

## Efficiencies

### Introduction

1. This appendix considers the efficiency of the eight largest banks in Northern Ireland. Inefficiency in the market may be evidence that the banks are not competing effectively.
2. Our analysis has focused on how the banks monitor their efficiency, and how they have attempted to improve their efficiency. In doing so, we considered how the banks operate their branches in Northern Ireland and in particular the effect any differences between the banks' branch structures has on their efficiency.
3. An analysis of efficiency would ideally be largely based on an analysis of costs. However, given the implications of using figures which rely in part on subjective assumptions (see Appendix 4.11 on cost allocation and return on capital), we attempted to reach more reliable conclusions by focusing on revenue figures, and other volume-based data.

### Analysis of efficiencies

#### ***What do the banks do to monitor their efficiency?***

4. During the course of the inquiry we asked the banks for detailed financial data on their Northern Ireland PCA business (including detailed profit and loss accounts). As discussed in Appendix 4.10, none of the banks routinely produce profit and loss accounts for their Northern Ireland PCA business and so we have not been able to obtain robust data on Northern Ireland PCA-specific costs (and hence profitability). This affects our ability to place reliance on PCA cost/income ratios (a common measure of efficiency in the banking industry).

5. In addition to the basic financial data we asked the banks for more detailed data and analysis on the following:
- benchmarking of their Northern Ireland PCA businesses against other regions in the UK;
  - comparison of the efficiency of their different products;
  - activity-based costing of their PCA activities;
  - the split of their activities between PCA/non-PCA business, and between back-office and front-office operations; and
  - revenue or contribution from branches for both their PCA and retail banking businesses.
6. The banks have been unable to provide us with answers to the detailed questions on efficiency sufficient for us to draw conclusions from them. We noted that, whilst the banks may monitor their efficiency for their retail business as a whole, they do not separately monitor the efficiency of their PCA businesses in Northern Ireland on a routine basis. [redacted] told us that whilst it may not have been able to respond to some of our specific questions it does monitor the efficiency of its PCA business. In particular it highlighted KPIs for [redacted].
7. This appendix highlights the gaps we have in the data. Some of the clearers (for example, [redacted] and [redacted]) are improving their systems following acquisitions, although some of the improvements are not solely linked to the acquisitions. The non-clearers monitor their business on a regional basis and in some cases will monitor their PCA business on a regional basis; however, these regions are all larger than Northern Ireland.

***What are the banks doing to improve their efficiency?***

8. We asked the banks what measures they took to improve the efficiency of their Northern Ireland PCA business. Their approaches are set out below.

*Bank of Ireland*

9. [REDACTED]

*First Trust*

10. [REDACTED]

*Northern*

11. Following its purchase by Danske, Northern is embarking on a programme of significant investment in technology to move to the Danske platform. It is believed that this will make Northern more efficient in providing services to PCA customers, [REDACTED].
12. Danske anticipates removing £[REDACTED] of costs a year from National Irish and Northern's cost bases through 'de-duplication' of back-office costs and other cost synergies— [REDACTED]. The fact that there are significant costs to be extracted is a reflection of historical inefficiencies. [REDACTED]

*Ulster*

13. [REDACTED]

14. [REDACTED]

15. [REDACTED]

16. In summary, the clearers are becoming more focused on possible efficiency initiatives and there have been improvements following the acquisition of Northern by Danske and Ulster by RBS.

### ***Non-clearers***

17. The non-clearers treat Northern Ireland as another part of the UK and do not have any Northern-Ireland-specific efficiency programmes. All the non-clearers have integrated IT systems, and centralized back offices, for the whole of the UK. They tend to see themselves as ahead of the clearers in Northern Ireland PCAs in terms of:
- more up-to-date IT systems; and
  - greater level of centralization of their back-office functions.
18. The non-clearers do not focus specifically on Northern Ireland, which they told us was a result of the low level of revenue and profit which they derived from their businesses there, rather than any general lack of efficiency in Northern Ireland.

