Retail banking market investigation

Metro Bank case study

21 May 2015

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the updated issues statement and the other working papers which accompany it. These papers do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in September 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to comment on this paper should send their comments to retailbanking@cma.gsi.gov.uk **by midday on Thursday 11 June 2015**.

The Competition and Markets Authority has excluded from this published version of the working paper information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

Contents

Case studies

In previous investigations we have found that case studies on market entry and expansion can provide powerful insights into the practical difficulties that firms may face trying to enter and/or expand into particular markets. Such studies have contributed to the identification of possible adverse effects on competition and where appropriate have helped us to develop remedies designed to remove or lower barriers to entry or expansion.

We have undertaken six case studies looking at examples of entry and expansion in the provision of personal current accounts (PCAs) and retail banking services to small and medium-sized enterprises (SMEs). We have in addition obtained information on a number of prospective new entrants in the process of seeking bank authorisation. The value of each case study lies in its ability to provide a detailed understanding of the way particular types of event unfold. They are therefore written as factual accounts of events.

We are publishing each case study as a separate working paper and each case study will inform our assessment of barriers to entry and expansion. We are also publishing separate working papers pulling together the evidence from the case studies and from other sources on potential barriers to entry and expansion. The first such working paper – Barriers to entry and expansion: regulation, IT systems and payments systems – will be published shortly and a further working paper on branches will be published in due course. Our updated issues statement published on 21 May 2015 sets out our current general thinking on barriers to entry and expansion.
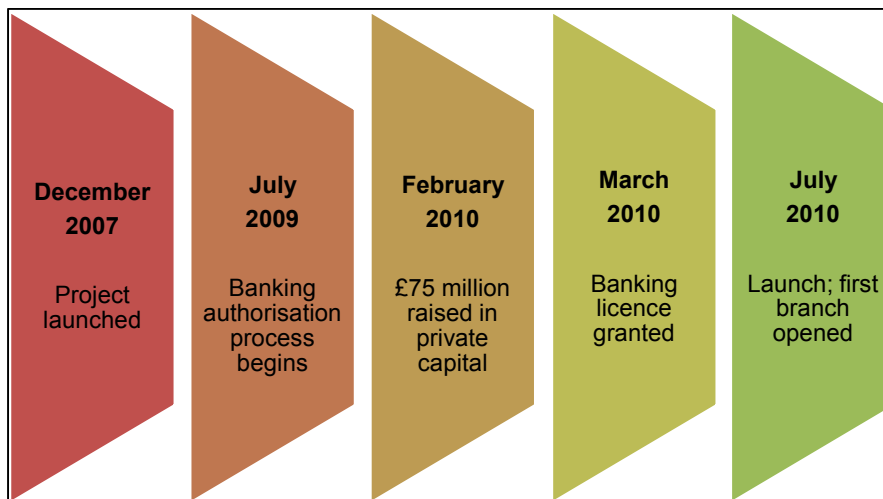
Executive summary

1.   The purpose of this paper is to examine Metro Bank's (Metro's) experience of entry and expansion as a relatively new high street bank in the UK and what, if any, obstacles that it faced in doing so.

2.   Metro launched in July 2010. It offers a range of retail banking services to personal and business customers (including SMEs), and at the end of 2014 had 31 branches in and around Greater London. Metro has grown its total number of customer accounts from 8,912 in 2010 to 447,000 in 2014, and aims to have 200 branches by 2020.

3.   Although Metro has grown rapidly since launch, it told us that it faced some obstacles to further expansion. These included: the availability of suitable high street corner sites for new branches; capital holding requirements; access to payment systems both in respect of quality of service and costs; and the larger banks' ability to subsidise new customers. However, it told us that it had sought to overcome these obstacles through a strategy of providing high-quality customer service coupled with a branch-based business model, to differentiate itself from its competitors.

4.   Metro successfully overcame what obstacles it encountered in launching as a new high street bank, and has grown well so far. However, Metro has chosen to focus on expanding in the South East around the London commuter belt, which if it cannot open new branches quickly enough in these areas may affect its ability to acquire customers and reach a certain scale.

Introduction and background

5.   The purpose of this paper is to examine Metro's experience of entry and expansion as a relatively new high street bank in the UK. The paper begins with a background to Metro's launch in the UK which is followed by a description of its business model and strategy. Next, it discusses how successful Metro has been in growing its business since launch, and finally considers the extent to which Metro's experience suggests the presence of barriers to entry or expansion in UK retail banking.

6.   Metro was launched in July 2010 and was the first de novo high street bank to be granted a licence in the UK in more than 100 years. It is a deposit-taking and lending institution which services retail (personal) and business customers in London and its wider commuter belt area. Metro's decision to enter the market was based on a belief that a significant opportunity existed for a new bank in the UK that provided customers with high levels of customer service and convenience, whilst providing good returns for its shareholders.

7.   Metro's launch in the UK was based on a successful antecedent – Commerce Bank – that was established by Vernon Hill in the USA in 1973.[1] At the centre of Commerce Bank's strategy was the branch, in contrast with other banks which were generally steering customers away from their branches to cheaper-to-serve channels. Commerce Bank started with a single branch in 1973 to become one of the largest banking groups in the USA before it was sold to Toronto-Dominion Bank for $8.5 billion in 2007.[2]

8.   Following his discussions with the Financial Services Authority (FSA), Mr Hill launched the Metro project in December 2007, and raised £75 million in initial capital in February 2010 from a pool of investors, including Fidelity and Wellington Capital.[3,4] Figure 1 shows key milestones leading up to Metro's launch in the UK.

Figure 1: Key milestones leading up to Metro's launch

December 2007	July 2009	February 2010	March 2010	July 2010
Project launched	Banking authorisation process begins	£75 million raised in private capital	Banking licence granted	Launch; first branch opened

Source: Metro.

9.   Metro told us that its decision to launch in the UK was a direct response to what it called lack of choice for consumers and businesses. Its aims are to differentiate itself from other banks by presenting to its customers a service-based rather than a product sales model. Metro has decided to initially set up its branches (referred to as 'stores' by Metro) in and around London – learning from the Commerce Bank's success in New York where it had 250 branches

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[1] Vernon Hill, the founder and chairman of Metro Bank is an American businessman. He is also the former Chairman and President of Commerce Bank which he founded in 1973 in the USA.
[2] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise (2010), pp9–10. Temenos is a software company which was founded in 1993 in Geneva, Switzerland. Its stated mission is 'to rid the banking industry of its legacy software.
[3] ibid, p12.
[4] The Financial Conduct Authority (FCA) replaced the FSA from 1 April 2013.

in Manhattan alone. Metro's first branch at Holborn, London, opened in July 2010 (Figure 2).

