calculate the net charges they would pay based on their typical transactional behaviour.

### **British Chambers of Commerce**

- the BCC noted that members had expressed concern that banks spend more time in winning customers than developing/continuing good relationships with existing customers
- the BCC noted that there has been some reference in their responses from business to the possible adverse effect that the transitional undertaking may have had on the competitive position of small banks.

### **Institute of Directors**

- the Institute of Directors (IoD) emphasised the 'general contentment' of members with SME banking services. The IoD noted that this was confirmed by the NOP data which the IoD had commissioned. Based on memory this revealed that between two thirds and three quarters of members did not have any problem with access to finance with about 70% of respondents saying that they had a good relationship with their bank.

## **ACCA SME Finance User Group**

- the ACCA SME Finance User Group was concerned primarily with access to finance. They expressed no particular views on whether the transitional undertakings should be removed or not.

### **Summary and results**

The OFT sought views from a wide spread of consumer groups and consumers through survey evidence. The survey evidence commissioned by OFT showed that consumers generally were not aware of the transitional undertakings nor the behavioural undertakings. This evidence was backed up by survey evidence conducted by the Forum of Private Business which showed that only a small proportion of businesses were aware of the undertakings but showed much greater awareness of the Business Banking Code. SME groups generally did not focus on the transitional undertakings, and did not have strong feelings on whether they had been beneficial or detrimental.

#### **4d. What views and evidence have been provided by the three 'challenger' banks regarding both the impact of the undertakings and of their removal (or possible revision)? How did the OFT seek input from these banks and with what results?**

The challenger banks were all strongly of the view that the transitional undertakings were having a negative impact on competition. Our questionnaires to these banks (and to the four main banks) specifically probed what they thought would happen were the transitional undertakings removed. We discussed the banks' submissions with them, and in some cases asked for further evidence and clarifications.

The views of challenger banks on the impact of the transitional undertakings can be found in the report at paragraphs 5.69 to 5.71. In addition all banks were asked by the OFT for views on the possible removal or revision of the transitional undertakings. The challenger banks' view was that if the transitional undertakings were removed this would present them with an opportunity to compete more effectively with the four main banks and gain market share.

The following paragraphs set out more detail of the challenger banks' views.

[...]

- [...] noted that the transitional undertakings have hindered new entrants including [...] ability to gain market share. Prior to the transitional undertakings being prescribed for the four main clearing banks, [...]. With strong differentiation between [...] offering and that of the four main clearing banks, [...] believed that market forces would in themselves have generated greater market competition and account switching
- in relation to the complete removal of the transitional undertakings [...] believe that the four main banks will leave their interest margins unchanged in the short run. A lack of price disparity would continue to work in their favour as they continue to dampen the appetite for competition. However, [...] said that should the main four banks offer a lower paid current account this would create some competitive benefits for the challenger banks.

[...]

- [...] argued that the transitional undertakings have hindered their ability to gain market share and compete on price. This is because the transitional undertakings have reduced the pricing differential between them and the four main banks making it more difficult for challenger banks such as [...] to differentiate its products and pricing from those of the main banks
- overall [...] believe that the transitional undertakings have not helped them compete in the business banking market place. [...] argue that this conclusion is supported by market share comparisons, which indicate that challenger brands have still not made significant inroads into the market share of the main banks
- [...] considers that the complete removal of the transitional undertakings will improve their ability to compete but on the assumption that one or more of the main banks would revert to their historic pricing propositions. [...] believe that complete removal

would free up the market and provide challengers with greater scope to differentiate their product/price proposition for customers.

[...]

- [...] have clearly argued that the transitional undertakings have not helped them grow business, narrowing the difference in the pricing of the big four banks relative to [...] offerings. [...]
- [...] argued that if the transitional undertakings were removed it is possible that the four main banks would not pay interest or offer free banking. This would improve the competitive position of [...], and likely to increase the opportunity for them to compete on price to grow its market share.

