

CRA Competition Memo



The SME Banking Report

Regulatory intervention to 'improve' the competitiveness of markets requires pragmatism. It is important to gauge what can reasonably be achieved in the light of market characteristics as well as to take account of the likely impact of intervention on the future development of competition. In this regard, the proposals outlined in the recently published UK Competition Commission (CC) inquiry into the supply of banking services to small and medium-sized enterprises (SMEs) are notable in a number of ways, but three themes stand out.¹

First, the report sets a tough benchmark as to what constitutes 'acceptable' behaviour by firms in a concentrated market. Second, it shows how important the assessment of profitability can be in UK complex monopoly cases. Third, it suggests the CC has an optimistic view of the role that price regulation can play. Critics of the report might argue that this third point translates into a textbook application of the 'law of unintended consequences'. This *Competition Memo* explores each of these themes in turn but first the findings of the report need to be summarised.

Findings of the report

Some of the report's findings are surprising in the light of the severity of the CC's final recommendations. The report notes, for example, that SMEs are generally satisfied with service quality (84% of respondents to the CC's own SME survey were either satisfied or very satisfied with their bank) and 'the cost and availability of lending are in general not a problem'. But the CC had fundamental objections to how the market was functioning. Its main criticisms were as follows.

First, there were high switching costs, making SMEs reluctant to change banks. Second, there were significant barriers to entry into the SME market. Third, the banks' profits were too high. The CC recommended a raft of measures to facilitate switching and to lower entry barriers. Most of these proposals are relatively uncontroversial and some (such as steps to shorten the time taken to switch accounts) mirror initiatives that had already been set in train. However, in addition to these measures the CC recommended price regulation. The four largest clearing banks will have to pay interest on business current accounts of at least base rate minus 2.5%.² The government accepted all of the CC's proposals. We can now turn to the three themes that emerge from the CC's analysis.

¹ 'The supply of banking services by clearing banks to small and medium-sized enterprises', March 2002. Lexecon Ltd acted as economic advisors to Lloyds TSB.

² The CC stated that, alternatively, the banks could offer SMEs accounts free of money transmission charges.

What is 'acceptable' behaviour?

The first theme relates to what constitutes acceptable behaviour by firms in a concentrated market. The CC states that 'one of the most important characteristics' of the supply of banking services to SMEs is the limited extent of switching. The CC acknowledged that it 'saw no evidence' that the banks caused unnecessary delays in switching and accepted that once a customer decides to move it is in the bank's interest not to delay matters. The factors identified which limited switching include: the perceived complexity of changing bank for little financial benefit; the importance of an SME's relationship with a manager who understands its business; and the ability of banks to lower prices for those SMEs tempted to switch.

An underlying premise throughout the report was that the observed low level of switching is hard to reconcile with a competitive market. Yet closer examination of the factors the CC identifies as explaining these low levels of switching suggest a more ambiguous picture.

- First, however efficiently the process is handled, switching costs are never going to be zero: at the very least there will be a time and inconvenience cost. This will be true whether there are four or four hundred banks providing banking services to SMEs. Under these circumstances, banks should compete vigorously for initial custom. This is what is observed: SME start-ups are offered free banking services for a given period.
- Second, if SMEs value their relationship with their bank manager, not least because of the knowledge he or she has accrued of their business over the period of their relationship, high levels of switching would not be expected. Again, fierce competition for initial custom can be expected as a result.
- Third, empirical evidence suggests that SMEs tend to switch when they are dissatisfied with their bank, mainly over service quality. Offering a customer a negotiated price reduced to prevent switching does not seem at odds with the behaviour one might expect in a competitive market. Indeed, doing nothing might be suggestive of complacency.

In short, in markets in which certain forms of switching cost are unavoidable, competition takes a different form, with particular emphasis on competition for initial custom. It is not the case that low levels of switching are always symptomatic of customer harm. Low levels of switching are often found in markets in which long term relationships matter (solicitors, accountants, etc.).

The CC had a different perspective. Free banking to start-ups and negotiation of better terms for those customers threatening to switch prevented 'the benefit of competition diffusing through to the majority of

customers'. By implication, if the market were competitive better terms should be available to everyone and differentiating on the basis of a customer's characteristics would not be feasible.

Price discrimination often raises difficult legal and economic questions in concentrated markets, but the CC's view is not far short of a *per se* objection. The CC seemed to have a strict view of what is 'acceptable' behaviour: the better terms offered to a dissatisfied customer to prevent switching should also be offered to a customer who had no problems with its treatment.