Figure 2: Metro's branch in Holborn, London

Metro's business model

Strategy

10. Metro's strategy is based on building a strong brand, creating loyal customers and offering its customers best experience from their banking.[5] Metro aims to implement this strategy through a customer-focused culture, retailer-type operations, and reliance on its customers telling their friends about their experiences, in order to attract more people to visit its branches.[6]

11. A key element of Metro's business model is its focus on service and not price. As Craig Donaldson, Metro's CEO told the Parliamentary Commission on Banking Standards (PCBS), 'If you [customers] want the very best pricing on deposits, you can go to other people … I do not expect to win everybody, just those who value real service and convenience, because that is what we offer'.[7]

12. Metro's PCA offers free-if-in-credit banking and currently pays 0% interest, and it has no imminent plans to introduce credit interest in the event of a base rate movement. Metro does not offer any incentives for new customers, and told us that 'Our products are designed to appeal to as wide a range of

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[5] In Mr Hill's words 'Our model in Britain, as it was in America, is this idea of building customers as fans. Great companies build fans who stay with the company and recommend them to a friend.' House of Commons Treasury Select Committee, 14 December 2010. Vernon Hill's oral evidence. Answer to Question 442.
[6] Hill, Vernon (2012), *Fans Not Customers*, Profile Books.
[7] Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q52.

customers as possible. Our model, focussed on high-quality service, is designed to attract all types of customers.'

13. In August 2013, Metro acquired SME Invoice Finance Limited, a company which specialised in invoice discounting, factoring and cash-flow funding for businesses.[8] Metro told us that it wanted to provide full-service range to SMEs, and in order to do so, wanted to include invoice and asset finance as part of its product portfolio.[9] Metro stated that since these markets were specialised in nature it thought it best to find an existing provider that had the technology, processes, expertise and resources in these businesses.

Importance of branches

14. Metro's branches are modelled like retail outlets, are located on high street corners, and represent its main sales channel, although telephone, mobile (for PCA customers) and internet banking are also available to its customers. It believes that customers are willing to pay more for superior service, because they enjoy the experience, likening this effect to the customers of Starbucks.[10]

15. Metro believes that having physical branches is important because it enables it to provide traditional banking services, and build relationship with customers. To build a relationship with customers, Metro wants its first interaction with a customer to be face to face, through a branch.

16. Metro's strategy is to build a branch network organically rather than buying branches of existing banks, and is focusing on building these in London, the South East and commuter belt locations near to where people live and work.

17. Metro's service offering to its customers in its branches includes the following:

(a) Open seven days a week for extended hours.[11]

(b) Instant account opening (cards + cheque book printed in store).

(c) Free coin counting.

(d) Internal ATMs.

(e) Safety deposit vault.

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[8] Metro-Bank 'The-Entrepreneur's Bank' acquires SME Invoice Finance, August 2013.
[9] The deal involved Metro purchasing an end-to-end Invoice Finance and Asset Finance capability – ie systems, processes and people.
[10] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise (2010), p13.
[11] Opening hours for all Metro's branches are Monday–Friday: 8am–8pm Saturday: 8am–6pm Sunday: 11am–5pm Bank holiday: 11am–5pm.

(f) Toilet and baby changing facilities.

(g) Dog friendly with dog bowls of fresh water in the lobby.

Product strategy

18. Metro offers a range of products but claims not to cross-sell, and its staff are not incentivised to do so, but are rewarded based on customer satisfaction. (see Appendix B for details of Metro's products).[12]

19. Metro's retail proposition for personal customers rests on offering superior levels of service and convenience. It aims to focus on simplicity and transparency by offering one type of PCA for all its customers, and having a simple overdraft pricing model. Metro claims that the simplicity of its product offering ensures that it does not cross-subsidise between customer segments, and provides its best rates and offers to all its customers.[13] The key elements of Metro's retail proposition include:

    (a) developing and communicating a series of commitments to its customers including giving them the best saving and mortgage rates it has, and simpler overdraft rates; and

    (b) keeping the product range simple while addressing some gaps in the range and also improving the availability of a number of existing propositions and channels.

20. Metro's strategy for its SME customers is based on a need to offer something on the high street to serve the SME market.[14] It categorises SME customers based on turnover, and its local business managers based in its branches focus on serving the needs of smaller businesses with under £2 million turnover; larger businesses are serviced by its Relationship Managers who also focus on specific sectors, including property, healthcare, not for profit, franchising and leisure. Metro told us that its SME business was key to its wider banking strategy, and SMEs represented 47% of deposits and 45% of its lending at the end of 2014.

21. Describing its product strategy, Metro had told the House of Commons Treasury Select Committee ('Select Committee'): 'We believe [that] people will

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[12] 'No Stupid Bank Rules. Metro Bank case study', *Customer Insight* (November 2011), p15.
[13] Metro indicated to the CMA that this was in contrast with the practices followed by many other banks, which offer attractive offers for their new customers but not to their existing customers.
[14] As Craig Donaldson told the PCBS 'what they [SMEs] tell us they want is the high street presence, continuity of relationship and somebody who will get to know their business' Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q49.

buy other products from you if you have fair products—not if you are aggressively out to sell them, but because they have faith in your brand.'[15]

Metro's growth and plans

22.   Since its launch in 2010, Metro has grown organically through de novo branches, and at the end of 2014, had 31 branches in the Greater London area (Figure 3).[16] It also continues to plan towards an initial public offering on the London Stock Exchange and, assuming favourable market conditions, is targeting 2016.

