

Review of banking for small and medium-sized businesses (SMEs) in the UK: Update on work to date

11 March 2014

Introduction

1. In advance of the transfer of various OFT functions regarding markets work to the Competition and Markets Authority (CMA) on 1 April 2014, the OFT is today, in the interest of transparency, providing an update on progress on the market study into SME banking.
2. That market study is ongoing. Working closely with the Financial Conduct Authority (FCA), the OFT continues to obtain information and engage with stakeholders to progress the analysis before the transfer of its responsibilities to the CMA. It is considering suggestions for actions that might be taken to improve the effectiveness of competition in SME banking which have been made during the market study. Decisions about market study outcomes, including on whether or not to make a market investigation reference (MIR), will be a matter for the CMA after 1 April 2014.
3. The OFT is also reviewing the [behavioural undertakings](#) given by various banks arising from the Competition Commission's 2002 inquiry into SME banking. The CMA will continue with this review after 1 April 2014.

Market study background

4. In June 2013 the OFT announced that it would carry out a market study on competition in banking services for SMEs, and consulted on its scope. In September 2013 it published the [scope of the study](#) and commenced detailed work.
5. The OFT has held a wide range of meetings with the banking sector and representatives of SMEs. It has sent requests for information to the major

providers of business current accounts (BCAs) and business loans and other providers of SME banking services, and has engaged directly with SMEs through roundtables and focus groups held across the UK.

6. This market study forms part of the OFT's [retail banking programme](#). That programme was launched following previous detailed studies by the OFT which raised concerns about the effectiveness of various aspects of competition in retail banking, including competition in personal current accounts, cash ISAs and SME banking, and more generally barriers to entry and expansion in retail banking. Similar competition concerns have also been raised by others such as the Independent Commission on Banking in 2011 and the Parliamentary Commission on Banking Standards in 2013.

Summary of analysis to date

7. The OFT is today providing an update on the analysis it has conducted to date in the market study of SME banking. This remains subject to further work.
8. The OFT recognises that some welcome actions have been taken, or are currently planned, to respond to concerns about the effectiveness of competition in the banking sector. These include:
 - changes to the authorisation regime for new banks
 - changes to capital requirements for new banks which lend to SMEs
 - the regulation of payment systems through the forthcoming establishment of the Payment Systems Regulator¹

¹ The Banking Reform Act (2013) created a new independent regulator for payment systems as a subsidiary of the FCA. The new regulator will be fully operational by April 2015 and has three objectives: promoting competition; promoting innovation; and ensuring that payment systems operate in the interests of their users. On 5 March 2014 the FCA issued a call for inputs to assist the Payment Systems Regulator to understand current concerns with UK payment systems, develop its regulatory approach and design, and identify early priorities for action. See the [FCA press release and a link to the call for inputs](#).

- the introduction of the new seven-day Current Account Switching Service (including for smaller SMEs), and
- proposals to increase the availability of credit information, which should enable new or small providers to make more effective lending decisions, thereby helping them to compete more effectively with the larger banks.

There has also been continued investment by banks in service quality and delivery including in mobile and digital technology.

9. The OFT's emerging analysis, which is on-going, suggests that, despite these and other positive developments, there may be competition concerns in SME banking that:

- The markets are concentrated and levels of concentration have remained stable over recent years. The four largest providers of BCAs to SMEs account for over 80 per cent of SMEs' main banking relationships in Great Britain and around 90 per cent in Northern Ireland. The supply of lending to SMEs is also concentrated and the tendency of SMEs to approach their main BCA provider when seeking lending appears to limit the degree of competition for lending.
- Barriers to entry and expansion have apparently contributed to smaller providers finding it difficult to enter and expand their business across the core business banking products, such as BCAs and general purpose business loans. We are considering concerns that have been expressed to us about a range of barriers including:
 - access to key information, particularly information on the creditworthiness of prospective borrowers needed to make effective lending decisions
 - the high cost of accessing payment systems, which are necessary for a provider wishing to operate BCAs
 - the cost of expansion arising from developing and running IT systems

- the need for a broad branch network given the continuing preference of many SMEs for using branches for many core business banking services
- banks' conduct in relation to existing security (outlined below) which appear to hinder SME customers from accessing finance from alternative providers, and
- aspects of SME behaviour, including the tendency of many SMEs to make their initial choice of BCA provider on the basis of which bank supplies their personal current account or the proximity of a local branch, and low levels of switching which limit newer and smaller providers' ability to acquire customers.

