

EXECUTIVE SUMMARY

1. Banks operate on a huge scale at the heart of the modern economy. Scale is often hard to grasp. To give an illustration, in 1998, three UK banks each made more profit than the UK's five major publicly traded supermarket companies added together. The top 10 banks together made 10 times the profit of all these supermarkets, and are, collectively, worth £200 billion. However, it is the banks' control of the money transmission systems - cash, cheques, cards, electronic payments - that makes their innovation and efficiency crucial to the UK economy as it competes in an e-commerce world. It is this feature of banks, more than anything else, that is the focus of the Review.

OVERVIEW

2. It was from this perspective that the Review defined the scope of its investigation against the terms of reference set by the Chancellor in November 1998:

- to examine the banking industry in the UK, excluding investment banking;
- to examine levels of innovation, competition and efficiency in various sub markets, including relationships with small and medium sized businesses;
- to look at how these compare with international standards; and
- to consider options for change.

3. Unusually for a review of competition, the report begins by examining the policy framework within which banking services are supplied. In its investigation of competition, the Review continually encountered issues which pointed back to the policy framework. Banks are treated differently from the rest of the economy in many respects. Regulatory barriers to entry are high, producers are represented on the board of the industry's regulator, their exposure to competition law is diluted, and in many areas banks are allowed to write their own rules.

4. Historically, the most likely explanation for this special treatment lay in the existence of an informal contract between successive governments and banks, designed to deliver public confidence in the banking system. In return for cooperating in the delivery of Government objectives, the banking industry escaped the rigours of effective competition. This contract cannot coexist with desirable levels of innovation, competition and efficiency in UK banking markets.

5. The essential first step towards increased competition in banking services is therefore to develop the new policy framework for the relationship between Government and the banking industry. In this new regime, the Government needs to set out clearly and transparently what it wants, determine a framework of explicit rules to achieve it, and

then let free and fair competition between suppliers deliver it, within the constraints of sound prudential regulation. Only then will consumers reap the benefits of vigorous competition for their custom.

6. Most of the report describes an investigation into the level of competition in the main UK banking markets. The Review was not a legal inquiry and did not have any formal powers to demand information from suppliers. In some areas, this created problems as suppliers were either unwilling or unable to provide the necessary information about, for example, the profitability of specific activities. However, the Review was able, in all markets, to gather enough information to come to robust conclusions.

7. In selecting areas for detailed scrutiny, the Review looked for those markets in which banks are major players and where there was a likelihood of competition problems. Application of these criteria led the Review to exclude many of the services supplied by the firms commonly described as banks. Among the exclusions were services to large corporates, advice and brokerage, insurance, equity based savings products and personal asset finance.

8. The markets which the Review did investigate in depth can be split into three groups:

- **money transmission.** This is the flow of money between firms, individuals and Government through the payment systems. The Review looked at all of the main methods of money transmission, including cash machines, credit and debit cards, cheques, direct debits and standing orders as well as high value payments;
- **services to personal customers.** The main services investigated were current accounts, savings products, personal loans, mortgages and credit cards;
- **services to small and medium sized businesses (SMEs).** The main services considered here were current accounts and external finance.

9. For each of these three groups of markets, the Review posed the following questions:

- is competition effective?
- will the future change things for the better?

10. The answer to the first question was ‘no’ for all three groups: competition problems were found in all markets investigated.

11. Money transmission services are supplied in the UK through a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers. This market structure results in the creation of artificial barriers to entry, high costs to retailers for accepting credit and debit cards, charges for cash withdrawals up to six times their cost, and a cumbersome and inflexible payment system that is only slowly adapting to the demands of e-commerce.

12. In the supply of services to personal consumers the Review found significant information problems. Many consumers are unaware of even basic details of financial services. Barriers to switching accounts are perceived to be high and many services are sold off the back of current accounts, the supply of which is dominated by a few large firms. If customers have a complaint, the systems for redress are inadequate.

13. Many of these information problems apply also to SMEs. However, the levels of market concentration in the supply of banking services to SMEs are much higher than in the corresponding markets to supply personal customers. Prior to the Royal Bank of Scotland/NatWest merger, the big four banks' share of the supply of banking services to SMEs was 83 per cent. SME banking markets are local and market shares at a local level are often higher still. The result of this market structure is high profits and high prices, in particular for money transmission services.