Figure 3: **Location map of Metro's branches**
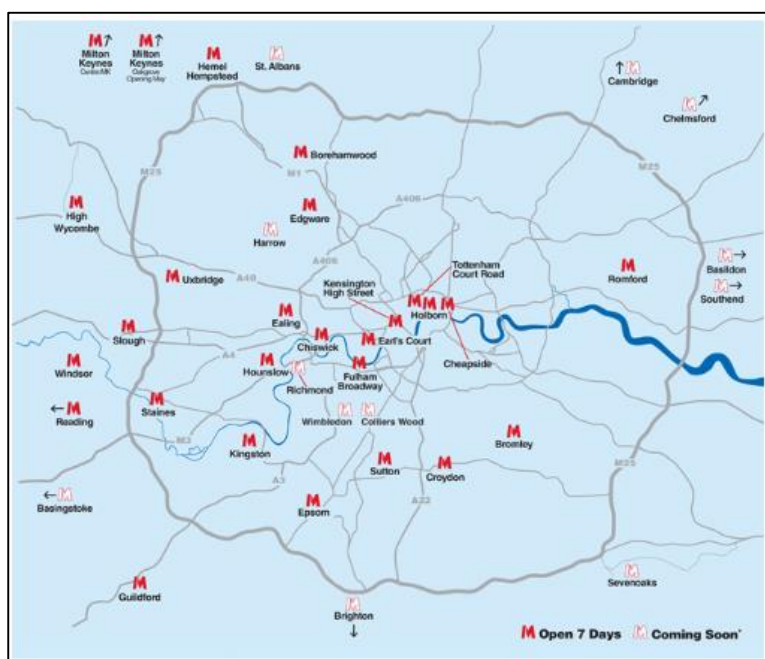
Source: Metro website (accessed 13 January 2015).

23.   Figure 4 (left panel) shows that Metro's number of branches at the end of 2014 – 31, is slightly behind its Strategic Plan of 34. Metro has plans to almost double its number of branches to 58 by the end of 2016 (middle panel of Figure 4). However, the predicted number of branches (as stated in Metro's branch acquisition plan) at the end of 2015 and 2016 is lower than the corresponding forecast in its Strategic Plan (middle panel of Figure 4); it

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[15] House of Commons Treasury Select Committee, Vernon Hill's oral evidence, 14 December 2010. Answer to Question 470. The Treasury Select Committee is one of the select committees related to government departments, established by the House of Commons. When the committee has chosen the subject of an inquiry it normally issues a press notice outlining the main themes of inquiry and inviting interested parties to submit evidence. In this instance, Metro was providing evidence to the Committee regarding Competition and choice in the banking sector.
[16] A list of Metro's branches at the end of 2014 is in Appendix A.

expects to have 44 branches by 2015 (50 according to the Strategic Plan) and 58 branches by 2016 (70 according to the Strategic Plan).

24.   Figure 4 also shows (right panel) that although Metro has quickly grown its number of branches over the last four years, it will need to grow much faster to achieve its target of having 200 branches by 2020.

Figure 4: Number of Metro's branches – actual, planned and target
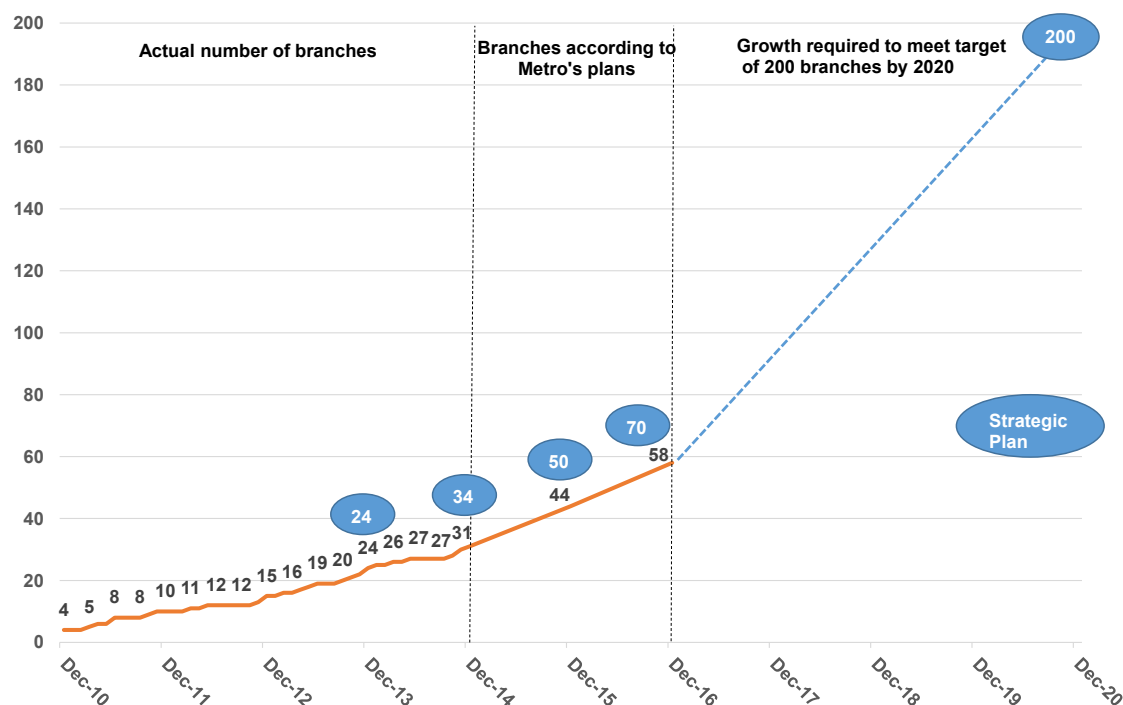
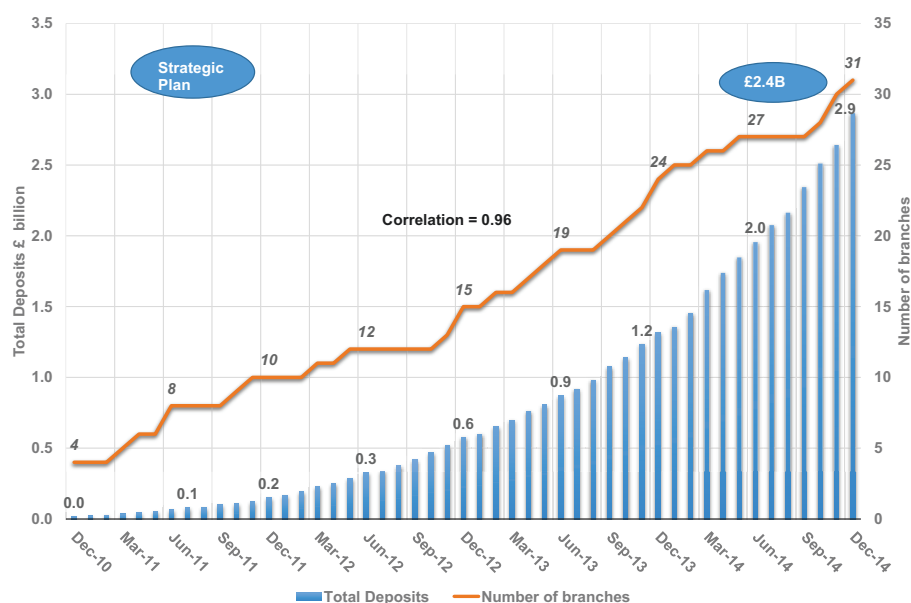Source: Collated from Metro's website and documents.