10. Whilst there has been some entry into the provision of SME banking services (and evidence that other providers are also considering entry), the scale of entry remains very limited and typically focused on servicing particular niches (such as particular types of lending) or particular types of SMEs (such as larger SMEs or particular industry sectors).

- The ability of SMEs to shop around to obtain a BCA or loan on the best terms appears to be restricted by difficulties in comparing the offering available from different providers due to limited transparency of information on price and service quality:
 - tariffs on BCAs are often complex and loan pricing and conditions take account of a wide range of individual SME specific factors, making comparisons between providers difficult
 - the quality of a bank's service, in respect of both transaction services and relationship management, is an important consideration for SMEs, but it is currently very difficult for SMEs to assess which bank would provide the best service for their individual circumstances.
- SMEs generally exhibit a significant degree of inertia and a low level of engagement with their banking provider(s), albeit some highly value their relationship with their bank and their bank's products and services. Shopping around for BCAs and loans is limited, as is switching provider. SMEs also perceive little benefit to switching

BCAs. This is partly because they often observe little to differentiate between the main providers in terms of price, terms or quality of service. They therefore tend to switch mainly if pushed by poor service quality from their current provider.

- Finance from alternative sources such as peer-to-peer lending, venture capital and equity finance may be available and suitable for some businesses. However, the OFT has observed generally low awareness of the existence of alternative sources of finance among SMEs.

11. In summary, the analysis by the OFT to date suggests:

- concentrated markets and stable market shares
- barriers to entry and expansion
- perceived barriers to switching
- difficulties in comparability of price, terms and service
- low customer engagement contributing to low shopping around and switching activity.

12. The analysis which the OFT has carried out to date suggests that competition may not be working effectively. This may reduce the incentive for providers to compete on price and terms, invest in service quality and delivery or innovate, which may mean that SMEs do not get the best deal from their banking provider.

13. The OFT's emerging thinking is that all these issues, taken in combination, could be consistent with a provisional finding that the statutory criteria are met for a potential market investigation reference (the Reference Test).² However, it is important to note that this represents only the OFT's

² The statutory criteria are that there are reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.

emerging thinking and, in light of the fact that the analysis is on-going, the OFT has not made any provisional finding or decision on whether or not the Reference Test is met. Moreover, the OFT has not considered the additional question of whether, in the exercise of its discretion, a market investigation reference would be the most appropriate way to proceed.³ Relevant factors on the exercise of the discretion to make a market investigation reference can be found in the OFT's guidance on market investigation references ([OFT511](#)).

Transfer of OFT responsibilities to the CMA

14. With the transfer of the OFT's markets functions to the Competition and Markets Authority (CMA), the OFT has concluded that it would be appropriate for this market study to be completed by the CMA and for the CMA to be entirely responsible for taking any decisions about market study outcomes, including whether the Reference Test is met and, if so, whether or not it would be appropriate to exercise its discretion to make an MIR.⁴ This is because such a decision appears to be best taken as part of a wider examination of the state of competition in the retail banking sector.
15. The CMA is today announcing its intention to build upon the OFT's programme of work in retail banking, including this market study, and to bring forward work on an update of the OFT's review of the personal current account market in the UK, which was completed in January 2013. The CMA will continue to work closely with the FCA⁵ on this retail banking work programme. See [further details of the CMA's statement](#).

³ The OFT is not under a statutory duty to make a market investigation reference even where the Reference Test is met.

⁴ The OFT's guidance on market investigation references is being adopted by the CMA subject to certain changes set out in the CMA guidance document, *Market Studies and Market Investigations: Supplemental guidance on the CMA's approach* ([CMA3](#)), but the factors taken into account when the CMA exercises its discretion on reference remain unchanged.

⁵ For the avoidance of doubt, the FCA will play no role in decisions regarding a market investigation reference.