#### **4e. How have the three challenger banks sought to compete in the market since 2002?**

##### **Views of the challenger banks**

In our information requests to the challenger banks, we asked how they had sought to develop their SME banking business since 2002. We also asked how they had sought to overcome what they perceived as barriers to entry in the market. In some cases we probed these points further in follow-up meetings with the parties.

[...] told us that in the last few years, it had identified a clear opportunity to launch a 'challenger' business banking proposition, with a focus on a simplified product portfolio, and transparently priced products offering customers good value. [...]

[...]

##### **Views of the four main banks**

The evidence provided by the four main banks also provides some examples of how the challenger banks have sought to compete in the market.

[...] noted the following points:

- There has been increased competition for recruiting relationship management teams. [...]
- A&L and Abbey are developing internet banking products to attract customers seeking a low cost, low bank contact offering. [...]
- A&L are moving into the market for larger SME customers. For example, [...]
- [...]
- Co-Op Bank has launched an account specifically designed for FSB members. [...]

[...] identified a series of market developments:

- new entry from overseas and expansion by competitors – [...]
- more switching, multi-sourcing and multi-banking since 2002
- providers such as Abbey, HBOS, A&L and Clydesdale are aggressively targeting certain types of customers from HSBC, Barclays, LTSB and RBS. Such providers benefit from the increasing number of SME customers multi-sourcing, i.e. running an SME account with a bank subject to the transitional undertakings, and accessing an SME current loan with another bank or financial services provider
- claim that [...] has been aggressively targeting non-current account SME business; [...]
- [...]

[...] told us that:

- [...] and [...] have more than doubled their share of start-ups each capturing [...] market share for start-ups in 2005, compared to [...] in 2000

- there had been significant strategic moves – such as the merger of Halifax and Bank of Scotland in 2001. [...] has shown itself able to acquire a suitable branch network in England & Wales and recruit and train relationship managers.

## Summary

Comparing the three challenger banks, our broad understanding was that HBOS has developed a full product offering to challenge the main banks. There is evidence that it is picking up a significant share of switchers, and also that four banks see it as a strong competitive threat. Abbey and Alliance & Leicester have focused on providing a lower-cost/more basic service, and have managed to gain market share. A&L in particular has aggressively marketed its low cost offering. However, the two also have differing strategies, particularly around delivery channels. A&L uses agreement with the post office to service cash businesses. Abbey is focused more on direct services (has not converted its personal bank network).

However, all the challenger banks have argued that they are hindered on competing on price because the transitional undertakings has reduced the price and product differential that was making the challengers more competitive before its implementation. Whilst the challengers have been competing successfully on product developments they have not been able to be as successful at competing on price.

**5a. There have been some changes in market share within the group of four large clearers; there has also been an overall loss of share by the four large clearers in favour of the challenger banks. It is unclear whether these changes have been sufficient to alter the incentives acting on the banks.**

As set out in the advice document, the OFT believes that the four main banks face stronger competitive constraints now than was the case in 2002 (e.g. paragraph 1.5). The changes in market share form only a part of that assessment, as set out in paragraphs 6.8 to 6.15 of our advice document.

The OFT found that the share of the four main banks had fallen from around 92 per cent in 1999 to 85 per cent by 2006 (paragraph 4.6). [...] had seen the greatest increase in market share (of the big four), with the market share of the

other three main banks falling by more than 7 per cent (paragraph 4.7). The three challenger banks had increased their market share from around 3 per cent to 9 per cent (paragraph 4.8). We noted that the challenger banks had started from a low base, with HBOS being newly formed in 2001, and Alliance & Leicester effectively relaunching its business banking service in 2003. Abbey also experienced significant changes during the period with its acquisition by Banco Santander. We believe it is also relevant that the challenger banks have publicly expressed frustration at the impact of the price remedies, suggesting that they would have made faster progress in their absence.

We believe that this progress has put the challenger banks on a more solid footing than was the case at the time of the CC inquiry. The CC made clear that developments in the market, such as the creation of HBOS, might have an impact, but that at the time there was insufficient certainty over how the challenger banks would develop (paragraph 6.22).

