

Retail banking market investigation

Nationwide small and medium-sized enterprise case study

5 June 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.

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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 [✂].

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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 (AECs) 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. In 2010, Nationwide Building Society (NBS) was starting to explore diversification opportunities that would provide an improved experience for its members and an acceptable return on capital. Despite the poor macroeconomic conditions, NBS believed that the SME banking market was relatively resilient and appeared to be attractive (particularly given the perceived political support and apparent ease of leveraging NBS's existing personal banking infrastructure).
2. The intended operating model was [✂]. This would be targeted at [✂] to minimise the impact on the existing NBS branch network.
3. However, additional work in early 2013 revealed that providing a credible entry into the SME market through the provision of a BCA product would require significant further and sunk capital investment in IT. It was concluded that the project offered insufficient returns on this capital in a reasonable time period and could potentially impact other projects which were perceived as a higher priority for NBS.
4. Despite what NBS saw as the continued attractiveness of the SME market for an incumbent business, the decision was made not to enter organically with the launch of a BCA, [✂].
5. [✂]
6. Our preliminary assessment is that NBS's decision not to enter the SME market was primarily on the basis of capital prioritisation. Based on [✂], there was a relatively long time period needed to build scale with only modest profits being made even at maturity. Hence this proposition appeared relatively unattractive compared with other opportunities to invest in NBS's retail operations. There were also risks associated with entry, primarily regarding integration of new IT systems, and the impact on NBS's branch network.

Introduction

7. In this case study we examine the analysis which NBS conducted when assessing whether to launch a BCA and additional SME banking services. We consider in detail the process by which NBS identified the opportunity and why it ultimately took the decision to put this work on hold.
8. In 2012, NBS launched a business savings product available to SMEs, although this represents a very small line of business.

Overview of NBS

Origins and development

9. NBS claims to be the world's largest building society, tracing its beginnings to 1846 when Provident Union Building Society was founded.¹ It subsequently underwent many mergers and acquisitions with other building societies, most notably with Anglia (1987), Portman (2007), and Derbyshire (2008) and Cheshire (2008) building societies.
10. As a mutual, NBS is owned by its members, primarily made up of its financial services customers (borrowers and savers²) who are given voting rights for the election of directors as well as voting on resolutions, operating on a one-member one-vote system.
11. NBS told us that prior to 1987 it largely offered savings and mortgages to personal customers. It subsequently introduced PCAs and a number of other products to personal and business customers. NBS now offers a range of financial products, including:³
 - (a) personal products: residential mortgages, personal savings, personal financial planning, insurance products, personal lending, and other general personal banking services; and
 - (b) other products: commercial lending.
12. In 2007 NBS launched a major IT investment programme ('Project Voyager') to update its digital infrastructure. The aim was to facilitate the launch of new products, but also to replace its PCA back-end systems with an SAP⁴ solution. This cost about £[~~8~~], and was completed in 2012.
13. NBS has grown its customer base and product offerings describes itself as 'a meaningful alternative to the established banks.' In 2014 it generated a profit before tax of £677 million, and highlighted its performance in three specific areas:⁵
 - (a) £130.5 billion of member deposit balances;

¹ [NBS Background](#).

² Generally requires a minimum of £100 savings or deposits as well as being aged 18 or over, [NBS Membership Criteria](#).

³ [NBS Financial Products](#).

⁴ [SAP](#)

⁵ 2014 Annual Report, with quoted profit levels given as statutory profit before tax.

- (b) £166.6 billion of loans and advances to customers (Including £145.7 billion of residential lending through 1.5 million mortgage accounts); and
- (c) 5.5 million current accounts.

Business description

- 14. NBS's core business is providing personal financial services to more than 14 million of its members. Its strategic agenda is focused on increasing its share of the personal banking market, with a specific target of achieving a 10% share of PCAs. In addition to this core focus, it said that its activities include specialist lending in both the commercial real estate and buy-to-let sectors as well as deposit-taking from SMEs. It does not currently offer a BCA or complementary SME banking services. It told us that this model is not expected to alter significantly in the short term.
- 15. NBS states that many of its existing members owned/operated SMEs but are unable to carry out their business banking with NBS. It told us that it recognises this gap in its offering and regularly reviews how it could best support SMEs.
- 16. Historically, NBS has sourced its funding from the personal savings and wholesale funding markets. In March 2012, it fully launched (ie available to new customers) simple business savings accounts to both meet its members' needs and to diversify its funding base. These catered to SME needs but were relatively simple, being postal-only.
- 17. By 2014, these business savings accounts amounted to £[redacted].⁶ NBS said that it intended to grow its business savings to £[redacted] by [redacted]. However, [redacted] given that NBS's total funding⁷ at 30 September 2014 was £185 billion.

