House of Commons

Treasury Committee

Competition and choice in retail banking: Government Response to the Ninth Report from the Committee

Seventh Special Report of Session 2010–12

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Seventh Special Report

The Treasury Committee published its Ninth Report of Session 2010-12, *Competition and choice in retail banking*, on 2 April 2011, as House of Commons Paper No. 612. The Government response was received on 9 June 2011 and is published as an appendix below.

We note the Government response to paragraph 216 of our Report, where we recommended that the proposed Financial Conduct Authority (FCA) should have competition as a primary objective. We ask the Joint Committee that will scrutinise the Draft Financial Services Bill to examine the case for competition being a primary objective of the FCA.

The response from the Government is in plain text and the Committee's conclusions and recommendations are in bold text.

Appendix: Government Response

Introduction

The Government welcomes the Treasury Select Committee (TSC) report as an important contribution to the debate on the future of our financial sector. As stated clearly in the coalition agreement, the Government considers a move towards a more competitive banking sector as a priority. The Government is clear that competition benefits consumers, ensures market discipline and can act as a spur to economic growth.

The Government's response is focused on those of the Committee's recommendations that are directed at the Government. Many of the recommendations made in the TSC report fall directly within the remit of the Independent Commission on Banking (ICB). The Government looks forward to receiving the ICB's final report in September 2011, and will respond to it thereafter.

The landscape of retail banking in the UK

The financial crisis has resulted in significant consolidation of the UK retail market. Well known firms such as HBOS, Alliance & Leicester and Bradford and Bingley have either exited the market or merged with rival firms. A large number of building societies have merged, undermining the diversity of provision in the sector. Whilst these 'rescues' were necessary in order to preserve financial stability, the consequence has been to reduce competition and choice in the market. (Paragraph 27)

There has been a clear increase in concentration levels in parts of the retail market. Indeed, concentration in many sectors of the market is now higher than when Sir

Donald Cruickshank examined competition in retail banking, particularly in the personal current account and SME markets. The five large banks—Lloyds Banking Group, RBS, Barclays, HSBC and Santander—have an overwhelming 85% share of the personal current account market. In 2008 the market for SME liquidity services was dominated by just four firms who shared 80% of the market. Other parts of the retail market such as those for savings products and loans, where the number of participants is larger, are less concentrated. (Paragraph 38)

Competition policy should maximise the benefit to the consumer. Our evidence suggests that this is not happening. The large banks perform poorly on many consumer satisfaction surveys relative to other providers. Survey evidence consistently shows customers are dissatisfied by service quality and the lack of real choice on offer in the marketplace. In a genuinely competitive market we would expect firms which provide superior service, choice or prices to gain significant market share from rival firms, but we see little evidence that this is happening. (Paragraph 58)

Our inquiry has led us to conclude that further measures are required to promote competition in the retail banking sector and ensure improved outcomes for consumers. Poor consumer outcomes can be addressed by reducing barriers to entry and expansion—in order to promote greater competition between existing players and to encourage new entry. A focus on tackling concentration without tackling these issues would do little to promote a more competitive market. New and expanding entrants will only succeed in growing in key markets, such as the current account and SME markets, if impediments to their expansion—primarily problems with switching and the lack of transparency and comparability—are tackled. (Paragraph 223)

As set out in the Coalition agreement, one of the Government's priorities is to bring about a more competitive market across the entire financial services sector. This is a broad view taking in:

- Retail financial services: personal current accounts, savings and investments, credit cards, loans, mortgages, insurance
- Small business banking: business accounts, business loans and financing
- Wholesale financial services: corporate banking, investment banking, asset / wealth management, treasury services

For most people, experience of competition in financial services will be on the retail side —for example as a current account holder at a high-street bank. Many of the same principles and concepts that we use to describe competition in this sort of market apply just as well to small businesses or large corporates engaging with their financial services providers.

The Government cares about competition because the <u>outcomes</u> that healthy competition leads to are good for people, businesses and the economy.

Strong customers are a prerequisite for a competitive market to function. This means people and businesses have the financial capability required to take charge of their finances. It also means people and businesses have access to the information, tools and advice they need to make decisions.

The Money Advice Service, formerly the Consumer Financial Education Body, will help in this area. The Service has been set up by the Government, funded by the financial services industry, to promote understanding of the financial system and raise levels of financial capability across the UK. It provides free and impartial information and advice across the whole spectrum of financial issues from budgeting to building up emergency savings and pensions, and is available to all online, over the phone and face to face.