Profitability

The second theme relates to measuring profits. A sizeable chunk of the SME report is devoted to this subject. Calculating profitability in this market is problematic for a number of reasons. First, profits are cyclical. Bad debts are higher and revenues lower in times of recession. Second, the measurement of capital is complicated with scope for interpretation of factors such as the treatment of intangible assets. Third, as there are no 'standalone' SME banks, a decision has to be made as to how much of each bank's overall capital to allocate to the SME part of the business.

Space precludes detailed examination of these factors but it is important to stress that the calculation of profit is far from an exact science. This means that the conclusions reached are sensitive to the assumptions used. For example, the CC concluded that the bad debt levels incurred in the recession of the early 1990s were unlikely to be repeated because banks had improved their credit risk assessment. The CC therefore concluded that the average bad debt over the past economic cycle was above what it considered a reasonable 'long term' ratio.

Adjustments like these can have a major bearing on conclusions about the extent to which profits are excessive.³ The CC is prepared to interpret persistent returns earned above the cost of capital as compelling evidence of a failure of competition. There is a concern that the 'battle of capital measurement' might become the dominant feature of complex monopoly reports.

The role of regulation

The third theme involves the role of regulation. In markets where barriers to entry are viewed as high and intervention is deemed to be warranted, intervention can take a number of forms. In the SME market, structural intervention (such as branch divestment) was ruled out. This seemed to leave two choices: take steps to minimise entry barriers and facilitate switching to encourage market entry (and a number of former building societies had expressed an interest in extending their services to include SME banking). Alternatively, acknowledge that the possibility of entry was so remote and current market circumstances so detrimental to SMEs that price regulation was needed.

The most remarkable feature of the SME report is that the CC adopted *both* approaches. The steps to reduce

entry barriers and facilitate switching are relatively uncontroversial. However, to insist that the incumbent banks also pay interest on business current accounts must have a detrimental effect on viability of new entry. The CC argues that one of the reasons that switching is not more common is that it results in little financial gain. But by making incumbent banks pay interest the gain from switching to a new entrant is reduced, undermining the incentive of the SME to switch. Many commentators view this as a classic example of the 'law of unintended consequences'. Redistributing a large chunk of the allegedly 'excessive' profits of the incumbent banks to SMEs appears to have undermined the viability of entry of their potential rivals.⁴

The report is also largely silent on the problems associated with price regulation. Two are particularly pertinent. First, the CC accepts that regulating only one aspect of pricing (the payment of interest) means that other aspects of price and service quality need to be monitored. The OFT is charged with monitoring money transmission terms and 'users and user groups' are asked to monitor any increases in charges or interest rates and declines in service quality or the willingness to lend. But the costs associated with regulation of this kind, particularly the burden it places on the OFT interpreting changes in interest rates and complaints about service quality, is virtually ignored. Second, the introduction of price regulation puts pressure on the OFT to demonstrate things have 'improved' before it can be relaxed. But the CC's form of price regulation damages the prospects for entry, which might well reduce the likelihood of regulation being lifted.

Conclusion

It is rare for the CC to recommend price regulation in a complex monopoly case. That the CC was willing to do so is surely suggestive of greater confidence in what intervention can achieve. But the basis for price regulation in the SME market is questionable on a number of grounds. First, the emphasis on low levels of switching appears to be predicated on a view that this is *per se* evidence of a market not functioning properly. Second, the emphasis placed on profitability to justify intervention is worrying given the unavoidable ambiguity of measurement.

Neither of these points would be of too much concern had the CC stopped at remedies aimed at reducing entry barriers and switching costs. Yet to regulate prices in the industry *as well* seems hard to fathom, as the payment of interest on current accounts was the key area in which new entrants were seeking to differentiate their offering. Given that the CC's recommendations appear to make entry less rather than more likely, it is doubtful whether market shares in three years time will be materially different from what they are today. Regulation of the SME market might be here to stay. It remains to be seen whether this is a high watermark in CC intervention or whether it is symptomatic of a more aggressive approach to 'fixing' markets deemed problematic.

April 2002

© Charles River Associates (published originally by Lexecon Ltd, prior to the acquisition of Lexecon by Charles River Associates)

³ For example, the OFT noted in its advice to the Secretary of State that if a 1.6% bad debt ratio (the average for 1989-2000) were used rather than the CC's choice of 1.2%, one bank's return on equity would be reduced to levels 'relatively similar to the CC's estimate of its cost of equity'.

⁴ This interpretation was widely reported in the financial press. HBOS, for example, is reported in the *Financial Times* of March 27th 2002 as stating that the move 'will favour' the incumbent banks.