### ***The relative costs of personal banking in Northern Ireland and Great Britain***

19. Some banks have claimed that the costs of personal banking activity have traditionally been higher in Northern Ireland than elsewhere in the UK, and that this is in part a reflection of its economic background (see paragraphs 2.3 to 2.12).
20. However, in contrast, some of the banks told us that there were offsetting advantages such as lower staff and property costs in Northern Ireland compared with the rest of the UK. We were unable to reach a conclusion on the net impact of these various factors on the relative costs of offering PCAs in Northern Ireland and the rest of the UK.

## ***Economies of scale***

21. We have been told by some of the banks that economies of scale exist in the banking industry. For example, when undertaking a new development, such as addressing stricter regulatory requirements imposed in the UK, the costs incurred in amending central systems, and developing new processes and procedures, are broadly the same for large and small institutions. Larger institutions can spread their costs over a significantly larger customer base throughout the UK, so the total cost recovery required per customer is in many instances a fraction of those of a smaller competitor. Larger institutions can also, by virtue of their size, negotiate lower prices from suppliers as well as for marketing, advertising and brand building.
  
22. Some of the clearers have claimed that they suffer from inefficiencies compared with the non-clearers due to a lack of economy of scale, resulting in higher cost/income ratios. However, [redacted] told us that it achieves efficiencies to generate value from its branch network and improve performance in terms of price, quality of service and new products.
  
23. Although the non-clearers have more branches in the UK than the clearers, we also considered the relative sizes of the parent groups of the clearers and the non-clearers in Northern Ireland to assess possible economies of scale. This is set out in Table 1 of the provisional findings.
  
24. The banks derive efficiency gains from the following sources:
  - (a) Size: larger groups should be able to generate economies of scale. Following the acquisitions by RBS (of Ulster) and Danske (of Northern), these two clearers are now part of large groups (in terms of total group assets). However, there are significant differences in the size of the ultimate parent among the four clearers and similarly among the four non-clearers.

- (b) Number of branches: having a large number of branches will increase the scope for centralization, and increase the number of branches over which centralized costs can be spread: costs can be spread across the UK branch network, rather than just across the Northern Ireland branch network. However, a substantial branch network and associated costs can a disadvantage if not utilized effectively.
- (c) Operating in the same regulatory and legislative regime (and in the same language), eg within the UK, will facilitate the banks' ability to integrate IT systems, regulatory operations and avoid duplication.
- (d) Centralized back-office functions and headquarters: the non-clearers are all integrated within the UK; Northern and National Irish Banks are migrating on to the Danske platform; [✂].

25. We note that many of the banks are part of larger groups, allowing them to benefit from economies of scale in terms of processing costs, advertising and brand building, and product and systems development. Following the acquisition of Ulster (by RBS) and of Northern (by Danske), the clearers are now part of groups that are as large, on average (in terms of total group assets), as the non-clearers' respective groups. In addition, BoI and AIB, First Trust's parent company, are the two largest banks in the Republic of Ireland.

### ***Cost/income ratios***

26. The banks do not report Northern Ireland PCAs as a stand-alone business: the clearers (other than BoI) look at Northern Ireland generally and some large business units within it; the non-clearers consider PCAs across the UK as a whole but do not split this geographically. The banks have therefore generally had to allocate and apportion costs to produce P&Ls for their Northern Ireland PCA business specifically for our investigation.

27. In the banking industry, a commonly used indicator of efficiency is the cost/income ratio (ie the cost divided by revenue: a figure over 100 per cent indicates a loss). The figures which the banks have produced for Northern Ireland PCAs are set out later in Table 4. Cost/income ratios are based on the same data as profitability (ie revenues and costs) and rely to a large extent on subjective assumptions about cost allocations.
28. The PCA revenue figures used are those provided by the banks, with the following exceptions: [redacted].
29. Although, in general, revenue figures are more reliable, it should be noted that:
- Revenue figures will be prone to misstatement where customers routinely operate their business through a different branch to where they hold their account (and so costs and revenues do not occur in the same place).
  - For some banks, producing PCA revenues required allocating and apportioning charges and NII.
30. We note that, as a mutual, Nationwide does not aim to return all its value by way of profit.

### ***Comparison of Northern Ireland and the rest of the UK***

31. There are differences in the business mix of the different banks. For example, in Northern Ireland the clearers will tend to have more SME businesses within their retail businesses, and the non-clearers will tend to have more mortgage business. The differences in cost/income ratios will often reflect these differences in business model as much as differences in efficiency.