Initial views on NBS's BCA project

- 18. In this section we consider NBS's reasons for delaying its BCA project.
- 19. NBS has consistently stated a number of reasons for entering the SME market through the launch of a BCA. Entering the SME market would:
 - (a) provide a better service offering to its members;

⁶ [redacted]

⁷ According to NBS's 2014 Annual Report, 'Funding' includes customer deposits (72%), wholesale funding (20%), reserves (6%), other (2%).

- (b) diversify its business model (in terms of both revenue and funding);
 - (c) allow it to further leverage its brand; and
 - (d) provide an opportunity to cross-sell products between personal and business (eg using existing personal base as an entry point).
20. NBS chose to prioritise its investment in other projects ahead of developing its SME proposition. Four other factors caused NBS to de-prioritise entering the SME market once NBS had investigated in more detail, specifically:
- (a) Developing the IT systems necessary to offer banking services to SMEs is complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. The original assumed ability to leverage existing IT investments from personal banking (ie Project Voyager) and thus minimise capital costs, was proved incorrect. Refined estimates indicated that an additional £[redacted] would be required.
 - (b) Based on the anticipated levels of switching and growth, the business plan illustrated modest returns for many years making the investment horizon long term (delivering low returns on capital) and unlikely to add any diversification benefit to its existing business model.
 - (c) The distribution requirements and, in particular, the use of branch space potentially conflicting with retail requirements, ie some of NBS's branches are currently too small or too busy to accommodate SME service requirements. This is expected to become less of an issue as more transactions are done through mobile and digital channels, but there is still a risk that counter service for personal customers would be impacted by servicing [redacted] SME customers [redacted].
 - (d) NBS has limited SME expertise particularly in origination, service and risk management. IN NBS's view, this risk could be substantially reduced through [redacted].
21. Although the SME market remained attractive after additional research, the level of synergy that could be achieved with existing assets was determined to be significantly lower than initially believed. This implied much higher capex requirements to enter, and hence a significantly worse return on capital employed. NBS acknowledges that as its analysis progressed, the scale of the challenges faced by new entrants to the SME market became apparent.
22. [redacted]:
- (a) [redacted];

(b) [REDACTED]; and

(c) [REDACTED].

23. NBS did not rule out a potential acquisition in the future, but considered that it would be dependent on an attractive target becoming available, and external market developments such as the CMA investigation.

Details on specific barriers

24. NBS told us that the primary reason it put its SME project team on hold was that its board took the view that investment in personal banking products and services must take priority over attempts to develop SME banking. The scale of change taking place in NBS's personal banking business made it unfeasible for it to develop the required SME capabilities in parallel. Its analysis had shown that for successful entry to take place, the following costs/complexities would need to be overcome:

Set-up/capital costs

25. NBS concluded that developing the IT systems necessary to offer banking services to SMEs was complex and expensive, especially the work required to integrate these systems into the existing IT infrastructure. It also required significant technology management resource and expertise.
- (a) The NBS board believed 'the Society could not afford to invest c.£[REDACTED] million at this time at the expense of other projects.'
- (b) At the point this statement was made (2013), SME banking appeared to be the lowest priority of the three 'discretionary' projects discussed.

Low financial returns

26. Based on the anticipated levels of switching and growth, the indicative business plan illustrated modest returns for many years making the investment horizon long term and unlikely to add any diversification benefit to the existing business model.
27. In 2014, the NBS board were 'generally supportive [of SME proposal] particularly from a diversification perspective although some concern was expressed that given the relatively small forecast financial contribution by years 5 and 10 a stronger consideration was the "member needs" argument'.