Several of the four main banks suggested in their submissions that they actively took account of the threat posed by the smaller banks. We were aware that they had an incentive to exaggerate the threat from challengers. However, the banks told us that they considered HBOS, in particular, to be an equal competitor.

**5b. If competition were becoming more effective, prices would be expected over time to fall below the controlled levels (unless there had been any offsetting improvements in other competitive factors such as service quality), as the CC's original calculations allowed for substantial headroom in the price controls. Such a process of price reduction (nor improvement in other competitive factors) is not yet apparent.**

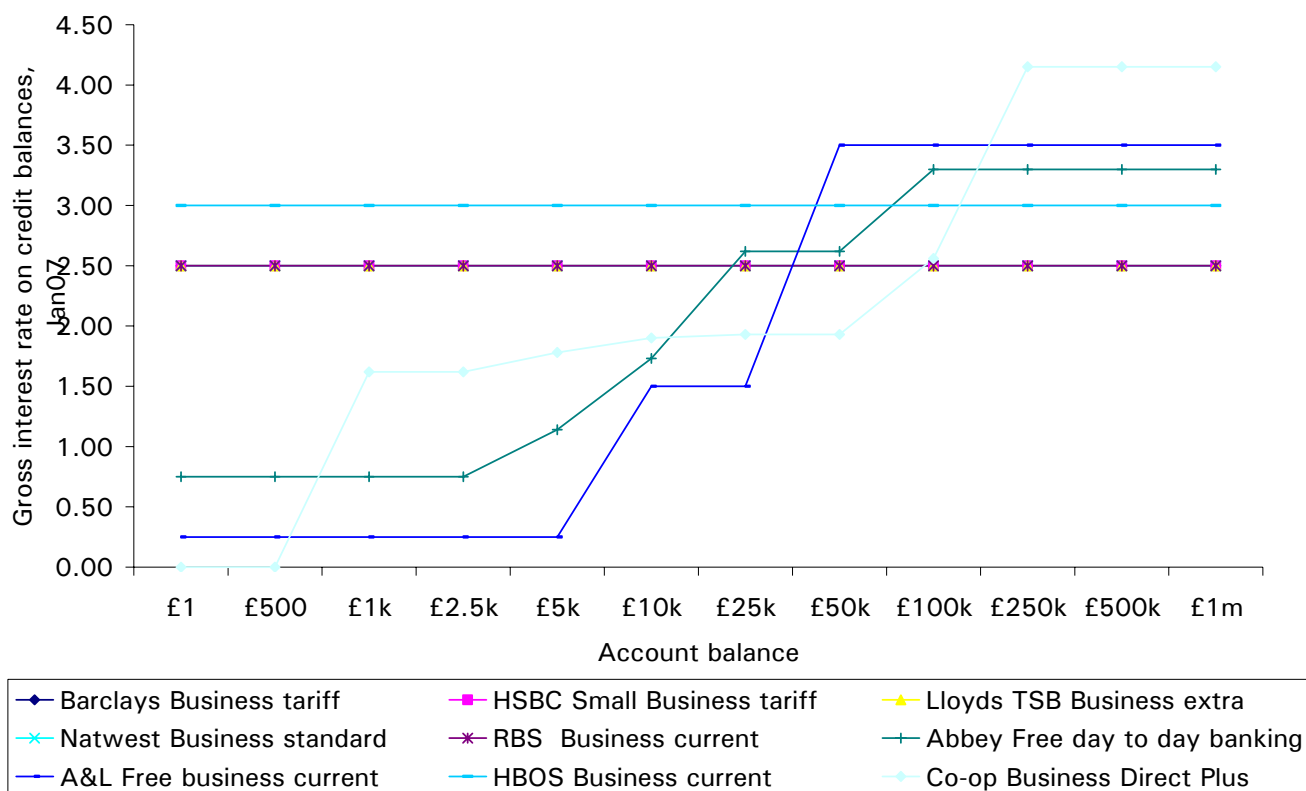
We acknowledge that the CC was careful to ensure that there remained some headroom in order to ensure that entry would still be attractive to an efficient operator. The pricing remedy appears to have achieved this - it has allowed some room for the smaller banks to expand in the market, as shown for example in our response to question 5a. We also understand the CC's argument in 2002 that entry and expansion had not been effective in reducing prices, even given the finding of excess profits.