The Money Advice Service provides targeted education on financial matters at key life stages such as beginning work or becoming a parent, through a range of initiatives delivered online and in partnership with other organisations. It has launched a Financial Healthcheck which will provide consumers with actions to take to help them better manage their money and plan ahead for the future. In addition to improving financial capability, the Service aims to ensure that consumers are encouraged to shop around for the best deal and its website provides impartial comparison tables for a range of financial products.

The outcomes of a competitive market in financial services that are the focus of the Government's attention are characterised by:

- <u>Efficiency:</u> This means all firms in the market are continuously focused on attracting and keeping customers. They do this by providing a full range of products and services that meet customer needs, including value for money.

- <u>Diversity:</u> This means there is a choice on every dimension that customers value (e.g. whether to use a branch or go online, whether to opt out of unarranged overdrafts, etc.). It also means different management teams taking different approaches so that firms exhibit variety in corporate governance, organisational structures and business models.

- <u>Innovation:</u> This means the market continuously delivers incremental improvements to the products and services on offer. It also means existing firms and new entrants try out radical innovations (e.g. mobile banking) that have the potential to fundamentally change the nature of the industry.

Since the Government was formed last year, there have been two ways in which the Government has sought to address to the issue of competition in banking. These are discussed in more detail below:

- The establishment of the Independent Commission on Banking; and
- The reform of financial regulation including a significant strengthening of the role competition will play in delivering better outcomes for consumers.

On 16 June 2010, the Chancellor of the Exchequer announced the creation of the Independent Commission on Banking, chaired by Sir John Vickers. The Commission has been asked to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition, and to make recommendations to the Government by the end of September 2011.[1]

The ICB will formulate policy recommendations with a view to:

- reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- mitigating moral hazard in the banking system;
- reducing both the likelihood and impact of firm failure; and
- promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.

The Commission will make recommendations to the Government in their final report covering both:

- structural measures to reform the banking system and promote stability and competition, including the complex issue of separating retail and investment banking functions; and
- related non-structural measures to promote stability and competition in banking for the benefit of consumers and businesses.

Competition will also be an important feature of the regulatory remit of the Financial Conduct Authority (FCA), the new conduct focused regulator being created as part of

1 The full terms of reference for the Commission can be found at http://www.hm-treasury.gov.uk/d/banking_commission_terms_of_reference.pdf

the Government's reforms to the domestic financial services regulatory architecture.[2] One of the FCA's operational objectives—facilitating efficiency and choice in the market for financial services—is specifically intended to reflect in the FCA's remit the importance of competitive markets in delivering better outcomes for consumers. The objective captures two crucial elements of competitive markets in delivering better consumer outcomes—efficiency in terms of pricing, supported by an appropriate degree of choice. Therefore this operational objective is framed in such a way as to provide a clear expectation that the FCA should seek to promote competitive markets.

These initiatives complement the ongoing work of the Office of Fair Trading (OFT) which has looked at the UK banking market in some detail over the past year. The OFT have recently undertaken and completed a market study into the fees paid for equity underwriting services[3] and a review of the barriers to entry, expansion and exit present in the UK retail banking market[4] which are important contributions to the debate. The OFT has also progressed work begun in 2007 on the Personal Current Account (PCA) market in the UK, working with banks to improve the account switching process, the level of transparency in the market and the level of consumer control over unauthorised overdrafts.[5] This is discussed further in the next section.

The current account market and switching

Market transparency, the role of information and competition

We are concerned by the significant increase in concentration in the personal current account market in particular and the dominance of a handful of large banks. Despite the larger banks' protestations, we consider the current account remains a "gateway" product which means dominance in this market by the large banks has competition implications elsewhere in the sector. This means that barriers to competition in the personal current account market need to be scrutinised particularly carefully. (Paragraph 65)

Sir Donald Cruickshank identified problems with price transparency and the difficulty of comparing products in his 2000 report on competition in the banking sector. Over a decade on those problems remain acute. The OFT is working with the banks to try to ensure greater transparency. It is vitally important to ensure information is provided in a way which enables meaningful comparability. We believe that, as a matter of priority, the OFT and the banks must examine how best to present information to consumers on net interest foregone. 'Information overload'—the tendency to simply 'flood' consumers with information, acting to increase consumer inertia must be avoided. (Paragraph 87)

2 Further details can be found in the Government's February 2011 consultation document A new approach to financial regulation: building a stronger system (http://www.hm-treasury.gov.uk/consult_finreg_strong.htm)