25.   Figure 5 shows that Metro has been able to rapidly grow its number of accounts since it launched in 2010. The total number of accounts increased from 8,912 in 2010 to 447,000 in 2014 – a compound annual growth rate (CAGR) of 166%. The figure also illustrates that the increase in the number of accounts has been in line with the growth in Metro's branches during this period (correlation of 0.98) reinforcing the importance of branches to its business model. The number of accounts at the end of 2014 was slightly behind its Strategic Plan of 490,000.

26.   A similar trend is seen in Figure 6 which shows that Metro's deposits have grown at a fast pace – CAGR of 256% between 2010 and 2014. Total deposits stood at £2.9 billion at the end of 2014, higher than the Strategic Plan of £2.4 billion. The growth in Metro's deposits also closely follows the growth in its number of branches (correlation of 0.96).

Figure 5: Evolution of number of accounts and branches
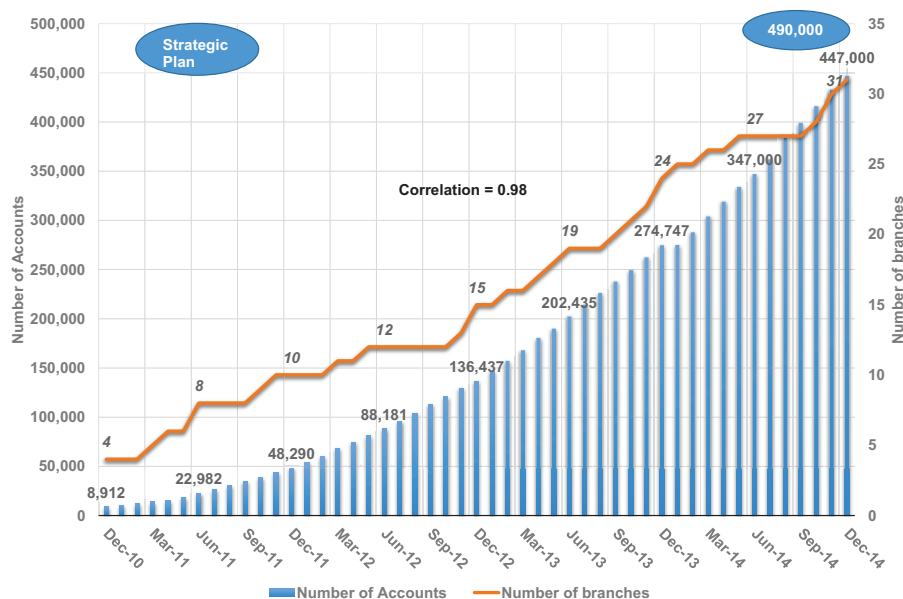
Source: Collated from Metro's documents.

Figure 6: Evolution of deposits and number of branches

Source: Collated from Metro's documents.

27. Figures 7 and 8 show the growth in Metro's number of accounts and deposits per branch. The number of accounts per branch has grown rapidly to 14,419 at the end of 2014 (CAGR of 59% since 2010) – close to what was assumed in the Strategic Plan. Similarly, average deposit per branch has also grown consistently over the last four years (CAGR of 113%) and was £92.5 million at the end of 2014, higher than what was assumed in the Strategic Plan (£71 million).

Figure 7: Evolution of number of accounts per branch
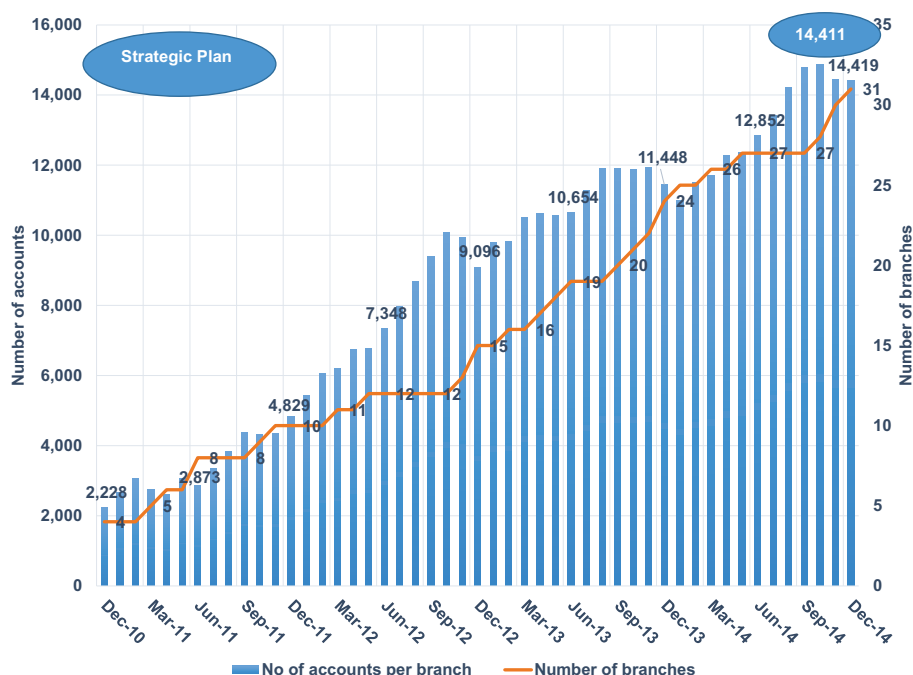
Source: Collated from Metro's documents.

Figure 8: Evolution of deposits per branch

Source: Collated from Metro's documents.