However, as discussed in our response to question 4a and elsewhere, we believe that there have been signs of improvements in competitive factors, within the constraints imposed by the transitional undertakings.

In terms of price, we stated previously that it is difficult to compare changes in prices on a like-for-like basis. The undertaking requires that banks offer either interest on credit balances, or free core money transmission. In internal discussions about our advice, the OFT was aware of the fact that most of the four main banks had focused on providing credit interest, and that none of them had offered more than the required rate (2.5 per cent below Bank of England base rate) on their standard (non-negotiated) tariffs. In a strongly competitive market, we might have expected some competition on interest rates at the margin.

However, we also felt that there were counter-arguments that could be made. First, some of the banks [...] argued that they would have preferred to offer a more graduated interest rate depending on the account balance, but were effectively prevented from doing this by the form of the price control. The OFT noted in its advice that some of the smaller banks have attempted to put together different interest rate packages. The figure below summarises the interest rates offered on some of the main business bank account, taken from Business Moneyfacts.

**Figure D.3: Summary of credit interest rates on business current accounts**



Second, several of the banks argued persuasively that 'free banking' was of more interest to SMEs in general than payment of high rates of credit interest. Given this observation, it is perhaps less surprising that the four main banks have not aimed to compete actively on their interest rate offer. For example, an effective competitive strategy for a bank might be to meet the transitional undertaking by offering credit interest at the required rate, but then focus on its competitive position in relation to other charges and services which are more important to consumers.

**5c. The OFT survey found the proportion of SMEs that had considered switching had marginally fallen since 2000 although other sources detected an increase. The OFT also considered it important that SMEs were increasingly considering the smaller banks. However, actual switching rates have not increased, so it is unclear that any increase in competitive pressures has been generated.**

We acknowledge in the report that the low rate of switching in the market remains a concern (e.g. paragraph 6.14). We believe it is important to tackle this through a range of measures, building on the behavioural remedies put in place by the CC. As you know, we are currently engaging with parties to the Banking Code review in order to address some of these concerns (paragraph 6.35).

At the same time, we have identified some factors in relation to switching that do indicate a change in the market. Most important is the fact that customers appear to be switching increasingly to the smaller banks (paragraph 4.18).

In drawing conclusions, the OFT considered evidence of switching behaviour alongside other changes in the market. Switching rates are not always a good proxy for the level of competition. For example in a perfectly competitive market, consumers would not have an incentive to switch. We focused particularly on whether there were barriers to switching. Our broad view was that switching had become easier since 2002, in part due to the switching undertakings, and also because of the development of price comparison services. This view was accepted by some SME representatives, as well as by the main banks – although some, such as the FSB, did highlight particular concerns about switching.

We were also encouraged by apparent increases in willingness to consider switching. Our advice presents evidence from a variety of consumer surveys on this point. As you note, the OFT customer survey registers a single point fall in the proportion considering switching between 2000 and 2006 (paragraph 4.48). However, the other sources we have seen suggested that there had been an increase in consideration of switching. This includes a panel survey by FPB which was updated at the start of this year, suggesting a ten per cent increase in willingness to consider switching since 2000 (paragraph 4.50). We would also emphasise the evidence that customers appear increasingly to be considering a move to one of the smaller banks.