32. As a first step, we asked the clearers to provide their cost/income ratios for their Northern Ireland businesses as a whole in order to compare their Northern Ireland businesses in total to the cost/income ratios of banks in the rest of the UK. The cost/income ratios for the clearers' retail businesses are set out below.

TABLE 1 Clearers total retail cost/income ratios for Northern Ireland

	<i>per cent</i>		
	2002	2003	2004
Bol	(	✂	)
First Trust			
Northern			
Ulster			
Average (unweighted)	55.0	53.4	56.8

Source: CC analysis of responses by the banks

Notes:

1. All year ends are to 31 December, except for Bol 31 March, Northern 30 September.
2. [✂]

33. We compared these cost/income ratios to those of the entire retail businesses of the non-clearers in the UK as a whole. The majority of the non-clearers business is retail and these are the figures quoted. These are set out below.

TABLE 2 Non-clearers retail cost/income ratios for UK

	<i>per cent</i>		
	2002	2003	2004
Abbey	(	✂	)
A&L			
Halifax			
Nationwide			
Average (unweighted)	53	55	56

Source: Annual Reports, company websites, CC analysis of responses.

Note: [✂] ratio is for total business. Other banks are for retail segment (as reported).

34. In addition, set out below are cost/income ratios for the retail banking business of four of the banks based in Great Britain.

TABLE 3 Selected UK banks' retail banking cost/income ratios

	<i>per cent</i>	
	2004	2005
Barclays	71	67
Lloyds	51	50
HSBC	66	58
RBSG	42	42
Average (unweighted)	57	54

Source: Annual Reports, company websites.

*Notes:*

1. HSBC relates to Europe personal financial services (the UK comprises the bulk of HSBC Europe business).
2. RBSG—relates to entire RBS group including Ulster.
3. 2005 figures for RBSG and Lloyds are on a UK GAAP basis (comparable with 2004), Barclays and HSBC only show 2005 retail cost/income ratios under IFRS.

35. Tables 1 to 3 show that there is little difference in cost/income ratios between the clearers' Northern Ireland retail businesses and those of either the non-clearers in the UK as a whole, or other banks based in Great Britain, and that there are significant differences within the four clearers and similarly within the four non-clearers. However, it should be noted that the figures in Tables 2 and 3 are taken from statutory information and are therefore not directly comparable to those in Table 1 which have been created for our purposes. Furthermore differences in cost/income ratios between banks may reflect differences in product mix.

36. There is a difference of at least ten percentage points between [X].

**Comparison of PCAs to other products**

37. There are obvious difficulties in comparing the efficiency of PCAs to other products. Some banks (eg [X]) have claimed that PCAs are sold at a loss to gain access to customers and to generate revenue from the sale of other products, eg savings, credit cards and loans.

38. Appendix 4.11 on cost allocation and return on capital noted that there were significant difficulties in allocating costs to the banks' PCA businesses in Northern

Ireland. [redacted] told us that the cost income ratios may also reflect differences in cost allocation methodologies and product mix. Nevertheless, we considered that useful information can be extracted from a comparison of cost/income ratios for the banks' Northern Ireland PCA businesses (see Table 4).

TABLE 4 Cost/income ratios (Northern Ireland PCA business)

	<i>per cent</i>			
	2002	2003	2004	2002-2004 CAGR
Bol	(	)	✂	)
First Trust				
Northern				
Ulster				
Average clearers	98	98	100	
Abbey	(	)	✂	)
A&L				
Halifax				
Nationwide				
Average non-clearers	110	107	92	
Average cost/income ratio	104	103	96	

Source: CC analysis of responses to the Financial and Accounting Questionnaire.

Notes:

1. 'CAGR' means the compound annual growth rate, e.g. the increase from 2002 to 2004 represented as an annual rate.
2. Cost/income ratio is operating cost (excl bad debts) over total revenue.
3. Averages are simple non-weighted averages.

39. The variation in cost/income ratios between the banks is likely to reflect in part at least the differences between the cost allocation methodologies which they have used as much as showing differences in efficiency. For example, [redacted].