Market dynamics

14. The extent to which the problems identified by the Review will be resolved by the dynamics of the marketplace varies across the three groups. The prognosis is: hardly at all for money transmission and banking services to SMEs; quite a bit for personal customers.

15. The lack of competition identified in the money transmission market are caused by the underlying economic characteristics of payment systems. Network effects mean that there is a natural limit to the extent to which competition is possible between payment systems. As a result, inefficiencies can persist for years, and payment systems can be run in the interests of those who control them rather than the public interest. The Review's findings are echoed in the experience of many other countries. To deal with these fundamental problems requires sustained intervention.

16. The market for the supply of banking services to personal consumers is now showing some encouraging signs of new entry and increased competition. These developments will, themselves, help drive better information and customer service. However, some well targeted intervention by government would drive these changes forward more rapidly.

17. The markets for the supply of banking services to SMEs fall between these two extremes. Effective competition between suppliers is a feasible outcome. However, the concentrated market structures that have resulted from successive mergers, combined with high barriers to entry and expansion, mean that this will not take place by itself. To produce competition in this market may require a one off structural solution, after which behavioural remedies, better information and redress should be sufficient to protect SMEs' interests.

18. Not all problems can be resolved through increased competition, however. The Review also considered how Government might best tackle market failures in the supply of small scale high risk capital to SMEs, and banking services to low income consumers respectively. The Review's analysis in these areas shows how it is possible for Government to achieve its public policy objectives, without perpetuating the old contract with the banks.

19. The rest of this executive summary describes the detailed recommendations made by the Review.

THE NEW POLICY FRAMEWORK

20. The first set of recommendations establishes the ground rules for the new framework for Government policy in relation to banking markets; one that recognises the special nature of banks without unnecessarily distorting competition.

21. The main elements of this new policy framework are to:

- increase transparency in banking supervision;
- get the institutional incentives right;
- deliver effective competition scrutiny; and
- eliminate regulatory distortions.

Increase transparency in banking supervision

22. Transparency is a cornerstone of effective regulation. Putting into the public domain accurate and timely information about the actions of regulators, in this case the Financial Services Authority (FSA), and of regulated firms, reduces information imbalances, lets everybody know where they stand and can reduce the need for intrusive regulation of firms' behaviour. The Review recognises that greater transparency can cause difficulties, but considers that the benefits outweigh the costs. The Review recommends that:

the Government should encourage the FSA in its efforts to make the regulatory process more transparent in the UK. It should also work with the FSA internationally to promote the importance of information disclosure in prudential regulation, for example through the European Union, and the Basel Committee on Banking Supervision.

the Government should examine the costs and benefits of requiring authorised firms to publish disclosure statements of their risk exposures and risk strategies, across all activities, in advance of the implementation of the new Basel Capital Adequacy framework. The statements should also include details of regulatory requirements such as capital asset ratios.

the Government should examine the benefits of introducing a requirement making all lender of last resort operations subject to public disclosure, within a fixed time limit, say one year, after the event.

Get the institutional incentives right

23. A key factor in devising a policy framework that will stand the test of time is to put in place the right institutional incentives for all parties charged with delivering policy. The

three key institutions in banking regulation and supervision are the FSA, the Bank of England and the Treasury.

24. Changes are required to ensure that the FSA is sufficiently independent from government and industry pressures. The Review recognises that the new regulatory regimes needs time to bed down. The Financial Services and Markets Bill¹ (FSMB) is a complex piece of legislation and so it will remain once it becomes an Act - the Financial Services and Markets Act (FSMA) - after parliamentary approval and Royal Assent, expected in spring 2000. All of its consequences cannot be predicted in advance. The Review recommends that:

the Government should monitor the impact of the FSMA on competition in financial services markets, and conduct a formal review, two years after commencement of the legislation.