3 Available at: http://www.oft.gov.uk/OFTwork/markets-work/completed/equity-underwriting/

4 Available at: http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/review-barriers/

5 Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf

Competition can only be effective if consumers feel confident in switching to new providers. Although there is evidence that the system has improved, the perception remains that there are still risks involved in switching, and levels of switching remain low. We believe it should be possible to find technical ways of making switching easier without excessive cost—one such suggestion has already been submitted by Cut Loose. We recommend an independent technical study should be done into how account portability could operate. There are also ways in which switching can be made easier without new technical infrastructure. These need to be explored more urgently by the regulator. This should include provisions that the provider, not the customer, should be penalised if things go wrong. (Paragraph 121)

The Government is clear that there needs to be more competition in the retail banking market in the UK and clear that banks need to do more to serve consumers. Consumers need to be confident in dealing with banks, and banks need to quickly respond to customer concerns, if competition is to work effectively.

The new Financial Conduct Authority will be the first body to have a single focus on the conduct of business. As such the FCA will have, as its core purpose, protecting and enhancing the confidence of all consumers of financial services–from retail customers choosing a current account to a hedge fund engaging in multi-million pound derivatives trades. Much of the FCA's focus will be on developing a new model of conduct regulation in the retail sphere, using early and proactive intervention to ensure that the interests of retail customers are protected.

It is also the case that the Government wants the FCA to play a far stronger role promoting competition than its predecessor. As has been noted regulation in itself is not enough to promote good consumer outcomes. We need to see competition between providers and choice between products. This emphasis on competition has been reflected in the statutory remit of the FCA.

The Government is also committed to ensuring better deals for consumers who take out credit. In October 2010 the Department for Business and HM Treasury launched a joint review of consumer credit and personal insolvency. The review covers all aspects of the consumer credit lifecycle from the decision to take out a loan through the lifetime of the loan, including what happens when things go wrong. This is an opportunity to ensure that we have a regulatory framework that is fair to both consumers and the industry.

As part of the review Government issued a call for evidence that closed on 10 December. We have received a number of submissions addressing a variety of issues, including interest rate caps and closer links between the Post Office and Credit Unions. We have also received a large number of individual emails that call for Government to take action in these areas. The Call for Evidence has now closed. The Government will publish its response to the review before the parliamentary summer recess in late July.

The Independent Commission on Banking is also considering issues surrounding market concentration and transparency, and is exploring ways to improve the switching process for retail banking customers. The Government looks forward to their final report in September 2011.

In addition and as noted in the Committee's evidence sessions, the OFT has investigated various aspects of the UK retail banking market numerous times in recent years.

The OFT's Personal Current Account (PCA) market study (2008)[6] found that many consumers were unaware of the key costs associated with their PCA. This was partly due to the low levels of transparency of the costs associated with holding a PCA such as unarranged overdraft charges and interest forgone. In October 2009, the OFT agreed a voluntary programme with the banks to implement a number of initiatives to enable customers to understand better the costs associated with their accounts and make comparisons with other accounts that may be available. Namely the banks agreed to:

- introduce an annual summary of the cost of their account for each customer.
- make charges more prominent on monthly statements, so that customers are more aware of the charges that they pay.
- provide average credit and debit balances, which will help customers to estimate the potential benefits of switching PCA provider.
- produce illustrative scenarios showing unarranged overdraft charges, giving customers an idea of the costs for different patterns of use.

The illustrative scenarios have been available from PCA providers' websites since June 2010 and the remaining information will be provided to consumers by late 2011.

The OFT did look into the possibility of providing consumers with information on interest forgone. There were concerns expressed by some sections of the industry over how any interest forgone metric would be calculated and whether consumers would understand and utilise this information. In light of the current period of low interest rates OFT decided instead to provide an on-line calculator of credit interest (which allows consumers to compare the amount of interest they are currently earning to the amount of interest they would be earning with a different account) which is available on the Consumer Direct website. The OFT may, however, further consider the need for interest forgone in its expected review of the market in around 2012.

The OFT also believes that the introduction of a PCA comparison tool would be of significant benefit to consumers. The OFT recommended such a comparison tool in October 2009 and the Money Advice Service were tasked with considering the feasibility

6 Available at http://www.oft.gov.uk/OFTwork/markets-work/completed/personal/

of such a tool. The Money Advice Service has earmarked the possible development of such a tool in the coming financial year, subject to the completion of a feasibility study and available resources. The Government continues to believe that market transparency can be improved in the PCA market, and work is continuing in this area.