40. Although we cannot place much reliance on the Northern Ireland PCA business cost/income ratios, it should be noted that the ratios for the banks' Northern Ireland businesses in total are significantly better than those for their PCA businesses.

41. For the non-clearers figures we also considered the cost/income ratios of their PCA business in the whole of the UK. These are set out below.

TABLE 5 Non-clearers UK PCA cost/income ratios

	<i>per cent</i>		
	2002	2003	2004
Abbey	(	✂	)
A&L			
Halifax			
Nationwide			
Average (unweighted)	114	104	87

Source: CC analysis of responses from the banks.

42. These are consistent with the figures and information that the non-clearers have given us for their Northern Ireland PCA businesses: [✂] estimated that the cost/income ratios for its Northern Ireland and UK PCA businesses are the same. Based on the financial information provided, we found that [✂] and [✂] PCA business in Northern Ireland were slightly more profitable (or slightly less loss-making) than the rest of the UK, and [✂] Northern Ireland PCA business was less profitable.

43. We asked the banks what benchmarking they produced of their products' performance against each other. In general, all the banks are unable directly to compare the revenues and costs arising from individual products. However, [✂] calculated the returns on risk-adjusted capital (RAROC) from its different products, and this analysis is set out in Table 6.

TABLE 6 [✂] returns on capital by product, 2002

	<i>per cent</i>	
	✂	)

Source: [✂].

Note: PCAs = [✂].

44. As can be seen from the analysis, PCAs<sup>1</sup> are loss-making under [X] calculations, and are being subsidized by the [X] businesses among others.
45. This supports our understanding that the banks derive benefits from the provision of PCAs beyond the simple revenue streams arising from their PCA businesses. It is also consistent with the non-clearers' perception of their PCA businesses as less profitable than their retail businesses as a whole.

### **Branches**

46. A wide branch network is both an advantage and a disadvantage to a bank. It provides access to more customers (and PCAs are usually opened through branches), and is important in terms of brand, but at a cost. The banks do not all agree on the value of a branch network:
- (a) Some of the banks ([X]) claim that the branch network is at the heart of their PCA businesses, notwithstanding the growth of direct channels such as telephone and Internet banking.
- (b) Others see the branch network as less important and see the need for fewer branches than the traditional clearer model. [X] does not consider that such a network is necessary for successful entry into the market and [X]. A&L publicly describes itself as 'a direct bank with a High Street presence' and has stated that '... the cost of supporting a large branch network will become a hindrance rather than an advantage'.<sup>2</sup>
- (c) [X] believes that multi-channel banking is becoming increasingly important in the Northern Ireland market, with less reliance on branches and greater emphasis on remote channels while the branch still constitutes the main way in which a PCA is opened.

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<sup>1</sup> This differs to the CC's definition of a PCA for the purposes of this investigation.

<sup>2</sup> Chris Rhodes, Managing Director of the Retail Bank, Alliance & Leicester, 12 November 2004 (source: Alliance & Leicester Press Release).

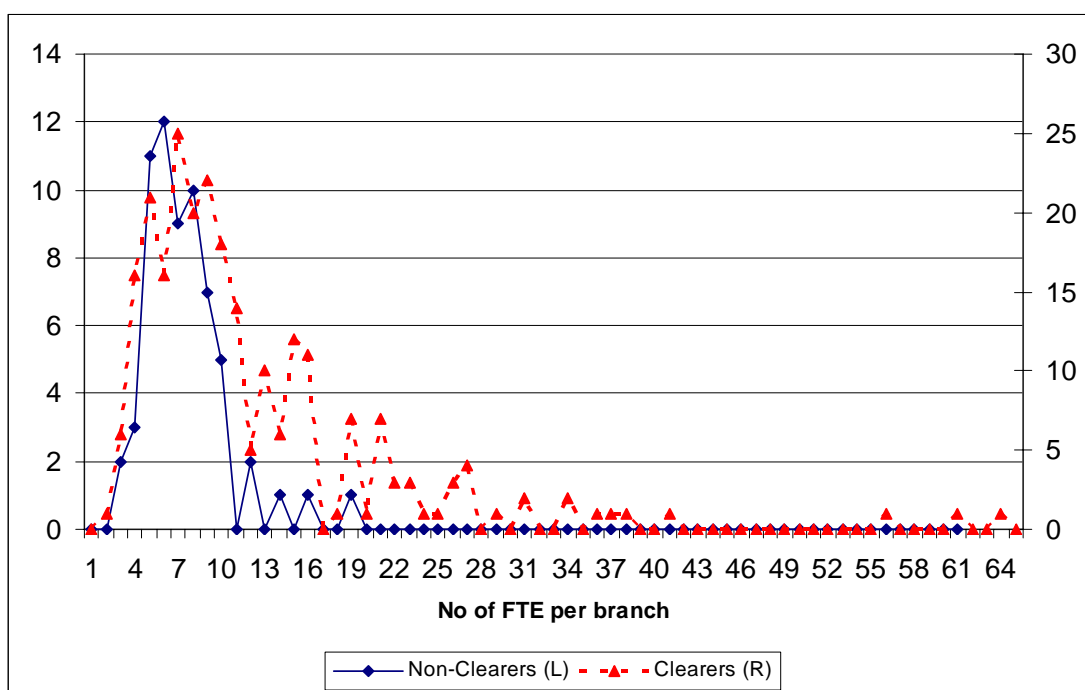
47. Despite the variety of views, there appears to have been no general moves by the clearers to reduce their branch numbers significantly [✂].