**5d. The OFT concluded that the evidence showed customers were more price sensitive than in 2000, and were more willing to consider banking with the smaller banks. These changes do not seem to be large, and the absolute levels of customers referring to price factors are not high. It is therefore not clear that this has become a sufficient constraint on banks.**

The evidence presented in our advice relating to price sensitivity included the following points:

- the OFT customer survey suggests that the importance of price competitiveness of a bank appears to have increased since 2000, with four per cent more SMEs than in 2000 (13 per cent in total) citing price as a reason for choosing their bank (paragraph 4.32)
- SMEs were asked about the characteristics that were most important to them in a bank, the largest number (24 per cent) mentioned reasonable charges/fees/rates of interest. In contrast, the proportion that noted quality of relationship with the bank manager (21 per cent) was lower than in 2000 (paragraph 4.34)
- the proportion agreeing that a long relationship means you can obtain more favourable rates has significantly decreased since 2000 from 48% to 32% (paragraph 4.36)
- we also quoted evidence from the banks to suggest that price sensitivity had increased. For example, [...] stated that its own research in June 2006 suggested that 19 per cent of in-switchers quoted price as the main reason for joining [...], 'a significant increase compared to levels of around ten per cent in the preceding three years'.

Our customer survey also suggested that there had been an increase in willingness of customers to consider switching to the smaller banks. Figure 4.13 shows a reduction in the proportion of SMEs considering a move to each of the four main banks, compared with an increase in this proportion for all of the smaller banks (taking Halifax and Bank of Scotland jointly).

The OFT accepts that it is difficult to show whether these changes constitute a 'sufficient' constraint on the banks. Our advice was based on a judgement as to change of circumstance in the market and the level of competitive constraints overall.

**5e. As SMEs usually get free banking on start-up, there may be little incentive for them to shop around until the free offer has ended. It may therefore be more**

**appropriate to consider search and switching behaviour of new customers one or two years later when the free-offer period ends, rather than at start-up. Some banks told the OFT that SMEs would shop around at this stage but we have no comprehensive data to measure this. The actual switching data as noted in (c) above does not seem to suggest any increase in switching.**

[...], in assessing the apparently low rate of shopping around, it is important to recognise that start-up businesses frequently will not have a good idea of their future banking needs at the point that they open a business current account. Banks typically offer 'free banking' to start-up customers for a period of between one and two years, which arguably gives customers little incentive to shop around. Several banks told us that a significant proportion of customers switch at the point when the free banking period ends, which is a more natural time to shop around for alternative offers.

Unfortunately this point was made by banks at a late stage in our review (during our final round of meetings with the parties). Although we requested further information from the parties, we did not receive any clear evidence to support their arguments.

Our focus during the review was on switching of existing customers, rather than on competition for start-up customers. This reflected the fact that the CC had argued that there was relatively strong competition for start-ups, and we were not aware of evidence that might have altered that conclusion since 2002. For example, the OFT observed that some of the main banks had extended their 'free banking' period for new customers. While we agree that it could have been helpful to collect further information on the extent of switching at the point when charges were introduced for new businesses, we did not consider that this would have raised significantly different issues from the more general consideration of switching and switching barriers, which was a key part of the review and our advice.

**5f. The CC report expected the remedies to give pricing a significant shift towards competitive levels. It is possible that this has changed SMEs' expectations of banks, but we have no definite evidence on this.**

Our advice document presents evidence that customers place more importance on the price competitiveness of a bank's tariffs than was the case in 2000. For example, the OFT customer survey suggests that the importance of price competitiveness of a bank appears to have increased since 2000, with four per cent more SMEs than in 2000 (13 per cent in total) citing price as a reason for choosing their bank (paragraph 4.32). The FPB's recent survey also recorded a sharp increase in the importance placed by customers on competitiveness of charges offered by their bank (paragraph 4.101). There is wider evidence that customers are more aware of alternative charges offered by different banks, for example as seen through the growing use of internet price comparison sites (paragraph 4.40).

We accept that there is limited evidence for a specific link between the transitional undertakings and SMEs' expectations of what constitutes competitive pricing. However we observed that the transitional undertakings had driven an expectation among SMEs that a reasonable rate of interest should be paid on account credit balances (paragraph 6.5). This point was made to us (unprompted) by [...] in its response. It appeared to us a reasonable supposition, given the CC's finding that, before the pricing remedies were put in place, SMEs were frequently not aware of the opportunity cost implied through earning very low rates of interest on their current account. Anecdotally, we also observed that there had been growth of high-interest personal current accounts, and that this might have an impact on expectations in the business banking market (particularly for start-ups migrating from a personal to a business bank account).