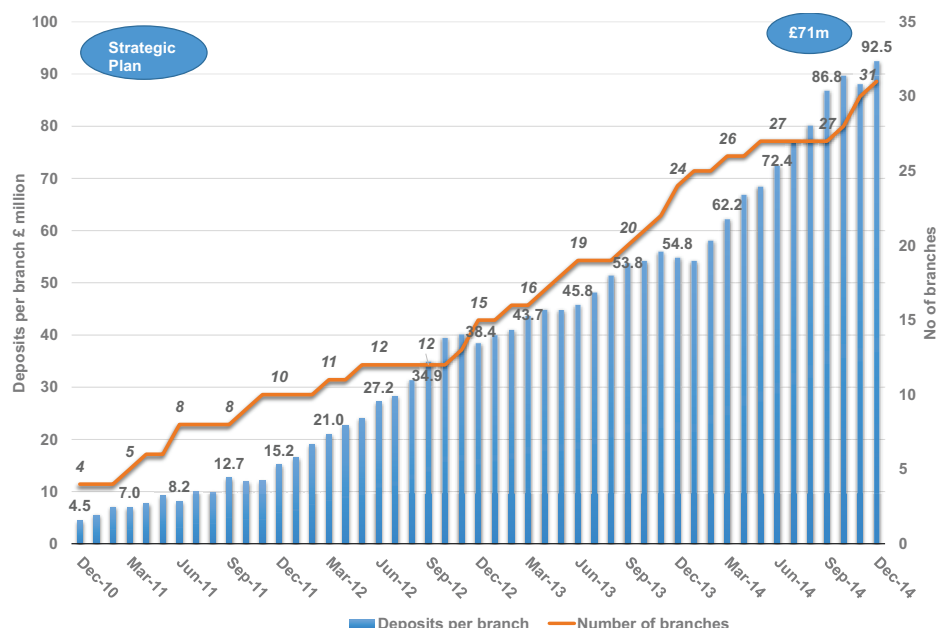28. Figure 9 shows that Metro's number of PCAs has also grown rapidly and between 2011 and 2014 saw a CAGR of [✄]. At the end of 2014, Metro had over [✄] PCAs, and plans to grow these to over [✄] by the end of 2015. In 2014, the PCAs accounted for about [✄]% of its customer accounts, and applying this percentage to Metro's Strategic Plan of [✄] million total number of accounts, it could potentially have over [✄] PCAs by 2020.

Figure 9: Growth in the number of PCAs

[✂]

Source: Metro.

29.   Similarly, Figure 10 shows that Metro's BCAs grew at a CAGR of [✂] between 2011 and 2014. At the end of 2014, Metro had about [✂] BCAs which it plans to almost double in 2015.

Figure 10: Growth in the number of BCAs

[✂]

Source: Metro.

30.   In 2014, of about [✂] new PCAs added, Metro is aware of the sources of customers switching to it for about [✂] customers, which are shown in Table 1. Although this data on switching is only for a small subset of new PCAs added, it shows that customers are switching to Metro from many major banks, with Barclays, Santander, HSBC, Lloyds and Natwest accounting for [✂]% of those switching in.

Table 1: Sources of switchers to Metro in 2014

	Number of PCAs	%
Barclays	[✂]	[✂]
Santander	[✂]	[✂]
HSBC	[✂]	[✂]
Lloyds	[✂]	[✂]
Natwest	[✂]	[✂]
Halifax	[✂]	[✂]
Nationwide	[✂]	[✂]
All other	[✂]	[✂]
Total	[✂]	[✂]

Source: Metro.

31.   In its 2015 annual road map for retail proposition, Metro mentioned that although its business model offering superior service and convenience had proved popular, [✂] Metro believes that it needs to continue to innovate to maintain itself as a customer focused banking brand. Regarding its SME business, Metro's focus for 2015 is [✂].

32.   Metro's CFO Michael Brierley believes that the bank is on track to make a profit in 2015/16 and stated that 'We will generate a greater long-term profit if we continue to invest in our infrastructure, IT and people.'[17,18]

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[17] Interview with Metro CFO Michael Brierley. *Financial Director,* 19 September 2014.
[18] While releasing its 2014 full-year results, Metro announced that its deposits had increased to £2.9 billion (annual increase of 118%) out of which deposits from business customers represented 64% or £1.9 billion. Total loans grew to £1.6 billion (an annual increase of 112%) with loans to business customers making up almost half

Barriers to entry and expansion

Authorisation process

33. Metro told us that the authorisation process it went through to get a banking licence was a challenging one mainly because a new bank had not been authorised in the UK in over a century. Metro stated that it 'navigated the process slowly but successfully alongside the Financial Services Authority'. It also noted the FCA's subsequent work on streamlining the authorisation process, and hoped that it facilitated more new banks to enter the market.[19]

34. In March 2013, the FSA and the Bank of England (BoE) published a review of the requirements for firms entering or expanding into the banking sector which set out reforms to the authorisation process to make it easier for the new applicants. These reforms were designed to provide firms with greater clarity about the information required to be submitted to facilitate authorisation as rapidly as possible and, to provide firms clear milestones along the path to authorisation, with the possibility of authorisation before they committed major resources to infrastructure investments.[20]

35. Another report of the Prudential Regulation Authority (PRA) and the FCA, published in July 2014 provided an update on progress in implementing these changes and clarified some issues that had arisen following the original review. Some of the developments mentioned in this follow-up report included the following:[21]

    (a) Increase in the level of pre-application support to the new applicants by the PRA and the FCA.

    (b) Streamlining of the application pack.

    (c) A new 'mobilisation' option – where authorisation was granted when a firm had met essential elements but with a restriction on its activities due to some areas needing to be completed (for example, investment in IT systems).

36. Overall, the authorisation process does not appear to have been a significant obstacle for Metro to enter retail banking in the UK.

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of total lending. The number of customers increased to 447,000, up 63% from last year. Metro Bank 2014 results announcement, 21 January 2015.
[19] The FCA replaced the FSA from 1 April 2013.
[20] BoE/FSA (March 2013), *A review of requirements for firms entering into or expanding in the banking sector*.
[21] BoE/PRA (July 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*. pp 5–8.

Capital requirements

37. Metro stated that it was currently required to hold around six to ten times more capital than the big banks and building societies when securing a mortgage for a customer, even if it was for the same customer, with the same deposit, on the same property – a situation which did not reflect a level playing field.

38. To elaborate this point, Metro told us that as a new entrant to the market, it had to use the standardised approach (SA) to credit risk when calculating capital requirements, while the larger banks were permitted to use an internal ratings based approach (IRB). Metro indicated that the IRB approach was based on many years of data, and enabled certain institutions to significantly reduce the value of their risk-weighted assets.