Areas of specific concern

16. Whilst conducting this market study, the OFT has also identified two issues concerning the conduct of banks about which it has specific concerns.

Waivers of security and deeds of priority

17. The OFT has also considered factors which may prevent alternative finance providers, particularly peer-to-peer lenders and providers of sales finance (such as invoice discounting or factoring, including new financial technology lending platforms) from expanding their offer to SMEs.
18. As part of the information gathered in the market study to date, various alternative finance providers have expressed strong and specific concerns about the way in which security held by an SME's existing bank can act as a barrier to that SME obtaining finance from an alternative provider. Often these alternative providers are approached by SMEs seeking a second, complementary source of finance where the SMEs already have some form of borrowing from their existing bank.
19. It is common practice for banks to seek security from many (typically larger) SMEs in the form of a debenture when lending to SMEs to help meet their working capital needs. Under a debenture, a bank is typically granted both fixed and floating charges over all of a company's assets.
20. When an SME seeks additional finance from an alternative provider, that alternative provider will often look to take security over certain specified assets of the SME. If the SME's existing bank holds a debenture, the alternative provider will approach that bank to obtain either a waiver of security (under a letter of waiver)⁶ or a deed of priority.⁷

⁶ A letter of waiver is commonly used when an existing bank holds a debenture and the SME subsequently applies for invoice finance or factoring facilities. The alternative finance provider will seek a waiver (or release) of the bank's security over the receivables (book debts) that are assigned under the invoice finance or factoring agreement.

⁷ A deed of priority is commonly used when the alternative provider wishes to take a second charge over certain specified assets of the SME. It does not involve a release of all or part of

21. The concerns raised by alternative finance providers relate primarily to the mechanisms used for seeking waivers of security or for agreeing deeds of priority. In particular, they have highlighted concerns about the time often taken by banks in dealing with requests for such waivers and deeds of priority, which they believe to be excessive.
22. The OFT is concerned that such practices may hinder SME customers from accessing finance from alternative providers, reducing the impact of an important potential additional source of choice and competition in the sector. New types of alternative finance providers such as peer-to-peer lenders and financial technology lending platforms represent a small but growing and increasingly important source of finance for SMEs and a source of innovation in this sector.
23. Industry parties and the British Bankers Association have responded constructively to these concerns. The OFT expects them to take swift and effective action on this issue, particularly to improve the processes by which requests for waivers over security or deeds of priority are granted. It will be open to the CMA to take any continuing concerns on these matters into account as part of the ongoing market study.

Review of undertakings

24. The OFT is currently reviewing undertakings given by various banks following the Competition Commission's investigation in 2002. As part of that ongoing review the OFT has received concerns about failure to comply with those elements of the undertakings, which prevent banks from requiring an SME to take out a BCA in order to obtain a business loan⁸ (that is 'bundling' of BCAs with business loans). The OFT considers that compliance with these undertakings is important as they are designed to help providers to compete effectively in SME banking.

the existing bank's security but is a means for the existing bank and the alternative provider to agree the order of priority in which their respective security will rank and their rights in relation to the SME's debts.

⁸ Or a business deposit account. The OFT's focus during this review has been on potential bundling of BCAs with business loans, as that is where concerns have been expressed.

25. The OFT's investigations into those concerns with the various banks are not yet complete and will be continued by the CMA for some months. Whilst the OFT has seen examples of good compliance with the undertakings, there is also evidence of some need for improvement and for the banks to monitor compliance.
26. The banks have worked with the OFT to agree a package of measures intended both to improve information provided to staff dealing with SME customers now and to help the CMA to assess compliance with the undertakings, both now and in the future:
- Each bank has agreed that its internal audit function, which is independent of the bank's business banking divisions, will conduct an annual review of compliance. The first report will be made within four months.
 - Each bank has agreed to provide a written annual reminder to all relevant staff to ensure they are aware of the bundling undertakings and the seriousness with which they are treated by the bank. The first of these will be provided to staff within the next month, and will therefore also act as an important interim measure whilst the review is ongoing.
27. After the first review, the results of which are due to be provided in July, the CMA will determine next steps in light of information on details of the compliance by each of the banks. The CMA will then decide on any action that should be taken on any failure to comply in relation to any particular bank.