When asked what would happen if the pricing remedy were to be removed, most of the banks argued that there would be little change in overall pricing levels (paragraphs 5.83-5.84). While we were aware of the incentive for banks to underplay the likely impact of removing the price control, we noted arguments that customer expectations had been shifted by the presence of the transitional undertaking.

**5g. Turning to the costs of the remedies, we acknowledge that price controls can distort incentives and impact on efficiency (but the controls should be evaluated against the market outcome which may be uncompetitive). All of the distortion effects were in principle present when the CC considered its report, is**

**there reason to believe these effects are now more substantial than foreseen at the time of the CC's report?**

As set out in the advice document, we observed that the transitional undertakings might distort competition by:

- limiting the opportunities for entry to and expansion in the market by smaller players, with the effect that SMEs do not benefit from the additional choice and competition that this might offer
- dampening the incentives for banks to invest and develop innovative products which would benefit SMEs
- distorting efficient pricing decisions by the banks and introducing a degree of similarity in pricing structure across a section of the market.

In broad terms, we believe that these effects were all foreseen, in principle, by the CC in 2002. The OFT notes that the CC did not attempt to quantify the potential costs of the remedy, although it did take account of these in the way it designed the remedy and in the level of the price control. Therefore, it is impossible for us to say whether the costs have been greater than was foreseen by the CC in 2002.

The main difference now is that there is some evidence on which to observe the potentially distorting effects of the price controls. As noted in the advice document, we acknowledge that even this evidence is not clear cut; fundamentally it is impossible to prove that any particular effect observed in the market is a result of the transitional undertakings as opposed to any other factor. However, we have noted some evidence for example on levels of investment by one of the four main banks, suggesting that the undertakings have reduced innovation in the market.

A further point raised by one of the banks [...] in its response was that the undertakings have distorted their commercial decisions over tariffs. [...]

[...]

5h. The incentive on other banks to enter or expand has been reduced, but the CC's report had envisaged that such incentives would not be eliminated. An expectation that their incentives would increase following removal of the transitional undertakings appears to be based on an expectation that the large clearers would therefore increase charges or cut interest rates, i.e. incentives would only increase if the current detriment also increased. In addition, the response of customer behaviour to the behavioural remedies appears to have been limited. This may reflect difficulties in changing customer behaviours. It is possible that the transitional remedies may have reduced the incentives for customers to switch and so maintained inertia in the market. If the transitional undertakings were removed, it may help a more competitive market structure develop at a greater pace than in the presence of these undertakings. Therefore we need to understand whether this process of adjustment to a competitive market structure would be both effective and sufficiently rapid in the absence of transitional undertakings to justify the costs to SMEs, as the welfare effect on customers could be detrimental in the short term and ambiguous overall. At the moment we do not understand the relative sizes of the losses to customers compared to likely gains arising from any stimulus to the development of competition.

First, it is possible to challenge the assumption that 'incentives would only increase if the current detriment also increased'. As noted in the advice document, most of the banks claimed that prices would not rise sharply overall in the absence of the transitional undertakings, but still felt that removal of the undertakings would encourage competition in the market.

Some banks argued that the price controls were constraining their ability to balance different charges within the current account package in an optimal way. [...] put forward particularly strong arguments in this regard (for example, see comments in the response to question 5g).

The transitional undertakings constrain the most 'visible' charges within the current account package – interest on credit balances and core money charges. The reaction of the challengers reflects this fact; they feel that the transitional undertakings removed their 'unique selling point' or 'clear blue water'. While the challenger banks can (and do) compete on other elements of the charging package, their responses indicate that it is hard to attract consumers once a

clear advantage on interest rates or charges is removed. The overall theme coming through the responses is that, in a market where there is a high degree of customer inertia (as was found by the CC in 2002), introducing price controls on the most visible charges has reduced the scope for competition. One outcome of removing the price control could, therefore, be that prices do not increase on aggregate, but that there is greater differentiation in product offerings and tariff structures between banks.

