

Notice of provisional decision to release Undertakings in relation to SME banking given pursuant to section 88 of the Fair Trading Act 1973

Introduction

1. On the basis of advice from the Office of Fair Trading (OFT), the Competition Commission (CC) has provisionally decided to release the UK's four largest clearing banks that is Barclays Bank Plc (Barclays), HSBC Bank Plc (HSBC), Lloyds TSB Bank Plc (LloydsTSB) and the Royal Bank of Scotland Group Plc (the four banks), from most of the Transitional Undertakings given by them in 2002. These undertakings require the banks to offer small and medium-sized enterprises (SME) an account that pays interest on credit balances of at least 2.5 percentage points below base rate or does not levy standing charges or charges for core money transmission services, or both.
2. The CC has also provisionally decided to retain undertaking 11 of the Transitional Undertakings, which requires the four banks to notify the OFT and to publish changes in charges. The Behavioural Undertakings, designed to make the market more competitive by making switching easier and faster, by making prices more transparent and by prohibiting the bundling of different products and services, will remain in place. The CC has also provisionally decided to recommend that the OFT reinforce the awareness and the impact of the Behavioural Undertakings.
3. The CC will take a final decision following consideration of representations received in response to this Notice.

Background

4. In 2002 the CC published its report into the supply of banking services to SMEs.¹ In its report, the CC found that Barclays, HSBC, LloydsTSB and RBSG, together had a market share in excess of 90 per cent. The CC also found that customers were unwilling to switch; this resulted from the perceived complexity of switching, the small benefit from switching, the importance of a relationship with their bank manager, and the lack of transparency in pricing. The CC further found that competition was restricted or distorted by the similarity of pricing between banks, by selective discounting, and as a result of entry barriers such as the need to establish branch infrastructure and the need to incur sunk costs.
5. Following that report, two sets of undertakings were agreed:
 - (a) The Behavioural Undertakings: nine clearing bank groups in the UK (including the four banks referred to in paragraph 1),² agreed undertakings aimed at increasing price transparency, reducing switching costs and limiting the bundling of current accounts with other banking services.
 - (b) The Transitional Undertakings: the four banks referred to in paragraph 1 agreed undertakings broadly requiring them to offer all SME customers either interest on credit balances not less than 2.5 percentage points below the Bank of England

¹CC (2002), *A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*, Cm 5319. This is available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm#full.

²AIB 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.

base rate, or no standing charges and free core money transmission services (such as direct debit payments and cash transfers).

6. Both these sets of undertakings are specified under paragraph 16(1) of Schedule 24 to the Enterprise Act 2002 (the Act) by the Enterprise Act 2002 (Enforcement Undertakings and Orders) Order 2004 (SI 2004/2181)³ (the Order) with the effect that the power to supersede, vary or release these undertakings has been transferred from the Secretary of State to the CC.

OFT recommendation

7. In accordance with section 88 of the Fair Trading Act 1973, and sections 4, 5 and 7 of the Act, the Office of Fair Trading (OFT) carried out a review focused largely on the short-term impact of the Transitional Undertakings. In doing so, it also considered the overall impact of the Behavioural Undertakings on competition more generally. Following the completion of its review, the OFT submitted its advice to the CC in January 2007.⁴
8. The OFT concluded that on balance if the Transitional Undertakings were to remain in place the costs associated with them would outweigh the benefits. The OFT therefore recommended to the CC that it should release the four banks from these undertakings (the Recommendation).
9. In its consideration of the Behavioural Undertakings, the OFT noted some concerns about some aspects of the market and noted that it was in continuing dialogue with the banks as to how these might be addressed. The OFT concluded that the Behavioural Undertakings continued to facilitate the development of competition in the market and should remain in place. Accordingly, the OFT did not provide advice to the CC to vary, supersede or release the Behavioural Undertakings.