25. This review should pay particular attention to the principle that the FSA needs to be seen to be independent from the industry which it regulates, and from government. The Review recommends that:

in reviewing the operation of the FSMA, the Government should give consideration whether to:

- *continue to appoint to the FSA members who are, or recently have been, employed by any of the firms authorised by the FSA;*
- *give ministers a general power of direction over the FSA, to be used only in appropriate exceptional circumstances, with all directions subject to public disclosure;*
- *restrict the grounds for removal of members of the FSA to ‘incapacity or misbehaviour’;*
- *separate the roles of chairman and chief executive of the FSA.*

26. Regulation influences how competition takes place. It is vital that all regulators, including the FSA, are aware of the impact that their actions have on the markets which they regulate. The Review therefore recommends that:

the Government should direct the FSA to assess the following in its annual report:

- *the degree of effective competition within financial services markets;*
- *the effects of regulation on competition in, and particularly entry into, financial services markets;*
- *the direct and indirect costs associated with any distortion to competition which have been estimated in the course of cost benefit analyses;*
- *progress towards greater transparency, especially in banking supervision.*

¹ All references are to the Bill as introduced in the House of Lords on 10 February 2000, HL Bill 32.

27. The Treasury also needs to adjust its own objectives and ways of working to take into account the establishment of the FSA as a regulator independent of Government. The Review recommends that:

the Treasury should re-examine its relationship with the FSA, in particular, ensuring its objectives, operations and staffing reflect the fact that the FSA is a regulator independent of Government.

the Treasury should amend its fourth objective to make clear that its scrutiny of the economy applies to all sectors, including financial services and banking.

the Treasury should give its competition and regulation team specific responsibilities for examining the Treasury's own initiatives in financial services regulation, and for providing the Treasury's advice on competition in financial services to external bodies such as the OFT and to interested parties within government.

the Government should ensure that the Memorandum of Understanding between the Treasury, Bank of England and FSA reflects the new policy framework.

Deliver effective competition scrutiny

28. It is essential that banks and other financial services firms are exposed to the full rigours of competition law, and are not able to shelter behind special exemptions or regulatory protection. The Review made a number of recommendations for improvement in its interim report². These were that:

the financial services sector should not enjoy any unnecessary exclusion from general competition law.

the FSA's rules should be within the scope of scale or complex monopoly investigations by the OFT and the Competition Commission.

while the OFT should not legally be required to scrutinise every rule issued by the FSA, its role in overseeing the financial services sector should be strengthened.

the FSA's rule making decisions should be open to review and especially their impact on competition.

the Competition Commission, not ministers, should be the final arbiters of the public interest in scrutiny or review of procedures.

29. In response to the interim report, the Government said it was committed to 'ensuring the FSA gives full weight to competition concerns'. It subsequently brought forward a number of amendments to improve the competition regime in the Financial Services and Markets Bill (FSMB).

² Banking Review Competition and Regulation in Financial Services: Striking the Right Balance, July 1999. Included at Annex F

30. The Review considers further action is necessary, in particular to prevent anticompetitive mergers. The Review found the structure of several banking markets, most notably the supply of banking services to SMEs and the supply of current accounts to personal customers, to be highly concentrated. Further increases in concentration in these and, potentially, other markets, should be looked at extremely carefully. The Review recommends that:

the Government should, in its reform of merger law, ensure that the proposed new competition based test for assessing mergers takes full account of the desirability of:

- *maintaining and promoting effective competition;*
- *facilitating the entry of new competitors into existing markets;*
- *improving the production of goods and services and promoting technical or economic progress*

so as to ensure that consumers receive a fair share of the benefits.

until UK merger law is reformed, the Government should:

- refer all mergers between financial suppliers to the Competition Commission for investigation if the merging entities have material shares of the relevant market, or if each has material shares in related markets from which there is the real possibility that one might enter to compete with the other; and*
- not approve any merger where the Competition Commission has produced an adverse report unless the merger:*
 - *maintains and promotes effective competition;*
 - *does not reduce the potential for entry of new competitors into existing markets;*
 - *improves the production of goods and services and promotes technical or economic progress*

so as to ensure that consumers receive a fair share of the benefits.