**Employees**

48. In order to understand a typical branch, we considered the distribution of branch staffing. Figure 8 shows the frequency of each size (in terms of FTE employed there) of branch.

FIGURE 8

**Distribution of FTE per branch**



Note: The y-axes are the number of branches (the blue line is non-clearers—shown on the left hand y-axis, the red is clearers—shown on the right-hand axis). Agency staff are excluded.  
Source: The banks.

49. On average, the clearers have a larger number of FTEs per branch than the non-clearers: the peak of their distribution curve is to the right of the non-clearers.
50. The number of staff per branch is affected by the service level the bank chooses to deliver and the business mix—clearers tend to have more loans and business

banking, for example whereas the non-clearers tend to have more mortgage business.

### **Movement in headcount for the banks in Northern Ireland**

51. One of the key drivers of efficiency which the some of the banks claim to be aiming for is to reduce headcount: it is a large and easily measurable cost. Table 7 shows the movement in branch FTEs in Northern Ireland over the period 2002 to 2004.

TABLE 7 Movement in total Northern Ireland branch headcount

	2002	2003	2004	2002–2004 CAGR %
Bol				
First Trust				
Northern				
Ulster				
Average (clearers)	819	771	776	-2.7
Abbey				
A&L				
Halifax				
Nationwide				
Average (non-clearers)	129	127	132	1.2

Source: The banks.

52. The chart shows that except for the reduction for [redacted] in 2003, there has been no significant headcount reduction despite an environment in which the banks are seeking efficiency gains, and when they have identified headcount as a potential source of these. [redacted] and [redacted] noted that an increase in branch headcount may reflect a more customer-oriented branch model and [redacted] noted that the number of FTEs has been relatively stable despite the growing number of customers.

53. The banks have a constant number of branches and a relatively constant number of FTEs over the period. We therefore considered the number of active accounts per branch—set out in Table 8. Efficient gains can arise from either decreasing the

number of FTEs needed to service a constant number of accounts or servicing an increasing number of accounts with the same headcount.

TABLE 8 Active PCAs per branch

	2002	2003	2004	2002-2004 CAGR %
Bol				
First Trust				
Northern				
Ulster				
Average clearers	3,219	2,926	3,086	1.2
Abbey				
A&L				
Halifax				
Nationwide				
Average non-clearers	2,210	2,514	2,846	13.5
Average total	2,715	2,720	2,966	4.5

Source: CC analysis of responses to the Financial and Accounting Questionnaire.

Notes:

1. Averages are simple non-weighted averages.
2. Halifax and Nationwide show active PCAs divided by their total number of branches and agencies.

54. The non-clearers are growing the number of accounts that they have at their branches without increasing their branch headcount. This would appear to be an efficiency improvement compared with the clearers (it also reflects the fact that the non-clearers are growing their businesses more quickly). It should be noted that this table uses the number of active accounts as a proxy for the number of customers and that some of the banks ([redacted]) have expressed concerns about this use of active accounts as a proxy as any comparison is therefore not on a like-for-like basis. [redacted] told us that branch efficiency could only be gauged according to the total mix of business carried out in that branch.