39. Similarly, in its submission to the PCBS, Metro had mentioned that:

> The business plan we put together [at the time of its authorisation application] had a significant capital requirement in there because it seemed proportionate and appropriate that, as a start-up bank, we had that … it is about how over time the capital requirement should reduce, as the risk of running an organisation reduces with longevity, and it is about the proportionality that is applied by a prudential approach that needed to be seen over time.[22]

40. Metro pointed out to the CMA the difference between the SA and IRB by using an example of a low loan-to-value residential mortgage. Metro stated that such a mortgage carried the same risk profile regardless of the lending institution but the challenger banks risk weight these particular assets at 35% compared with 3 to 6% for the larger banks.

41. Metro suggested to us that there should be tighter bands for capital require-ments for standard product sets, rather than allowing for the current wide differentiation in the market. It also mentioned that the approaches used by many existing banks allowed for too much variability in capital in order to promote a truly fair and competitive market. And, in order to promote a truly fair and competitive market, capital requirements for all product sets should be brought in line with each other using industry-wide indicators set by the regulators.

42. In March 2013, the FSA and the BoE announced a shift in approach to the prudential regulation of banking start-ups whereby the additional requirements

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[22] Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q3.

(known as 'add-ons and scalars') previously applied to reflect the uncertainties inherent in start-ups were no longer to be applied. These requirements according to the two regulators often resulted in capital and liquidity requirements for start-ups being higher than for existing banks.[23]

43.   In a follow-up review, the PRA and FCA referred to the IRB approach to calculating credit risk versus the SA (the default position) for all new and existing banks and noted that 'The PRA has taken steps to address underestimation of risks that can result from applying the IRB approach to certain types of exposures.'[24] According to this review, the PRA was to continue to consider the impact of its policies on competition as required by its competitive objective with a caveat that the regulatory capital requirements were to a large extent determined by the relevant EU legislation over which PRA had little or no discretion.[25]

44.   Metro mentioned in its Offer for Subscription in 2014 to investors that its capital and liquidity requirements had been further reduced reflecting the greater maturity of the company. However, it believed that as a new bank, it was required to hold disproportionately higher capital than an old, established bank. Metro's view was that capital requirements for all product sets should be brought closely in line with each other using industry-wide indicators set by the regulator. Metro told us that the way capital rules differed between larger banks and challenger banks made expansion and growth expensive.

45.   The capital requirements did not prevent Metro from entering the UK retail banking market, and do not seem to have prevented it from growing at a fast pace so far. However, according to Metro, the requirement to hold higher capital than the larger banks may affect its expansion in the future.

Access to payment systems

46.   Metro told us that access to payment systems continued to be a barrier for challenger banks, and the current payments infrastructure did not promote effective competition where small and new banks were heavily dependent on their competitors, to serve their customers.

47.   Metro stated that the cost of developing and maintaining membership of one of the payment systems meant that any new bank wishing to provide a trans-actional service, such as direct debits or faster payments, had to accept an

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[23] BoE/FSA, *A review of requirements for firms entering into or expanding in the banking sector.*
[24] BoE/PRA, *A review of requirements for firms entering into or expanding in the banking sector: one year on,* paragraph 40.
[25] Ibid, paragraph 41.

'agency banking arrangement', essentially contracting an existing bank to provide its payment infrastructure.

48. According to Metro, this arrangement was anti-competitive since it meant that banks without their own clearing capacities were subject to the service levels and payment structures of existing players, and could be forced to provide the same or worse service to their customers. Metro pointed out that it had experienced many outages with some of the payment systems, which were not due to the payment systems but because of IT issues at one of the banks through which it accessed those systems.[26]

49. Metro informed the CMA that at the start of its relationship with its clearing bank supplier, it was paying £[✂] per outgoing Faster Payment, and given its growth over the last four years this had reduced to £[✂]. Metro told us that the corresponding cost for the members of the Faster Payment Scheme was £[✂] per transaction, and this 'imposes a high cost on all small challenger banks, who may not be direct members, while acting as a clear and significant source of profit for the large larger clearing banks.'

50. Metro's submission to PCBS regarding payment systems made the point that:

> If you look at the banking industry across the world, different models are applied, where you would have payments as a utility that banks link into. Therefore, everybody was starting from a level playing field and could then differentiate themselves, based on the proposition they wanted to offer customers, rather than having to rely on the proposition that the big banks wanted to offer customer. If we genuinely want competition, we need to create the level playing field, almost like a utility play, rather than forcing challenger banks to go to the lowest common denominator.[27]

51. Metro suggested to us that the CMA, in conjunction with the Payment Systems Regulator, should investigate the possibility of an independently run, licensed 'Plug and Play' payments platform with the same service levels for all banks, which could be funded according to volume.[28]

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[26] Metro provided a specific example illustrating the effect of accessing payment systems through another banks on its customer service. It cited the outage of its Faster Payment functionality using the Direct Corporate Access (DCA) between 08:00 and 20:00 on 29 November 2014, during which time outbound DCA payments were rejected and payments were not stored.
[27] Craig Donaldson's oral evidence to PCBS, 13 November 2012. Answer to Q6.
[28] According to Metro, elsewhere in the world, such as in the USA, banking payment systems are run independently by a central organisation (such as the USA's Clearing House Interbank Payment System).

52.   Metro's experience suggests that it has to rely on larger banks, ie its competitors, for accessing payment systems, which may have both cost and quality implications. Metro's business model relies on high-quality service to its customers, but it cannot directly control the quality of the service of the payment systems since it accesses them through other banks.

IT system

53.   Metro told the Treasury Select Committee that the biggest barrier to being a new bank in Britain was IT. It said that in the USA there were outsourced providers who were ready to put you in business almost immediately, while in the UK one had to build IT from scratch.[29]

54.   Metro's IT strategy was intended to minimise the size of initial capital outlay and manage the bank's cash flow and profitability.[30] Metro chose to work with Temenos, which provided it with an IT platform with a single customer view that underpins its banking services. It selected Temenos because it offered an integrated IT solution which 'lowered the entry barriers by offering a flexible and massively scalable delivery model which reduced capital outlay and operating costs to a bare minimum.'[31] The implementation period for Metro's IT system was also relatively short at nine months.[32]

55.   According to a report by Temenos,[33] it was able to offer the T24 IT[34] platform to Metro on a Software as a Service (SaaS) model – where a vendor (in this case using a third party) hosts an application on behalf of a customer and provides access through the internet, normally in exchange for a monthly or quarterly rental.