Distribution concerns

28. The distribution requirements and, in particular, the use of branch space potentially conflicted with personal requirements, ie some of NBS's branches were currently too small or too busy to accommodate SME service requirements.

(a) [✂]

(b) [✂]

(c) NBS analysis has, however, suggested that this concern may become less important in the future as SMEs increasingly adopt digital banking solutions such as online and mobile. [✂]

Limited expertise and risks

29. NBS was concerned that as a personal financial service provider it did not have sufficient SME expertise in the fields of origination, service and risk management and would thus need to recruit and establish these areas of specialisation.

(a) Although identified by NBS as being an area of concern early on in the process, [✂] appears to have given NBS sufficient confidence that it would be able to build a credible offering.

(b) [✂]

Awareness of opportunities for inorganic growth

30. [✂]

31. [✂]

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

External communications and regulatory pressures

32. [✂]

(a) [✂]

(b) [✂]

(c) [✂]

(d) [✂]

(e) [✂]

33. In August 2013, the *Financial Times* reported that NBS had:

Put on hold its plans to start offering loans to small- and medium-sized enterprises as it battles to meet tougher capital requirements set out by the financial regulator earlier this year [...] after the Prudential Regulation Authority revealed that Nationwide would have to strengthen its capital position after it fell short of the required 3 per cent leverage ratio.⁸

34. The CMA notes that later in the same month *The Guardian* reported that the Bank of England (BoE) 'rejected any suggestion that Nationwide's decision to hold off from a launch into the SME sector was due to its demands on capital strength', quoting a BoE spokesman as saying 'the plan agreed with Nationwide to meet the 3% leverage ratio in 2015 will not result in them restricting lending to the real economy. Therefore it is wrong to blame their SME decision on the regulator'.⁹

35. NBS subsequently confirmed to us that the capital holding requirement was not one of the primary reasons for its decision to put its investigation of entry into the SME market on hold.

⁸ [Financial Times report](#), 26 August 2013.

⁹ [Guardian report](#), 27 August 2013.

Appendix A: Timeline of events

1. A summary of the timelines is laid out in Figure 1 below, along with the key figures as they were presented to the executive committee/board:

Figure 1: Summary timeline of events

[✂]

Source: CMA analysis.

2010

2. At NBS's September 2010 Strategy Conference, an initial document assessing the prospects of NBS's entry into the provision of SME banking services (including BCAs) was presented to the board. This included an overview of the SME sector and the main competitors, a channel and product strategy, indicative financials and independent market research.
3. Specifically, the paper highlighted that entry into the market should be possible, based on a strategy of [✂]. It stated that [✂].
4. The overall recommendation of the paper was that a full business case should be developed for presentation to the board in early 2011.
5. The board sought further clarification on a number of areas including:
 - (a) the size and nature of the target market;
 - (b) the impact of the SME product suite on the NBS operating model including its branch network;
 - (c) the impact on NBS's 'transformation agenda' (its IT platform, facilitating multi-channel service delivery);
 - (d) the business case for parallel IT developments to support the SME business;
 - (e) the credit process for SME customers; and
 - (f) further refinement of the product proposition.

2011

6. The subsequent paper presented to the board in April 2011 sought to clarify these issues. It proposed that [✂]. It recommended a project team be

assembled ([§]) and that the team work towards a pilot launch [§] and a full launch [§].

7. The paper explained that NBS [§]. It considered that these businesses tended to [§].
8. [§]
9. The paper set out the breakdown of the [§] market ([§]).

Figure 2: [§]

[§]

Source: [§].

10. [§]
11. [§]
12. The paper also concluded that [§].

Figure 3: [§]

[§]

Source: [§].

13. The proposed operating model for serving SME customers would utilise NBS's internet, branch, telephone and ATM channels. [§]
14. The proposed SME products at this time were:
 - (a) [§];
 - (b) [§];
 - (c) [§];
 - (d) [§]; and
 - (e) [§].
15. One of the questions highlighted by the board in response to the original proposition in 2010 concerned the distribution requirements associated with serving the SME market and, in particular, the use of branch space. This was of particular importance, since this board paper forecast that the SME customer base would grow to [§]. Supporting analysis estimated that this could have potentially generated up to [§] branch counter transactions a year. It stated that it was clear that entering the market with no controls could

place undue pressure on branches as SME customers could increase transaction levels by about [REDACTED].

