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Retail Banking Team  
Competition and Markets Authority  
Victoria House  
Southampton Row  
London  
WC1B 4AD

12<sup>th</sup> September 2014

**RE: SME Banking Market Investigation**

Dear Sir/Madam,

As the former Entrepreneur in Residence at the Department for Business, Innovation and Skills (BIS), I experienced much first-hand experience of SME's interactions with banking providers and their encounters with access to finance. I therefore submit the following response to the Competition Market Authority's (CMA) consultation in regards to the decision to make an MIR based upon the knowledge gained at BIS, and my personal insights into the banking sector as an entrepreneur.

If you would like further clarification or comment, please do not hesitate to contact my Adviser Fiona Mawer.

Yours sincerely,

Lawrence Tomlinson  
Chairman of the LNT Group

**1. Overview**

1.1. I concur thoroughly with the CMA's views on the banking sector. I strongly believe the lack of competition in the banking marketplace causes significant difficulties for SME customers. This is not simply the aftermath of the 2008 recession, but the result of over a decade of market consolidation and expansion by the largest providers. Driven by excessive growth targets and misaligned incentives, the dominant providers have lost sight of, and ability to deliver, customer-focused services with no real competitive impediment to acting in the interest of shareholder, rather than customer, value.

1.2. The CMA's findings closely mirror what I saw as Entrepreneur in Residence and provide a thorough overview of the problems facing SME banking. In the submission which follows, I therefore briefly elaborate on the CMA's findings and fervently urge the CMA to take decisive action on breaking up the large providers to ensure a competitive marketplace with barriers to future consolidation. The largest providers are too big to fail, giving them competitive advantage of a Government safety-net, and are also too big to regulate, enabling them to act in

any manner they see fit with proportionately minor comeuppance for 'bad behaviour'. Ultimately, this balances the incentives in favour of risky, non-customer focused behaviour which benefits the bank to the detriment of their customers.

## **2. Market Structure and Entry**

2.1. The divestments from Lloyds Banking Group (LBG) and Royal Bank of Scotland Group (RBSG), as required by EU State Aid rules, have taken significant time to progress - TSB has only just been rolled out and Williams and Glyn has been delayed until 2016. The OFT was clear in its findings that this will do little to increase competition in the marketplace. Given the lack of business banking share they will receive, it is hard to see how they will be able to gain an ample segment of the market to drive competition in SME banking. These actions alone will thus not be capable of downscaling LBG and RBSG's dominant position in SME banking and creating a competitive environment

2.2. Market entry for new providers is entirely prohibitive, and as we have seen over the past years, not guaranteed to create competition in the long term. A varied and vibrant banking marketplace is vital for SME banking and the future stability of growth in the real economy. Alternative finance providers are to be welcomed in the market and can offer good solutions for SMEs but are inadequate for the purposes of challenging the core banking services required by businesses. This is especially so when you consider the close link between PCAs, BCAs and business loans (BLs).

2.3. Furthermore, to date, any legitimate challenger that has arisen in the banking sector has been acquired by one of the larger banking providers. There is nothing to prevent this happening going forward – the stagnant position of BCAs and BLs market shares since 1999 is testament to this. For example, Santander and Metro Banks are highlighted in the CMA report as growing challenger propositions. Similarly at the smaller scale, there are finance providers such as Aldermore and Handelsbanken who are beginning to increase their market share. The CMA correctly identifies that, at present, these offer no real competition to the market share of the four largest positions. However, even if they were to, the incentive for the larger banks would not be to outdo them on customer offering, to gain back their market share, rather it would be for them to acquire the bank. To achieve the type of return that shareholders in the large banks expect, it is almost impossible to do unless buying another bank. Without splitting these big banks up, the incentive for market consolidation will simply perpetuate as any authentic competitor risks being taken over by one of the major providers.

2.4. I strongly believe that the only effective solution to the anti-competitive structure of the market is to split the largest providers, LBG and RBSG into their constituent parts with sufficient market share of BCAs and BLs to establish true competitors.

## **3. Customer Service**

3.1. With true competition and clear differentiation of product offer and service level, customer inertia will be overcome. It is undeniable that with less than 15% of SMEs believing they can trust their bank, and 75% being unwilling to state they consider their bank to be acting in their best interest, apathy to switching providers will be rife. For many, it is simply a case of "better the devil you know" and without any demarcation between banks' services, there will be little impetus for change. Again, when you take into account the close relationship between BCAs, PCAs and BLs, as the CMA correctly identifies, there is an enormous barrier for any new

challenger to offer a genuine alternative, which encompasses the full needs of the SMEs to surmount disinterest in switching provider.