Provisional decision partially to accept Recommendation

10. The CC has provisionally decided to accept the OFT's Recommendation to release the four banks from the Transitional Undertakings with the exception of undertaking 11. Undertaking 11 requires the four banks to notify the OFT and to publish in a manner and within a period of time approved by the OFT all increases in charges and all new charges.
11. In addition to its provisional decision on the Transitional Undertakings the CC proposes to recommend to the OFT that it should:
 - (a) raise awareness of increases in charges, new charges introduced or interest payments reduced in response to the release of the four banks from the Transitional Undertakings;
 - (b) take account of any such response to the release of the Transitional Undertakings in any future review of the Behavioural Undertakings;

³ Which came into force on 4 October 2004.

⁴The OFT's report may be found at: http://www.of.gov.uk/of_at_work/markets/services/SME-banking/ . This report contains the advice submitted to the CC in January 2007 and further information provided by the OFT to the CC following discussions.

- (c) work with the nine banks subject to the Behavioural Undertakings to publicize their obligation under those undertakings, for example by working with organizations such as the Federation of Small Businesses and the Forum of Private Business, and by taking advantage of the high levels of interest currently in the banking industry; and
- (d) explore with the British Bankers' Association whether and how to include the substance of the Behavioural Undertakings in the Banking Code.

Provisional decision on the Transitional Undertakings

- 12. The CC's provisional decision was taken on the basis of the evidence and analysis contained in the OFT's report. The CC considers it appropriate to set out how it has considered that report and assessed the Recommendation.
- 13. Overall, the CC noted that the OFT, in making its Recommendation on the Transitional Undertakings, had conducted a thorough review of the evidence in relation to change of circumstance and had considered carefully whether the change of circumstance it had identified was sufficient to release the four banks from those undertakings. The CC shared the OFT's view that there was some evidence to support their retention, though it did not interpret all of the evidence in the same way as the OFT. However, considering the OFT's report as a whole, the CC agreed that on balance there were sufficient reasons to remove these undertakings, with the exception of undertaking 11..
- 14. In reaching its provisional decision to accept the OFT's Recommendation (with the exception of undertaking 11), the CC placed particular weight on a number of pieces of evidence cited in the OFT's report. The CC noted the stronger position of the 'challenger' banks (in particular HBOS, Alliance & Leicester and Abbey). This was evidenced by the increase in the market share of those banks from around 3 per cent in 2000 to around 9 per cent in 2006, the fact that switching data indicated that the challengers had been net winners, and the suggestion from the OFT survey that those SMEs that have switched or are considering switching are increasingly switching or considering switching to the challenger banks. The CC also noted the way in which the challenger banks had expanded their SME services since 2002. Noting the gains that SMEs could enjoy from switching to the challenger banks, this strengthening of their position appeared to be consistent with their posing a competitive constraint.
- 15. In considering the evidence on barriers to switching, the CC noted that only if barriers to switching were sufficiently low would the four banks be constrained in their ability to raise prices following a release of the Transitional Undertakings. The CC was concerned that actual levels of switching remained low. The OFT's 2006 survey for example showed an annualized switching rate of 4.3 per cent and showed that in three years prior to the survey 13 per cent of customers had switched, as compared to 12 per cent in 2000. The CC also noted that SMEs still typically stay with a particular bank for a very long period of time (the Warwick survey showed that the average length of the financial relationship was 15 years). The CC further noted the OFT survey showed that 25 per cent (up from 14 per cent in 2000) of those that had switched had encountered problems in doing so. However, it noted that the Transitional Undertakings themselves may to some extent have reduced the incentive to switch and also that the fact that the OFT survey had found an increased perception that 'all banks are the same' could indicate this. The CC also noted that not all, or even most, customers would need to exercise a credible threat to switch in order to constrain a bank's pricing. It noted that the Behavioural Undertakings, which will be retained, are concerned in part with making switching easier. The CC also

noted the OFT survey, which suggested that in response to a 5 to 10 per cent price rise 19 per cent of those SMEs surveyed would definitely switch bank, and a further 48 per cent would consider switching. In addition, the CC accepted that the Transitional Undertakings might have achieved a 'ratchet effect' by establishing an expectation among customers that an interest-bearing account or an account without standing charges or money transmission charges would be available so that it would be difficult for banks to abandon these offers.