The Government has also committed to introduce measures to end unfair bank and financial transaction charges. This commitment is being taken forward as part of the Consumer Credit and Personal Insolvency Review. The Government is considering responses to the call for evidence and will come forward with more detailed proposals later in 2011.

Internet security

Given that a much greater share of the market is likely to be taken in by the internet in later years it is surprising how little work has been done to improve security, and the lack of detail apparently available to the police concerned us. We recommend that the regulatory and competition authorities return to this. (Paragraph 109)

The FSA expects the firms it regulates to establish and maintain appropriate policies and procedures for countering the risk of products being used for purposes concerned with financial crime, including Internet based services.

The OFT and the FSA will continue to work together, via the OFT/FSA Competition Concordat, to keep under review any anti-competitive effects that may result from business practices intended to reduce fraud. Work currently undertaken in this area by the FSA will be passed to the FCA once the reforms to the new financial regulatory architecture are complete.

The OFT's e-consumer protection study[7] found that there is a common perception among consumers that the Internet is susceptible to fraud; with concerns over the security of financial details the most often cited reason for not buying goods and services online. However, this concern is often uncorrelated with the number of fraud cases occurring. For example, in 2009, reported internet fraud in the UK decreased by 15 per cent from 2008, whilst internet transactions increased by 14 per cent during the same period.

7 http://www.oft.gov.uk/OFTwork/consultations/closed/2010/eprotection/

Competition for SME business

The Merlin Agreement

The Merlin Agreement is welcome. We hope that it does deliver the amount of SME lending that it promises, and given that there remains scepticism about this we shall examine the Bank of England's reports carefully. We are also concerned that the FSA's requirements on capital may inhibit the lending that is needed. (Paragraph 130)

Potential entrants to the SME market are faced with the same problems of customer inertia and fear of the switching process as face those entering the personal current account market. SMEs need access to a branch network and staff who understand their circumstances. It is unsurprising that the growth of new entrants in this market is slow. It is all the more important that Government policies positively encourage them and are designed in ways that recognise the challenges they face. (Paragraph 142)

In February the banks committed to increase the capacity of lending available to UK businesses this year. The commitment to make available £190 billion of new lending to businesses is up from £179 billion last year. £76 billion of this will be allocated to SMEs, a 15 per cent increase on 2010. The Government is clear that the banks must do all that they can to ensure that they meet their commitment at the end of the year.

Increasing the amounts that the banks are willing to make available to businesses over the next year will help to give businesses the confidence they need to seek finance from their bank and ensure that banks are focused on providing that flow of credit to businesses.

The Committee will be aware that the Bank of England reported the banks' first quarter performance against the Merlin Agreement on 23 May. The banks aggregate gross lending to all UK businesses was £47.3 billion. It is important to recognise that lending is not linear, so the Agreement has an annual target. The Government is encouraged that the banks are broadly on target to meet their overall commitment, and hopes that this progress continues.

Lending to SMEs in the first quarter was £16.8 billion. The Government is disappointed and the banks must do more to ensure that they meet their commitment. But it is significant to note that the Agreement with the banks was made mid-way through the first quarter and this might have impacted on the figures.

The commitment to lend to SMEs is linked to the remuneration of the banks' chief executives and senior managers responsible for business lending. But the Government is clear that, if the banks fail to meet their commitments, the Government reserves the right to return to the matter and take further measures.

In addition, the divestment of Royal Bank of Scotland branches to Santander will serve to increase competition in the SME banking sector. This is discussed in more detail below.

The Independent Commission on Banking is also working in this area, where the market for SME banking services has similar characteristics than the PCA market (including high concentration and the reliance of many customers on an established branch network). The Government looks forward to their final report in September 2011.

Availability of credit, customer service and non-price factors

The debate on SME banking has often only been focused on the availability and cost of credit. Good customer service for SMEs can be as, or even more, important to SMEs. Competition and the ability to switch, is the most important spur to better service. (Paragraph 134)

Recently the major UK banks have made firm commitments to improve the service received by their business customers. The new Lending Code and Principles were launched in April 2011, along with a transparent appeals procedure for declined loan applications. This procedure will be independently reviewed. In addition, the banks have agreed to improve customer information, signpost potential alternative sources of finance and initiate a pre-financing dialogue with businesses twelve months in advance of any term loan coming to an end.

The Government welcomes these commitments by the banks, and is working closely with the BBA to ensure that the measures are delivered for the benefit of business banking customers.