- 3.2. Not only are SMEs exposed to the results of an uncompetitive market, but have little protection due to commercial lending not being regulated, compounding the impact of market domination. The situation for SMEs has progressively worsened over the past decade and a half. The 2008 recession has clearly demonstrated the extent to which they have suffered from anti-competitive behaviour and poor treatment, such as the interest rate hedge products scandal. The adoption of a more customer focused approach by the dominant providers will not rectify this problem in itself because whilst in the short-term some service experience may improve during a time of economic prosperity, the longer term perverse incentives of a concentrated market remain. As can be seen by the consistent low levels of customer satisfaction, radical change is needed for any tangible improvement in SME banking.
- 3.3. The impact of the size of the bank, and their ability to internally regulate, also has to be borne in mind. It is clear in the case of the biggest banks that not only have they come too big to fail but they are also too big to regulate. Within these banks are numerous diverse business arms covering large geographies meaning that no one person or team can have effective oversight across the operation. At a certain size, economies of scale are no longer possible and the business becomes too complex, mired with bureaucracy and layers of management. Too many decisions become 'automated' with little discretion for those at the frontline who have a true understanding of customer needs. Only bank employees at the very extremities of the bank have any genuine customer-facing activity, but it is those at the top of the bank who make policy decision. They are, however, simply too far removed to understand and react to the realities the banks' customer service.
- 3.4. The core-focus of these large banking groups is no longer their business customers and their attention is distracted by their investment arms. Given the low levels of competition in business banking, with little change in market share between the top providers (unless acquiring another institution) and the lack of regulation in commercial lending, their market share is unaffected *despite* all the scandals that have come to light post 2008. We have often seen how the unintended consequences of bank policies have led to widespread scandals, such as PPI, IRHPs and LIBOR. The same is also true of business lending, for example with targets on approval rates for loan application creating a culture of pre-screening and relationship managers discouraging their customers from submitting requests for business loans.
- 3.5. Without any transparency throughout the organisation and short lines of command, the banks are unable to identify these issues until they have become rife. At this point, the damage has already been done and for many businesses it is only identified, and admitted to, beyond the point when financial compensation can truly give them reparation for their losses. Banks therefore need to be much smaller and more reactive to the needs of their customers to enable the management, and bank policy makers, have proper oversight of their operations
- 3.6. If the banks are not able to understand and effectively manage themselves, what chance do the regulators have? These institutions have grown to such a size that it is impossible to ensure they are acting in their SMEs customers' favour.

#### **4. Unfair Competitive Advantage**

- 4.1. The very fact that they are too big to fail gives them an unfair market position as they know, whatever happens and however they treat their customers, they will be saved by the tax-payer because not doing so would be too dangerous to the UK economy. In a competitive market, especially one as vital as banking, no provider should be of such a size that their demise could lead to the collapse of the whole economy. This is an unfair competitive advantage and divesting TSB and Williams & Glyn will not mean LBG and RBSG are no longer too big to fail – LBG is, in fact, bigger than it was when it was bailed out by the tax payer.
- 4.2. Allowing exits has to be a key part of any well-functioning market. Without adequate risk for failure, there is little to motivate competitive behaviour or create the drive to increase and maintain the customer base.

#### **5. The Solution**

- 5.1. Without structural reform, the banking market will never truly offer a stable platform for competitive behaviour. As outlined in the Tomlinson Report, the only way to secure more competition in the market place is to split the Government-backed banks, who are incidentally the two most dominant banks for SME lending – as well as the most complained about. By selling off the investment arm, and dividing the rest of the groups respectively into three banks each, with an equal share of retail and business banking, there will be sufficient diversity and choice in the market alongside shorter reporting lines, to begin to create impetus for customer focused behaviour. The incentive to push down inappropriate products will be removed and most importantly, given that the constituent bank will not be too large to fail, should they not be successful and behave irresponsibly, they will face the very real possibility of a market exit.
- 5.2. Smaller more responsive banks will also increase transparency internally so that Management can take full control and responsibility for the banks' actions to ensure it is operating properly. The regulators will then also have a clearer insight into the inner workings of the bank, enabling better monitoring to catch any anti-competitive or trends of unscrupulous behaviour at an early.
- 5.3. In conclusion, the CMA's proposed MIR is extremely timely and I advocate the need for immediate action. With the Government's intended timetable for the privatisation of the Government-backed banks it is imperative that any market reconfiguration is taken soon.