55. As a comparison for the absolute number of accounts per branch, we compared these figures with those of other banks in the UK, as shown in Table 9.

TABLE 9 Selected UK banks—number of customers per branch in UK

<i>Bank</i>	<i>Branches</i>	<i>Customers ('000)</i>	<i>Customers per branch</i>
Lloyds TSB	2,238	10,338	4,619
Halifax	1,105	4,516	4,087
Barclays	2,070	7,883	3,808
HSBC	1,587	6,026	3,797
RBS	2,368	8,794	3,714
Average			4,009

Source: Datamonitor 'Branch Banking in Western Europe' (2002 and 2003).

Note: The number of debit cards in use has been used as a proxy by Datamonitor for the number of customers. This is likely to approximate the number of PCA customers.

56. It can be seen that the UK banks have on average a larger number of customers per branch than those in Northern Ireland. If it is more efficient to service more customers per branch, then in comparison the Northern Ireland banks are operating at a level of customers per branch that may create inefficiencies. However, this will also be the result of a relatively large size of branch network compared with Northern Ireland's lower population density as well as the other demographic differences discussed earlier, and [redacted] and [redacted] noted that any differences could not be regarded as a measure of inefficiency. Also we noted that the figures in Table 8 are based on the number of active accounts whilst the figures in Table 9 are based on all accounts, and this could be an explanatory factor for the differences.

### **Branch structure**

57. We asked the banks to provide us with a breakdown of their business activities separating those which are done centrally and those done at branches. In addition, we asked the banks to estimate the number of staff at branches which are 'back office' as opposed to customer facing.

58. While we received a poor response on the detailed split of branch activities, we received some useful overall comments: [redacted] and [redacted] told us that at branches all staff members participated in all activities; [redacted] that the vast majority of staff were customer facing; [redacted] believed that around 25 per cent of its branch staff were in the

'back office'; and [X] told us that the proportion of branch staff dedicated purely to 'back-office' activities is estimated at 7 per cent but the total proportion of customer-facing 'front office' work is approximately 70 per cent.

59. It appears that between three-quarters and all of the staff at a branch are customer facing. This confirms the trend for increasing centralization of back-office tasks that the banks (and also [X] and [X]) have described.

### **Financial analysis**

60. An analysis of efficiency would ideally be largely based on an analysis of costs. However, for the reasons discussed earlier, we also considered using volume-based data as proxies for costs.

### ***PCA employees***

61. The number of employees (or FTEs) is one of the main drivers of costs for the banks and one of the most clearly identifiable. We therefore sought to determine the proportion of FTEs that were related to the PCA businesses of the banks, as the differences in business mix do not allow us to make comparisons based on total FTE numbers, and asked the banks for this data. However, the only banks to have provided data on the allocation of FTEs to their PCA business are [X] and [X], which estimated that 34 per cent and 37 per cent of branch effort/time were related to PCAs respectively.
62. We were unable to estimate with sufficient confidence the percentage of FTEs that were PCA-related for the non-clearers to allow us to carry out any analysis involving relative PCA FTEs (for example, comparing transaction volumes, revenues or costs per PCA FTE). Nor were the banks able to provide any analysis which they had done to help us allocate FTEs to PCAs (for example, activity-based costing exercises).

### ***Branch contribution***

63. In order to analyse how productive each branch was in terms of how much retail banking revenue (and ideally how much PCA revenue) it generated per PCA FTE, we sought to determine both the total retail banking revenue and PCA revenue per branch and the total retail banking contribution per branch.
  
64. The only banks able to provide the branch contribution analysis that we requested were [REDACTED] and [REDACTED]. [REDACTED] produces cost/income ratios for each branch but could not split these into retail, or PCA. The other banks have not been able to provide any branch analysis comparing individual branches in terms of retail or PCA revenue or contribution. We were therefore unable to compare efficiency using these measures.
  
65. We note that one bank ([REDACTED]) told us that it believed that branch performance was also largely dependent on the branch manager—ie the effect of a good (or bad) manager can more than compensate for other factors.