# Banking and competition in the UK economy

TWO MINUTE SUMMARY

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SMF Social Market Foundation

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**This report explores the state of competition in the UK economy, and the extent to which supposedly competitive markets are delivering good outcomes for customers, with a particular focus on the retail banking sector.**

Done right, a renewed focus on competition policy in the UK could be a powerful lever for reducing the cost of living, enhancing customer service and driving up rates of innovation as businesses have to strive harder to retain and attract customers.

This research focuses on eight key consumer markets:

- Automotives
- Broadband
- Electricity
- Gas
- Groceries
- Mobile telephony
- Mortgages
- Personal Current Accounts

## The state of competition in the UK

Six of the eight markets listed above are moderately or highly concentrated in the latest available data, with a small number of firms accounting for a significant share of the market. However, there have been some encouraging trends over time, particularly in the groceries sector and energy market where new market entrants have reduced the market share of large incumbents.

In contrast, the telecoms market, personal current account market and mortgage market have seen relatively little change in market concentration in recent years. The personal current account market remains more concentrated than prior to the 2008 Global Financial Crisis and, despite new entrants to the sector, there has been little change to market concentration since the separation of Lloyds and TSB in 2013.

An important driver of the diverging trends in market concentration is differing levels of customer engagement. Between 2015 and 2019, annual customer switching rates for both the electricity and gas markets increased markedly, from 12% to a record high of over 20%. In contrast, the number of customers switching personal current account each year languished at about 2% over this time period. While telecoms switching rates have improved since 2015, this has not been as marked as for energy. The Coronavirus pandemic saw a decline in customer switching rates in the energy and personal current account markets in 2020.

Low switching rates in concentrated markets suggest that levels of competition are weak, with firms subject to limited pressure to cut prices or improve product quality. There is evidence that greater levels of competition in sectors such as energy and groceries have translated into benefits for customers. Conversely, lack of competitive pressure in markets such as telecoms and banking is contributing to substantial “loyalty penalties” for customers, with businesses taking advantage of customer inertia to charge excessively. Banking-related loyalty penalties account for over half (56%) of the £3.4bn aggregate penalty estimated by Citizens Advice. This includes customers overpaying for mortgages and receiving reduced interest on savings.

## Competition and banking

There are a number of obstacles to smaller “challenger” banks gaining market share in the UK. Given the business model inherent to banking, where the amount of money they can make depends on the amount of money they can lend out, big banks gain large advantages as a result of having more assets under their control and more data.

Perceived risk of “something going wrong” can decrease customer willingness to switch bank – particularly to relatively new challenger brands. Past SMF research has shown that more consumers would be resistant to taking out a bank account, loan or mortgage from a company established in the last three years than any other type of product or service.

Product complexity can also make it more difficult for households and businesses to compare and switch banking products. For example, the use of cashback and rewards in addition to simple interest rates can make it difficult to compare personal current accounts. Business current accounts often have complex tariff structures, with a range of fees and charges.

While the mortgage market appears to be a relatively competitive part of the banking sector, we note the existence of uncompetitive sub-sectors in which consumer detriment is significant. This includes “mortgage prisoners” for whom re-mortgaging is difficult or impossible.

Government-backed lending schemes brought in during the financial crisis – the CBILS and BBLS – have seen business lending increasingly concentrated in the hands of large incumbent banks. Challenger and specialist banks’ share of total gross lending to SMEs fell to 31% in 2020 from 48% in the previous year.

## Policy recommendations

### To enhance competition in the UK economy

- **Government should establish the position of Minister for Competition and Consumers**, to ensure competition and consumers are prioritised across government.
- **A presumption in favour of competition should be introduced into takeover and mergers policy**, with policymakers erring on the side of caution by not permitting mergers in concentrated markets.

### To enhance competition in the banking sector

- **Government procurement should be used as a lever for creating greater competitive pressure in the banking sector.**
- **Government should ensure that future lending support schemes, such as CBILS and BBLS, can support competition in banking.** This includes ensuring that challenger banks are involved in governmental and Bank of England discussions, at an early stage, with respect to such policies.
- **The FCA should require banks to “prompt” their current account customers to renew their consent for continuing to bank with their current bank** (or banks) and create an artificial “prompt point” to stimulate switching, or at least consider switching.
- **The Financial Services Compensation Scheme should provide enhanced rates of deposit protection for challenger banks**, to encourage greater levels of account switching, and reduce the perceived risk of using a challenger bank.
- **The regulator should introduce a transition period requirement for all customers whose mortgage policy expires before they move onto the full standard variable rate.** This transition period should be time limited and involve a cap on the number of basis-points that an interest rate paid by the customer can increase for that period.
- **The FCA should bring coherence to its regulatory treatment of smaller businesses** by recognising that, in many ways, they are akin to consumers when engaging with the use of financial products.
- **The Bank of England’s PRA should expedite the introduction of the so-called Basel IV rules** to put a “floor” under the capital reserves of the banks that utilise the IRB models for risk modelling and identifying their reserve requirements and reduce the advantage that the IRB approach gives to bigger banks.
- **The Bank should also take the opportunity offered by its ongoing review of MREL to ensure regulations do not excessively disadvantage mid-tier banks**, by making them more transparent and predictable and minimising ‘cliff-edges’.
- **Further ahead, the PRA should examine the extent to which barriers to entry and growth could be reduced further** – for example through reductions to capital requirements - while at the same time maintaining stability of the banking system.
- **Regulators should trim back some of the unnecessary regulatory barriers that make switching more onerous for SME customers**, in particular. This includes making the current Anti-Money Laundering (AML) rules more risk-based and proportionate.

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