16. The board paper therefore set out the controls that it believed should be put in place from the outset:
 - (a) [REDACTED]
 - (b) [REDACTED]
 - (c) [REDACTED]
 - (d) [REDACTED]
17. NBS stated that the business case was based on an assumption that [REDACTED]% of accounts would be opened in branch, about [REDACTED]% of accounts would be opened online and about [REDACTED]% through the telephone channel. As a new entrant in this sector NBS believed it would look to demonstrate continuously improving account opening capabilities through [REDACTED] channels, so these opening percentages were viewed as conservative.
18. The paper stated that adopting this recommended approach, with its focus on attracting [REDACTED], the forecasted transaction levels at NBS branches would rise by about [REDACTED] and the number of branch-based customer representatives required to service this [REDACTED]. It said that the cost of this (worst-case) scenario was included in the business case.
19. However, the paper estimated that [REDACTED], so the argument was made that this cost (provision for which was made in the business case) might not have materialised since [REDACTED].
20. The paper also stated that the proposition might require an additional [REDACTED]. As with branch servicing, it stated that these costs were included in the business case but might not have materialised [REDACTED].
21. The business case accompanying the board paper showed a £[REDACTED] contribution by year 5 and a £[REDACTED] contribution by year 10. This assumed an estimated set up cost of £[REDACTED] and that it could grow to [REDACTED] BCAs ([REDACTED]) by year 5 and [REDACTED] ([REDACTED]) by year 10. The paper stated that it considered this achievable, considering that [REDACTED].
22. The major areas of operating costs were forecast as:
 - (a) product costs ([REDACTED]);
 - (b) channel costs ([REDACTED]);

(c) attributed costs ([REDACTED]); and

(d) provisions ([REDACTED]).¹⁰

23. The NBS board agreed to support in principle entry, and approved the creation of the formal project team to further develop the business case. It raised a number of further questions and challenges including:

(a) the possibility of accelerating the launch date or initially launching an SME deposit account;

(b) the benefits of a large branch network with managers having a strong understanding of the business needs of the target market;

(c) differences in the training requirements relating to the product T&Cs; and

(d) cross-selling opportunities and the need to avoid value destructive activities.

2012

24. Another paper was presented to the executive committee in April 2012, and subsequently the board in May 2012, which provided an update on the SME project team's progress in assessing the options available to NBS. In particular, it discussed:

(a) an update on the market conditions which indicated that despite the economic downturn, the SME sector remained broadly stable;

(b) [REDACTED]; and

(c) the assumption that the required SME IT infrastructure could be developed in parallel to the significant investment taking place to support NBS's personal banking operations.

25. The board also heard that within the SME market, the government had been actively encouraging competition and lending; and received information on the newly launched Commercial Deposits (business savings) accounts, which were piloted to existing NBS Commercial customers in 2011 and were launched to the external market for the first time in March 2012.

26. The paper included an updated business case based on the latest assumptions, which showed the [REDACTED]. However, no additional details on the expected

¹⁰ See Appendix B for the details of the business case.

set-up costs were provided. NBS highlighted the main changes in the business case assumptions as the following:

- (a) [REDACTED]
 - (b) [REDACTED]
 - (c) [REDACTED]
 - (d) [REDACTED]
27. NBS provided us with an initial Experian presentation from November 2012 which supported previous size estimates and gave more detailed information regarding the make-up of the SME market.
28. The board paper shows that in this period NBS completed a programme of competitor benchmarking [REDACTED]. It stated that [REDACTED].
29. The paper stated that NBS [REDACTED].
30. NBS designed a BCA product whose features included:¹¹
- (a) [REDACTED];
 - (b) [REDACTED];
 - (c) [REDACTED];
 - (d) [REDACTED];
 - (e) [REDACTED];
 - (f) [REDACTED]; and
 - (g) [REDACTED].
31. During this period NBS was also aware of a number of inorganic entry options, [REDACTED].
32. In October 2012, alternative IT solutions were proposed to support the delivery of an organic SME proposition:
- (a) Option A (Original): [REDACTED].
 - (b) Option B (Alternative): [REDACTED].