The Government recognises that improvements to the SME banking market go beyond simply the availability and cost of credit. The Government published a Green Paper in July 2010, 'Financing a Private Sector Recovery', which explored the different finance options available to different sized businesses. The Government's response to the Green Paper set out a comprehensive package of Government and industry-led measures to support small businesses which go beyond the availability and cost of credit.

These included:

- Additional support for the Enterprise Finance Guarantee (EFG) over the next 4 years to enable over £2 billion of lending to viable small businesses that lack collateral or track record.
- Increased equity finance, through a £1.5 billion bank-led 'Business Growth Fund' and through £200 million of additional funding for the 'Enterprise Capital Funds programme', both of which could unlock further debt finance for small and medium-sized businesses.[8]

8 More information can be found at: http://www.bis.gov.uk/businessfinance

In addition, in October 2010 the British Bankers' Association (BBA) published the outcomes of their Business Finance Taskforce, which was written in conjunction with the six major UK banks. The Taskforce banks have committed to improving customer relationships through a new Lending Code, ensuring better access to finance and promoting better understanding.

The Independent Commission on Banking is also working in this area. The Government looks forward to their final report in September 2011.

Encouraging greater competition and new entry

Royal Bank of Scotland

The sale of the RBS divestments to Santander was a missed opportunity to inject more competition into UK retail banking. Whilst Santander may have met the EU state aid criteria and enjoyed only a small share in the SME market, it was already a leading player in other areas. (Paragraph 167)

The RBS divestment goes to the heart of the trade off between maximising revenue and increasing competition. If the divestments had been sold to some of the other potential bidders it might (in the words of RBS) have represented "a straight giveaway from the taxpayer." However, whilst acceptance of an alternative bid may not have maximised short-term revenue for RBS and the taxpayer as the majority shareholder, it might have provided a greater impetus to competition in the sector. (Paragraph 168)

The RBS divestment to Santander illustrates the importance of giving greater consideration to competition when considering divestment policy. There may be a trade off between maximising revenue from the divestments by the part-state owned banks, and maximising the increase in competition through the divestments. The creation of a more competitive retail market is essential to secure lasting benefits for consumers. Maximising competition through the divestments will ultimately bring greater longer-term economic benefits to the UK through a higher overall GDP and subsequent higher tax yield. (Paragraph 173)

As a condition of EU State Aid approval for the aid they have received, RBS are required to execute a number of divestments including a UK retail divestment amounting to a 5 per cent market share in the UK SME market.

The terms of the State Aid agreement required that the buyer of the divestment must, in combination with the divestment business, have a UK SME market share of no more than 14 per cent. This was to ensure that the divestment could not be purchased by one of the large incumbent banks.

On 4 August 2010 RBS announced the sale of this divestment, equating to 318 branches and associated assets and liabilities, to Santander UK. Santander UK currently have a small presence in the UK SME market, with only 3 per cent of total assets, and so the divestment will increase their share of the SME market to 8 per cent. As a result, the sale will serve to increase competition in the sector.

As part of the State Aid agreement, the European Commission considered that the RBS divestment "adequately addresses the distortion of competition created by the aid and is an appropriate means of increasing competition on the concentrated UK banking market".[9]

Both banks continue to work closely to enable the separation and transfer of the business. Before the deal can close the FSA has to approve that an acquisition by Santander UK is consistent with financial stability.

Lloyds Banking Group

Lloyds Banking Group is currently the market leader in most parts of the retail market. In some segments, Lloyds market share is almost double that of its nearest competitor. As yet, there has been no assessment to see what impact Lloyd's strong position has had on competition in the retail market. We are concerned by the emergence of such a powerful player in the retail market and the potential competition implications. The divestments required by the EU will go some way towards addressing this concern as well as (in conjunction with the RBS divestments) reducing concentration levels in the sector. That said, Lloyds Banking Group will retain a leading position in many market segments even post-divestment. (Paragraph 180)

The European Commission approved the support by the UK Government to Lloyds Banking Group (LBG) under State aid rules subject to a number of measures imposed on LBG to minimise and compensate for the distortions of competition caused by the aid provided. These measures included for example the sale of 600 branches (including a 4.6% market share in personal current accounts and a proportion of LBG's mortgage book) and a reduction in LBG's balance sheet of at least £181.5 billion. Under the State aid decision, LBG has also committed to certain restrictions on its business behaviour. For example, it is not allowed to refer to the fact that it enjoys any State support or to the fact that the UK is a shareholder in LBG in any of its advertising, and it must not acquire any financial institutions until at least 2012.