56.   A recent report by Temenos concluded that in the UK, computer systems may put larger banks at a disadvantage.[35] Another report by Deloitte and Temenos has found that over the past five years, banks using third party banking applications have enjoyed on average a 19% higher return on assets, a 28% higher return on equity and a 6.5 percentage point lower cost-to-income ratio than banks running legacy applications.[36]

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[29] House of Commons Treasury Select Committee. Vernon Hill's oral evidence, 14 December 2010. Answer to Question 460.
[30] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise, p15.
[31] ibid, p15.
[32] ibid.
[33] Ibid, p15.
[34] Temenos T24 (T24) is a front- to back-office, Customer Relation Management and product life cycle management software platform that powers core banking operations.
[35] Succeeding through the digital revolution. Lessons from Banking Industry Disruptors. White paper 2014. Temenos. pp13 & 20.
[36] Temenos and Deloitte. Restoring Profitability in the Digital Age. 2014.

57. Metro seems to have overcome many of the scale advantages enjoyed by the large banks by deploying an integrated IT solution. It has taken the application on a hosted pay-per-use basis minimising the level of upfront IT investment needed and rendering IT as a variable cost.[37] Since Metro has focused on growing organically, it has not been burdened by legacy IT systems, and its IT system appears to be a key competitive advantage.[38]

Need for branch network and availability of suitable sites

58. Metro's submission to the Treasury Select Committee pointed out the importance of a branch network to its business model: 'as a retailer, we know the more stores we put in the same market, the better those stores all do.'[39] Metro told us that its customers' feedback was that branches were important to them. It also made the point that, 'Our customers tend to be based in the areas and communities surrounding our stores, as new customers have to open their first account in a store', thus reinforcing the importance of its branches to its business model (see Figure 11 below).[40]

Figure 11: Metro's branches and customers (November 2014)
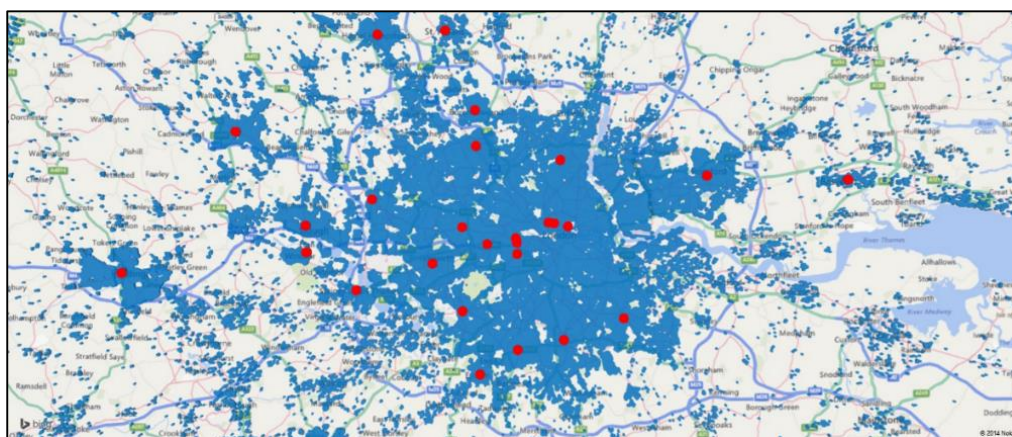
Legend: Red – Metro Bank branch. Blue – Metro Bank customer.

Source: Metro bank.

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[37] Temenos Metro Bank case study: Breaking the Mould but Breaking the Malaise, p1.

[38] According to Temenos case study on Metro '…lower absolute technology spending as result of having a modern, integrated system offers Metro Bank not just the opportunity to achieve a minimum efficient level of scale with lower volumes, but also a source of enduring economies of scale and competitive advantage - which it could choose to invest in higher deposit rates. Temenos Metro Bank case Study: Breaking the Mould but Breaking the Malaise, p19.

[39] House of Commons Treasury Select Committee, Vernon Hill's oral evidence, 14 December 2010. Answer to Question 461.

[40] Subsequent accounts can be opened online.

59. Although having branches was important, Metro stated that they made up only one part of its all-channel offering. As Metro mentioned in its response to the CMA's issue statement:

> … competition should be about banks offering different models to customers; some will take an all-channel approach (like us) and others will choose different strategies. As a result, we do not think that a branch network should act as a barrier to competition – banks must choose models that suit them and their customers, concentrating on differences and choice rather than more of the same.[41]

Planning permission

60. Metro stated that prior to April 2014, the majority of prime sites on the UK's high streets and in retail outlets were classified as A1 retail uses, while the Use Classes Order (1987) classified banks as well as other financial and professional service providers, as A2 users. This meant that in order to open a bank in a prime retail location, significant time and money had to be spent applying for planning consent from local authorities for a change of use (from A1 to A2 use). Metro told the CMA that this had a significant impact on its ability to grow branch numbers, since in many cases, planning permission could take six to nine months.

61. Metro informed the CMA that in April 2014, the Department for Communities and Local Government changed the rules to allow greater flexibility for change of use. Under the new rules, Metro (categorised as an A2 Financial and Professional services use), no longer needs planning consent to take an existing shop (or an A1 Retail use) and convert it to a bank. Metro stated that it had benefitted from the change in planning rules, and as a result, was able to acquire eight new branches in 2014 without the need for a planning application.

62. Metro also informed the CMA that following a consultation carried out in 2014, the government proposed further amendments to the planning process that would effectively merge use classes A1 and A2. According to Metro, should these changes fail to take place, it would continue to encounter the following problems in acquiring suitable sites for opening branches:

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[41] Metro's response to the issues statement.

(a) Where a new property was developed and a planning consent granted for A1 retail use, it was not possible to utilise it as a bank until it had first been used as a retail space.

(b) Some properties had restrictive planning conditions which limited their use to A1 retail uses only, despite the changes to the rules in April 2014.

63. In its Offer for Subscription in 2014 for raising additional capital, Metro mentioned its ability to acquire suitable sites for its branches as a business risk. It said that 'A cornerstone of Metro Bank's business strategy is prime locations for its stores … any future inability to obtain additional properties could have a material adverse effect on Metro Bank's business, financial condition, performance, results of operations and/or prospects.'