16. The CC noted that there had been changes in the market shares of the four banks with [X] falling from [X] per cent in 1999 to [X] per cent in 2005, [X] falling from [X] per cent to [X] per cent, [X] rising from [X] per cent to [X] per cent and [X] remaining stable with [X] per cent. However, it also noted that these changes could have occurred for a number of reasons, including, for example, the different strategies pursued by HSBC and LloydsTSB on the one hand and by Barclays and RBSG on the other. The CC was not therefore persuaded that these shifts in market share necessarily indicated an increased intensity of competition. The CC further noted that the aggregate market share of these four banks remained high, at 85 per cent in 2006 as compared with 92 per cent in 2000. The CC also noted the changes in the banks' tariffs since 2002. However, since many of these changes represented attempts by the banks to encourage customers to use technology that was lower cost for the banks, it was not clear that these changes were indicative of increased competition.
17. The CC did not attach great weight to the evidence cited in the OFT report that the Transitional Undertakings were having a negative effect on innovation. This evidence largely consisted of statements from banks that the undertakings have had a negative effect on investment and also about what they would have done in the absence of the undertakings. Whilst accepting that this might be true, there was no additional evidence from other sources that enabled it to be substantiated one way or another.
18. Similarly, the CC did not attach significant weight to the banks' argument that the need to comply with the undertakings had resulted in significant hedging costs. These estimated costs appeared to be highly dependent on the form of hedging policy chosen by the banks and the shape of the interest yield curve in recent years. These assumptions may not apply on a prospective basis. The OFT told the CC that it did not place great weight on this evidence.
19. The CC acknowledged the potentially distortive effects of price control remedies. However, it also noted that the CC inquiry group gave this full consideration during the original investigation and sought to ensure that the Transitional Undertakings allowed substantial opportunity for profitable entry and expansion. The CC did not therefore consider that the distortive effects of the price controls were likely to be a significant element in the change of circumstance identified by the OFT. However, to the extent that the benefits had diminished, the CC accepted that these distortive effects were a significant element in its consideration of the balance of costs and benefits now associated with the Transitional Undertakings and, it noted that in general, the distortive effects of price caps are likely to increase over time. In this regard, the CC noted that although it appeared that the inquiry group had expected the price controls to remain in place for around 'two to three years' they had now been in place for more than four years.
20. The CC noted that the original purpose of the Transitional Undertakings had been to mitigate certain of the adverse effects of the lack of competition which the CC had found in its 2002 report (specifically excess prices, which had manifested themselves in excess profits). They were not aimed at remedying the lack of competition itself,

which the Behavioural Undertakings were designed to remedy. The CC noted that the four banks appeared to have complied with the Transitional Undertakings, and were offering SME accounts which offered either interest of at least 2.5 percentage points below base rate or no standing charges or money transmission charges (or both).

21. The CC considered what might happen if it were to release the Transitional Undertakings. Taking into account the stronger position of the challenger banks, the effect of the Behavioural Undertakings in making switching easier, the greater propensity of SMEs to consider switching, and the shift in customers' expectations (the ratchet effect referred to in paragraph 15), the CC considered it unlikely that banks would be able to raise prices significantly in a visible way. The CC also considered that the degree of scrutiny to which banks were currently subject would reinforce this constraint. However, the CC remained concerned that the opacity of pricing for SME banking services could allow banks to raise prices in ways that would not be immediately visible to customers. The CC therefore decided that undertaking 11 of the Transitional Undertakings, which requires the banks to notify the OFT and to publish notifications of new charges and increases in charges, should be retained. In reaching this decision, the CC noted that the Behavioural Undertakings enable the OFT to require the banks to provide information. However, the CC took the view that there was significant value in maintaining a requirement that the banks pro-actively notify the OFT of changes in charges.
22. In addition, the CC has provisionally decided to recommend that, were the banks to increase charges, introduce new charges or reduce interest payments in response to the release of the Transitional Undertakings, the OFT should raise awareness of this fact. The CC has also provisionally decided that the OFT should take account of any such response to the release of the Transitional Undertakings in any future review of the Behavioural Undertakings.