Lloyds is responsible for executing its retail divestment in accordance with the legally binding state aid term sheet. A Monitoring Trustee has been appointed to monitor and ensure under the European Commission's instructions, compliance with the commitments.

9 http://ec.europa.eu/eu_law/state_aids/comp-2009/n422-09.pdf Para 244

The Independent Commission on Banking is also looking at structural measures to enhance competition as set out in their recent Interim Report. The Government looks forward to their final report in September 2011.

UKFI and Northern Rock

Whilst none of the large five banks will be able to bid for the Lloyds divestments, we still believe a public interest test based on competition considerations should apply both to the Lloyds divestments and the sale of Northern Rock. A failure to introduce such a test would be tantamount to admission that the Government has no real interest in promoting competition and is concerned solely with revenue maximisation. (Paragraph 174)

There are attractions to the mutual model. A remutualisation would certainly lend credibility to the Government's desire to foster diversity and promote mutuals. We would urge UKFI, notwithstanding the timescales for a return on its investment to the taxpayer, to honour that commitment by giving due consideration to a mutual option when considering the disposal of Northern Rock. This should be facilitated by taking expert advice on re-mutualising Northern Rock, placed at the appropriate time in the public domain. (Paragraph 196)

UKFI will assess competition considerations when making recommendations on the appropriate exit option for Northern Rock to the Chancellor. The UKFI Framework Document makes clear that any disposal recommendations put to HM Treasury must have due regard to competition.

Without prejudice to any future recommendations that UKFI may make, the factors that HM Treasury would expect to be considered by UKFI as part of a competition assessment include:

- The expected impact on the structure of the UK banking market: This may include consideration of the market shares of different institutions before and after the transaction in question, as measured by numbers of accounts or volumes of activity. The expected impact may be different for different product segments (such as mortgages or savings products).
- The expected impact on bank customers: This may include consideration of a range of factors relating to outcomes for bank customers. The expected impact may be different for different customer groups and/or regions within the UK.

Given that the sale of Northern Rock is subject to certain requirements set out by the European Commission in the State aid decision,[10] a decision on the exit option will also take into account compatibility with the State aid decision and general State aid rules.

10 Available at: http://ec.europa.eu/competition/state_aid/cases/225083/225083_1058677_200_1.pdf

The Treasury remains responsible for the Government's overall policy stance on the financial services sector. This includes the commitment made by the Government to foster diversity and promote competition in the banking sector.

As part of their assessment and evaluation into returning Northern Rock to the private sector, UKFI will assess the possibility of remutualisation before making their recommendation to the Chancellor.

Mutuals

We welcome the Government's intention to foster diversity and promote mutuals. This will only be possible if both Government and regulators take the sector into account from the very beginning of the policy making process. The evidence we received from the sector confirms our concern that this is not the case. In the Plan for Growth the Government has said it will "assess whether changes are required to update building societies legislation." We will study that assessment carefully. All market participants should be consulted at all stages on the basis that a level playing field exists for mutuals compared to companies based on the PLC model. To clarify matters and allay the concerns of the mutual sector the Treasury, working with the regulator, should set out the terms of the Government commitment to bring forward "detailed policies to foster diversity in Financial Services and promote mutuals." (Paragraph 188)

The Government acknowledges the benefits that mutuals bring to the marketplace and their role to play in fostering diversity and competition. Previously the FSA has worked with mutual trade bodies on a sector by sector basis but now intends to establish a working forum, to be up and running by the summer, to bring all the trade bodies together to ensure that mutuals collectively input into FSA policy formulation.

The Government has also committed to a legislative programme designed to strengthen mutuals in the UK. This includes assessing building society legislation and modernising how credit unions do business, enabling them to grow and compete with other financial services providers. At the European level the Government is leading the way in the Capital Requirements Directive negotiations, to ensure requirements take into account mutual specificities while ensuring the quality and quantity of capital in the banking system is improved.

The Government is clear that regulation should not seek to promote or favour one type of ownership model over another, and that consumers should not be advantaged or disadvantaged because of the ownership model of their provider. The same consumer protection, conduct and prudential standards must be applied to every regulated firm, regardless of their ownership model.

In order to ensure that a 'level playing field' operates across the financial system, the Government will modify the consultation requirements for both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) so that they must provide not only an analysis of the costs which will arise from a proposed rule, but also an analysis of the extent to which those costs (and benefits) affect mutually-owned institutions differently to other ownership models; this analysis will be undertaken alongside the usual cost-benefit analysis. This will serve to build up an impartial evidence base so as to assist the regulators, the public and Government in understanding whether the legislative framework continues to treat diverse financial business models appropriately.