¹¹ The CMA notes that subsequent work was commissioned which questioned the feasibility of parts of this delivery model, and recognises that the exact proposition would likely evolve before reaching market.

2013

33. In 2013, after assessing these supporting IT options against a number of criteria including: strategic fit to the business and IT strategy; timeline to deliver; delivery and operating costs; risk profile of delivery, IT solution 'Option B' was adopted as the recommended solution should NBS decide to enter the SME market.
34. In 2013 it also became clear that developing the required business banking infrastructure would have an impact on the investment taking place in personal products and services as IT resource would need to be diverted.
35. In March 2013 NBS papers were presented to the executive committee and subsequently the board which showed that the latest business case estimated the programme cost as being significantly higher [redacted]. Therefore what was anticipated to be a relatively modest investment of capital (£[redacted]) and resource turned out to be more onerous. Most of this requirement was in the form of capital expenditure ([redacted]), with the majority consisting of IT design and development, [redacted]:
- (a) [redacted];
 - (b) [redacted];
 - (c) [redacted];
 - (d) [redacted];
 - (e) [redacted]; and
 - (f) [redacted].
36. Although some board members expressed concern that NBS was missing an opportunity to broaden the services it offers to its members, it was agreed that NBS could not afford to invest around £[redacted] at that time and at the expense of other projects.
37. The board considered that, due to the levels of profit at the time, some discretionary programmes would need to be deferred. [redacted]:
- (a) [redacted]
 - (b) [redacted]
 - (c) [redacted]

38. It was agreed at the board meeting that [redacted] should be progressed, and it was generally accepted that the preference would be to invest in [redacted] ahead of SME banking. The SME proposition would be deferred and reviewed in 12 months' time.
39. The work of the SME project team was therefore put on hold, [redacted].

2014

40. In June 2014, another board paper gave an updated overview of the SME market which showed the following:
- (a) There were [redacted] SMEs, [redacted], of which [redacted] used a BCA.
 - (b) The number of SMEs was expected to show steady growth over the next [redacted] years.
 - (c) The BCA market was still 'dominated' by the major banks with 90% held by the Big 5.
 - (d) There was no current tangible alternative to the Big 5, although there were a number of new smaller/niche players entering the market, for example Williams & Glyn, and TSB, which were looking to grow their market share. The paper specifically highlighted the levels of political support and the ongoing Office of Fair Trading investigation as factors which encouraged these entrants.
 - (e) SME customers were becoming more digitally active [redacted].
 - (f) [redacted]
41. The paper recommended that the preferred NBS proposition should be [redacted]:
- (a) [redacted];
 - (b) [redacted];
 - (c) [redacted];
 - (d) [redacted]; and
 - (e) [redacted].
42. The recommendation to the board was that [redacted].
43. [redacted]

Figure 4: [REDACTED]

[REDACTED]

Source: [REDACTED].

- 44. The NBS board reviewed the above, considering [REDACTED] with regard to the appropriateness of developing a business banking offering in the context of their new 2014–2019 Corporate Plan.
- 45. The board was told that since the update in 2013, [REDACTED]. The business plan predicted [REDACTED].
- 46. [REDACTED]
- 47. In conclusion, the board agreed that the SME market still represented a market opportunity in the medium term but [REDACTED].

Latest statements

- 48. NBS has told us that developing an organic entry into the SME market remains an option and it is retaining the SME project team’s deliverables, which provide insight into how to overcome key challenges such as maximising synergies from IT integration, distribution requirements and supplementing NBS’s personal expertise with SME experts.
- 49. NBS estimated that the project had cost about £[REDACTED] to reach this stage ([REDACTED]) and the paper identifies [REDACTED] based on incorporating the required bridging of gaps in NBS’s IT functionality whilst also taking advantage of relevant existing IT infrastructure.
- 50. [REDACTED]
 - (a) [REDACTED]
 - (i) [REDACTED]
 - (ii) [REDACTED]
 - (iii) [REDACTED]
 - (b) [REDACTED]
 - (i) [REDACTED]
 - (ii) [REDACTED]
 - (iii) [REDACTED]

Appendix B: Details on 2011 business case modelling