64. It appears that the changes to planning rules that took place in April 2014 removed an impediment to Metro's ability to acquire suitable retail sites for its branches. Further changes to planning rules – for example, merging A1 and A2 user classes – can help Metro further in its ability to acquire suitable sites to grow its branch network. Since Metro plans to grow its branch network organically, if it cannot open new branches quickly enough, this may affect its ability to acquire customers and reach a certain scale.

Customer acquisition and advertising

65. Metro does not spend significantly on product marketing, sales incentives or introductory incentive offers, and does not make use of acquisition costs per customer or lifetime value per customer metrics. Metro stated that it relied more on word of mouth than advertising to attract and retain customers.[42]

66. Metro stated that it did not target a particular customer segment. In its evidence to the Treasury Select Committee, Metro had stated that 'We do not believe there is such a thing as a high-profit customer or a low-profit customer … We believe every customer has real value. They may have low value when they are students and they may have higher value over time but we're out to serve as wide a market as we can get, from wealthy people to students.'[43]

67. Regarding the current account switch service (CASS), Metro's view was that its effect on switching would be limited until there was more competition and choice in the market. Although Metro viewed CASS as a helpful utility, it did

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[42] Metro mentioned that, 'By keeping customers happy, building stores and surprising and delighting them, we create real advocacy….As a result, they [customers] will recommend us to their friends, and in our opinion this is much more powerful, and effective, rather than advertising.' Metro's response to CMA case study.
[43] House of Commons Treasury Select Committee, Vernon Hill's oral evidence, 14 December 2010. Answer to Question 460.

not view it as a factor actively influencing its customers in their decision to switch.

68. Metro's decision not to advertise does not appear to have affected its ability to acquire customers and expand so far. This may be due to its decision to invest in a branch-based business model. It does not use retention as a measure of satisfaction, but pointed out to the CMA that many more people were joining rather than leaving Metro, and that its customers were switching to it from all the major high street banks.

Access to funding and capital

69. Metro stated that larger banks often competed unfairly with introductory switching bonuses and 'free banking', and they could do so due to cross-subsidy from small subsets of existing back book customers who paid significant fees on overdrafts.

70. Metro pointed out that the larger banks used the savings they made from offering lower interest rates to existing customers to cross-subsidise new customers, which effectively provided them with cheap deposit funding from their less active loyal customers. Metro stated that this created a barrier to entry in the market since the larger banks were able to use this cheap source of funding to drive down their cost of lending. Metro stated that the 'challenger' banks, with higher funding costs, were forced to compete at an unfair price for lending, and in some cases assumed higher-risk lending in order to compete.

71. Metro also told us that since it funded lending through customer deposits rather than through wholesale funding, it was adversely affected by the ability of large banks to drive up its cost of funds by being able to offer higher rates on deposits to new customers.[44,45]

72. Metro suggested to us that 'In the interests of transparency and treating customers fairly, banks should be obliged to give existing customers the same favourable rates and products offered to new customers.' It also added that 'Banks should also be obliged to keep fee structures simple, let customers

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[44] PCAs and BCAs represent an important element of Metro's funding representing [✂] and [✂] of its deposits as at December 2014. Metro stated that it had never cut a variable interest rate for an existing customer or offered a bonus rate to a new customer – because it does not consider that to be fair treatment of its customers.
[45] Retail funding refers to the various types of deposits that households and small companies keep with a bank while wholesale funding is from external sources including other banks, large corporates, pension funds, insurance companies. 'Bank funding costs: what are they, what determines them and why do they matter?' Bank of England *Quarterly Bulletin*, Q4 2014.

know personally about every rate change and inform customers of any better suited products available to them.'

73.   Despite this potential barrier, Metro has been able to rapidly grow its deposits to support its funding requirements. Metro has also been able to raise equity capital to fund its expansion, it appears, without any difficulties. So far, Metro has raised £641 million as equity capital from private investors, as is shown in Table 2 below:

Table 2: Equity capital raised by Metro

	Equity capital raised £m	Comments
2010	75	Initial equity capital
2010	51	
2012	128	Additional equity capital
2013	287	
2014	100	
Total	641	

Source: Metro's website.

Conclusions

74.   Metro successfully overcame what obstacles it encountered in launching as a new high street bank, and has grown well so far. Its IT system appears to be a competitive advantage.

75.   It considers capital holding requirements, the larger banks' ability to subsidise new customers and indirect access to payment systems to be key impediments to its further expansion. Metro has chosen to focus on expanding in the South East around the London commuter belt. Metro has also adopted a branch-based business model to promote itself and acquire customers. However, if it cannot open new branches quickly enough in these areas, this may affect its ability to acquire customers and reach a certain scale.

Appendix A – List of Metro's branches at the end of 2014

No.	Store location	Date of opening
1	Holborn	Jul-10
2	Earl's Court	Sep-10
3	Borehamwood	Oct-10
4	Fulham Broadway	Oct-10
5	Tottenham Court Road	Mar-11
6	Kensington High Street	Apr-11
7	Bromley	Jun-11
8	Croydon	Jun-11
9	Uxbridge	Oct-11
10	Hounslow	Dec-11
11	High Wycombe	Mar-12
12	Chiswick	May-12
13	Reading	Nov-12
14	Hemel Hempstead	Dec-12
15	Romford	Dec-12
16	Sutton	Feb-13
17	Guildford	Apr-13
18	Slough	May-13
19	Ealing	Jun-13
20	Staines	Sep-13
21	Kingston	Oct-13
22	Cheapside	Nov-13
23	Edgware	Dec-13
24	Windsor	Dec-13
25	Milton Keynes	Jan-14
26	Epsom	Mar-14
27	Milton Keynes Oakgrove	May-14
28	Wood Green	Oct-14
29	Basildon	Nov-14
30	St Albans	Nov-14
31	Orpington	Dec-14

Source: Metro website.

Appendix B – Metro's main products

Personal banking[46]

- Current Accounts

- Savings Accounts, eg ISAs, Young savers account

- Mortgages

- Borrowings – eg Credit card, Overdraft, Personal loans professional studies loan

Business banking[47]

- Business Bank Accounts

- Deposit accounts, eg Business Instant Access Deposit Account

- Borrowings, eg Small business loans

- Commercial Banking, eg Not-for-profit banking

- SME finance services, eg Invoice and Asset Finance

- Cash management services

Other

- Safe Deposit Boxes

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[46] www.metrobankonline.co.uk/Personal/.
[47] www.metrobankonline.co.uk/Commercial/.