The Financial Services Compensation Scheme (FSCS)

The Committee also took evidence regarding the arguments over whether mutuals are treated fairly by the FSCS, where the arguments are finely balanced. We recommend the FSCS levy should be reviewed as a matter of priority. (Paragraph 189)

The rules governing the FSCS are set by the Financial Services Authority (FSA), which has commenced a review of the funding model of the FSCS. They will proceed to a formal consultation and cost benefit analysis once discussions on European directives affecting compensation arrangements have been concluded and the Government's policy on the future role of the FSCS in the context of reform of the regulatory architecture for financial services has been settled.

It is essential that the Financial Services Compensation Scheme (FSCS) is able to pay out compensation to all eligible policyholders. Without certainty of payout, consumer protection is substantially weakened. It is therefore vital that the FSCS is able to raise resources in a range of circumstances to compensate consumers effectively.

Barriers to entry and prudential regulation

We disagree strongly with the assertion that the UK retail banking market is contestable. A market is contestable if entry and exit barriers are low and whilst this may be the case in certain parts of the retail market, it does not appear to be the case in parts of the personal current account and SME markets. Furthermore, the financial crisis has demonstrated that exit barriers in the UK banking market are anything but low. (Paragraph 44)

The OFT published a review of barriers to entry, expansion and exit in retail banking in November 2010.[11] With reference to differential access to information potentially disadvantaging smaller banks, the review ultimately found that there is a wealth of information on personal and SME customers' risk profiles available from a number of commercial sources to assist firms in accurately pricing their products. Access to this information, therefore, does not appear to be overly restricted nor a significant barrier for most firms.

11 Available at: http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/review-barriers/

The review did find that several providers face barriers to acquiring information on existing customers' income flows and spending patterns. This information can act as a barrier to expansion for existing smaller players or a barrier to entry for prospective new entrants. This information, however, is considered commercially sensitive and the wider availability of such information to all retail banking providers would undermine banking relationships.

The review also found that there is less information readily available on the smallest SMEs which can also act as a barrier to expansion for those providers wishing to offer small business banking services. This can have the effect of making it harder for new retail banking providers to be able to offer products, such as loans, to these businesses due to a lack of reliable information on their risk profile. SMEs themselves appear willing to provide much information and there are a number of private sector initiatives which, in time, may help remedy this information gap. For example, recent initiatives allow for SMEs to upload information for submission to retail banking providers. Such schemes have the potential to allow the smallest SMEs to make available the relevant information to providers to allow them to offer them business banking services.

As noted by the Committee, the recent financial crisis has shown the extent to which barriers to exit in retail banking, particularly where large banks are perceived to have gained a competitive advantage from being seen as “too big to fail”, can distort competition. The Independent Commission on Banking is considering these complex issues as part of its remit. The Government looks forward to the ICB’s final report in September 2011.

We have been told that the Basel II capital requirements currently disadvantage small banks. The move to Basel III may remove some of the disadvantages smaller banks face compared to their larger competitors. However smaller banks may suffer higher fixed costs of compliance which will disproportionately affect them. The Government and regulators should ensure that any competitive advantage accruing to incumbents is not unfairly reinforced through regulation. (Paragraph 208)

Under the Basel II accords, in general smaller banks have to hold more capital for a given level of assets than large banks with more sophisticated risk models, and this is likely to continue under Basel III. Smaller banks and mutuals may also face proportionately greater costs in raising the necessary additional equity finance compared to large banks, and the increase in fixed costs of providing banking services may also serve to strengthen the position of large incumbent banks by reducing the threat of entry.

However, other Basel III measures will to lesser or greater degree offset these effects of higher international standards, including the planned surcharges for systemically-important firms. Another example of measures that may reduce the extent to which prudential regulation imposes relatively higher capital requirements on smaller banks is the more stringent treatment of trading book assets, in particular where sophisticated risk models are used, which generally make up a larger proportion of large banks' balance sheets.

For smaller banks, sophisticated risk management technologies and techniques may be proportionally more expensive to acquire and operate, but where the FSA has discretion, it has sought to apply prudential policy in a way that avoids imposing disproportionate costs on smaller banks. One example is of liquidity requirements, where the process of model development and review is simpler and less resource-intensive for simpler firms.