Provisional recommendations on the Behavioural Undertakings

23. The CC noted the OFT's observations on the impact of the Behavioural Undertakings in the context of the impact of both the Transitional Undertakings and the Behavioural Undertakings taken together. The CC wishes to stress that its provisional decision to release the Transitional Undertakings with the exception of undertaking 11 should not in any way be seen as indicating a lesser need for the Behavioural Undertakings (and undertaking 11 of the Transitional Undertakings). The CC agrees with the OFT that these undertakings should remain in place, certainly until the OFT has undertaken a full review in the future.
24. The CC shared the concerns raised by the OFT in connection with the Behavioural Undertakings. As noted in relation to its provisional decision on the Transitional Undertakings, the CC was concerned that actual levels of switching have remained low. The CC also noted that the OFT had observed a very low level of compensation payments made by the four banks, which appears not be consistent with the banks complying with their obligations under the Behavioural Undertakings in a pro-active way (for example by making customers aware of the existence of compensation and encouraging eligible customers to apply for it). The CC also noted the OFT's observation that awareness among SMEs of the undertakings was low. This was not necessarily an indicator of a failure on the part of the banks to be pro-active (as customers may not know that what banks are doing is a result of the undertakings). However, the CC considered that increased awareness among customers of the obligations placed on the banks not to impede switching and to pay compensation if certain stages of the switching process are not completed in the required time or if

errors occur, could increase their propensity to switch or threaten to switch and thereby enhance the impact of the Behavioural Undertakings.

25. For this reason, the CC has provisionally decided to recommend that the OFT work with the relevant banks to publicize the obligations they face under the Behavioural Undertakings. The CC would hope that this could be done, for example, by working with organizations such as the Federation of Small Businesses and the Forum of Private Business, and by taking advantage of the high levels of interest currently in the banking industry. The CC would also hope that such activity could become part of, or complementary to, the OFT's wider work on banking and could be undertaken in a way that would be consistent with its more general advocacy role.
26. The CC also noted the OFT's finding that awareness of the Banking Code among SMEs was much higher than awareness of the undertakings. The CC considered that it would be helpful for the OFT to explore with the British Bankers' Association whether and how to include the substance of the Behavioural Undertakings in the Banking Code itself. This would seem not only to have advantages in terms of increasing the impact of the Behavioural Undertakings but would be in line with the general principles of better regulation. In making this recommendation, the CC is aware that a review of the Banking Code was only recently completed. It does not intend to recommend that this review should be re-opened, but rather than the incorporation of the Behavioural Undertakings in the Banking Code should be considered as appropriate and certainly in the next review of the Code.

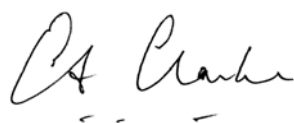
Next steps

27. The CC is issuing this Notice to provide an opportunity for representations to be made in relation to its provisional decision to release the four banks from the Transitional Undertakings with the exception of undertaking 11, which relates to the notification of charge increases and new charges.
28. Comments are therefore invited and should be received by the CC no later than 17.00 on Friday 28 September 2007 and should be addressed to:

Cathryn Ross
Director of Remedies and Business Analysis
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Or emailed to: cathryn.ross@cc.gsi.gov.uk

29. Before releasing the Transitional Undertakings with the exception of undertaking 11, the CC will have regard to any representations made in accordance with this Notice and may modify its decision as a result of such representations.



CHRISTOPHER CLARKE
Deputy Chairman
23 August 2007