As part of the review, the OFT considered whether it would be possible to model explicitly the process by which removal of the undertakings could stimulate competition – either through an increase in prices encouraging greater levels of switching, or through greater differentiation between products and tariffs. However, we decided that we did not have enough information on costs and benefits in order to make such a modelling exercise worthwhile. We also considered how similar decisions had been taken in other industries, including: opium derivatives (where price control remains in place), condoms, telecoms, classified directory advertising (where price control remains in place), and electricity supply. In these cases we were not aware of detailed modelling having taken place. As in our review, the focus in these other cases was on developments of competition which might place a competitive constraint on large incumbent firms in the absence of a price control.

**5i. We still do not fully understand the exact origin of the costs to banks arising from changes in internal funding arrangements and would welcome further clarification on the source of these costs and how they have been calculated by each of the banks.**

The cost to banks from the change in internal funding arrangements materialised as a real cost, rather than an expected cost, due to the required change in the way banks hedge their current accounts, following the transitional undertaking.

To explain this, it is necessary to consider how the banks' approach the management of interest risk. Looking at a bank's balance sheet, it is clear that they have a mixture of maturities and interest rates (some fixed and some variable) on their assets and liabilities. Unless some hedging was carried out, a bank would be subject to variations in their earnings due to movements in interest rates e.g. base rate.

To reduce such interest rate volatility, banks generally have a hedging policy to match terms and interest rates on their products, through their Treasury function. So, if they have a 5 year fixed rate loan, they will look for corresponding 5-year fixed rate funding. Conversely, if they are paying out a deposit interest rate related to base rate, they will look for base rate funding benefit. In this way the margin on a product is protected from interest rate movements.

The position is more complicated for a non-interest bearing current account, as no interest is paid and hence there is no contractual term or rate to match in this way. In this case, banks considered the behaviour of current account customers e.g. the typical life of a current account and found that it approximates to 3- 5 years. They then use this knowledge to hedge their exposure using a rolling hedge over the 3 or 5 years. In the 5-year case, this might represent a series of 20 hedge arrangements set up at quarterly intervals over a 5 year period – as one contract matures, a new one would be taken out for another 5 years, depending on their current level of balances.<sup>124</sup>

The key point is that the banks would have in place hedging arrangements based on not paying interest when the position changed and they started to pay interest. Taking the 5-year hedge as an example, once they pay interest, their position is unbalanced i.e. 5 year rolling hedge benefit vs. base rate related interest paid. As their bank policy requires them to hedge interest risk, they would have to wind up the previous hedge and look for a base rate related alternative.

In addition to paying interest, the banks will consequently face an additional loss (or gain) depending on the difference between the 5 year hedge benefit and the return on the base rate hedge. As 5 year rates have, over the last 5 years, generally been higher than base rate this would incur a loss. The loss would be ongoing, as long as the 5-year rolling hedge rate was higher than base rate. This loss would not generate an offsetting benefit for SMEs.

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<sup>124</sup> Typically these hedging decisions would be taken at regular meetings of an Asset and Liability Committee. The actual hedge arrangements will vary from bank to bank, depending on the modelling for their balances.

The banks have estimated the loss by comparing the income in the two situations. Their estimate was based on the rolling hedges in place at the time they are unwound and this will have been used as an estimate for future losses in subsequent years. The estimate would be less accurate for later years, as the rolling hedge would, in actual fact, have moved forward with each quarter having a new 5-year hedge related to the then current 5 year rate and level of current account balances. However, as only roughly 20% of the hedge would change each year, in this case the accuracy of the estimate does not deteriorate rapidly and it would be difficult to accurately hypothesise an alternative counterfactual. The effect on banks would vary according to the proportion of accounts that became interest bearing and where the modelling/hedging of the current accounts took a different form.

If it was assumed that the banks would have paid base rate related interest without the undertaking, it would be inappropriate to include the change in hedging as a cost arising from the undertaking. However previous banks' behaviour suggests that they would not all have started paying at that point and so the cost was included.

[...]