While the Government supports reducing barriers to entry as an important lever to achieving greater competition, it is important that this does not undermine the regulatory authorities in setting clear standards for regulated firms, within which competition and innovation can thrive. It is the Government's view that financial stability, supported by a rigorous and effective regulatory framework, provides a strong platform for this industry's sustainable growth and success, and the new regulatory authorities will have simple and clear objectives aimed at promoting financial stability (the PRA) and protecting consumers (one of the FCA's objectives). The standards that both authorities set to allow firms to become authorised will be consistent with these objectives. The PRA will concentrate its resources and actions on those firms—primarily larger and more complex firms—and issues that pose the greatest risks to the stability of the UK financial system.

The objectives of the FCA

We are disappointed that the Government has not gone further in making competition at least one of the operational objectives of the FCA. We repeat our earlier recommendation that the FCA should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation. We do not understand how the FCA will be able to facilitate efficiency and choice in the market while treating competition as a secondary consideration. (Paragraph 216)

To ensure competition concerns are at the heart of the new conduct regime the Government has decided to impose a duty on the FCA to promote competition, in discharging its general functions in pursuance of <u>any</u> of its operational objectives, unless this would be incompatible with its strategic and operational objectives.

The Government is clear effective competition plays as an important role in protecting consumers. One of the FCA's operational objectives–facilitating efficiency and choice in the market for financial services–is specifically intended to reflect in the FCA's remit the importance of competitive markets in delivering better outcomes for consumers. The objective captures two crucial elements of competitive markets in delivering better consumer outcomes–efficiency in terms of pricing, supported by an appropriate degree of choice. Therefore this operational objective is framed in such a way as to provide a clear expectation that the FCA should seek to promote competitive markets.

Size and systemic importance

The large banks have told us that ultimately consumers will benefit from lower prices resulting from the economies of scale and synergies provided by larger more diversified banks. We agree that there are economies of scale/minimum efficient scale in retail banking which will ultimately limit the total number of firms in the market. However, we question whether the need for economies of scale justifies banks having a 30% share of the market or whether such benefits, if they exist, will be passed onto consumers in a market where competition is deficient. Indeed, such economies of scale benefits are likely to be outweighed by the negative impact on competition by those providers who are perceived to be 'too big to fail'. (Paragraph 61)

Banks which are seen as too important to fail are also too big for fair competition. They receive an implicit subsidy to their funding costs placing them at an unfair competitive advantage to other smaller and less systemically important banks. It also means that providers who offer poorer quality or over-priced products face little threat of being forced out of the market, as they would do in any other industry. Solving the too big to fail problem is critically important from a competition as well as a financial stability perspective. The Independent Commission on Banking must address this problem which is crucial to achieving the objectives outlined in its terms of reference. We are encouraged by signs that it is already considering ring fencing as a possible solution which would provide a more level playing field to all market participants. Furthermore, we expect the Government to respond to our predecessor Committee's Report on this issue when it responds to the ICB. (Paragraph 222)

The Government is aware of the interaction between perceptions of the systemic importance of financial institutions, and the competition dynamics across the sector. In setting up the ICB to address the issue of systemic risk, the Government has shown its commitment to address this issue. We will continue to support the ICB's work as they progress to making final recommendations in September.

The Government is also actively supporting international reform processes targeting Systemically Important Financial Institutions (SIFIs). Over the course of the last year the UK Government has played a prominent role in developing an international consensus on how to ensure financial stability going forward. At Seoul, in November 2010, G20 Leaders endorsed a requirement that SIFIs and initially in particular Global-SIFIs (G-SIFIs) should have higher loss absorbency capacity to reflect the greater risks that these firms pose to the global financial system.

This was reiterated at the G20 summit in Paris in February 2011, with Leaders highlighting the importance of the ongoing work of the Financial Stability Board in developing, "higher loss absorbency measures through a menu of viable alternatives that may include, depending on national circumstances, capital surcharges, contingent capital and bail-in instruments"[12] as part of its 2011 work programme.

The Government supports this work and believes a strong international agreement in this area can make a significant contribution to addressing perceptions of a systemic importance, and thereby enhance competition. We look forward to reviewing the final recommendations when the FSB delivers a proposed policy framework for G-SIFIs to G20 leaders in November. The FSB will publish proposals for public consultation in late-July.

12 G20 Communiqué-Paris, February 18-19, 2011, Available at: http://www.g20.org/Documents2011/02/COMMUNIQUE-G20_MGM%20_18-19_February_2011.pdf