31. Competition should also be encouraged at a European level, so that UK suppliers are able to compete and expand overseas and that regulations set at a European level take enough account of competition issues.

the Government should encourage the European Commission to:

- *deliver a framework for competition scrutiny of proposals brought forward by the European Commission's directorate responsible for financial services (DGXV); and*

- *expand and accelerate the work of the European Commission's competition directorate, DGIV, in investigating competition concerns in the European banking sector, including state aids.*

Eliminate regulatory distortions

32. The Review identified a number of specific areas in which regulation was having, or was likely to have, an adverse effect on competition. Most regulatory distortions are not deliberate. They tend to arise because regulations are not kept up to date or because too narrow a view is taken of their impact at the time of implementation. It is not just government imposed regulations which have the scope to distort competition. All too often, self regulatory initiatives have given banks special treatment in return for undertaking tasks which should really be the responsibility of government. The introduction of the new policy framework will help to ensure that banks are given special privileges only when strictly necessary and that regulations minimise distortions to competition. As a general principle the Review therefore recommends that:

the Government should:

- *apply competition scrutiny systematically to all its policies and regulations in the financial services sector to ensure that they are proportionate and minimise distortions to competition;*
- *ensure that banks are not accorded exclusive participation or preferential treatment in the development of government initiatives unless there are legitimate reasons for doing so, having special regard to e-commerce developments.*

33. This principle should be applied specifically in: the developing area of digital signatures, where there is a danger of banks being given special treatment; deposit protection, where the danger is of over regulation; and the VAT treatment of financial services, which risk distorting financial firms' decisions to contract out activities or undertake them in house. In these areas, the Review recommends that:

the Government should ensure that the self regulatory 't-scheme' proposed for approving digital signature suppliers does not distort competition. It should subject all suppliers to the same, objective approval criteria and approvals process and, in particular, not favour suppliers who happen to be regulated for other purposes.

the UK deposit protection scheme should adopt all the exclusions permitted by the Deposit Guarantee Directive.

the Government should review the definition of financial services for the purposes of VAT, to ensure that there is no discrimination between in house provision by financial suppliers and outsourcing.

34. Money laundering is another area in which the Review has identified potential distortions to competition from over regulation. This is an area in which the banks have effective discretion to decide how to apply EU legislation in the UK. Of particular concern

are the rules that apply when a customer opens a bank account without making face to face contact with the supplier. This risks holding back the development of distance banking, and of increasing barriers to entry. The Review recommends that:

the Government should ensure that its money laundering requirements are proportionate and minimise distortions to competition and, in particular:

- *reassess the requirement that customers opening an account by a non face to face method should provide four separate pieces of identification;*
- *investigate the scope for one financial supplier to verify the identity of an individual to another supplier;*
- *examine the role of new technological developments, such as digital signatures, in providing alternative means of identification;*
- *subject its new proposals to a rigorous cost benefit analysis, including both the direct and indirect costs on competition.*

the Government should ensure that the FSA uses its powers under the FMSA to assume full responsibility for both the rules and guidelines on money laundering.

35. These recommendations describe the new policy framework to apply to all banking markets. This will drive increased competition and better targeted government policy across the board. The recommendations that follow are aimed at correcting the specific competition problems found by the Review in the various economic markets studied.

MONEY TRANSMISSION

36. The Review uncovered profound competition problems and inefficiencies in the market for money transmission services. Some of these problems will be only too familiar to bank customers: slow clearing cycles for cheques and automated payments, and high charges for cash withdrawals. Others are less evident, but just as important: for example the three quarters of a billion pounds of interchange fees paid in the UK each year, and the way in which full participation in payment schemes is nearly always restricted to banks. Innovation is stifled and the system has proved slow to adapt to an e-commerce environment. Many of these problems can be traced back to the structure of the UK payment systems market which consists of a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers.

37. Changes in the external environment, such as European Monetary Union and increasing internet use, are likely to have a significant impact on the supply of some payment services. But they cannot be relied on to resolve the competition failures as they will not affect the underlying structural problems.

38. There is an overwhelming case for robust and decisive government intervention in these markets based on the following three actions:

- set up a payment systems commission - PayCom - a new regulator with strong powers to deliver competitive outcomes;
- avoid being the source of regulatory distortions; and
- act as an intelligent consumer of payment services.

PayCom

39. The existing framework of competition law is not sufficient to deal with network industries such as payment systems. The incentives and scope for abuse by firms, or groups of firms, with significant market power are simply too strong. To achieve effective competition in this type of industry requires the Government to set down a series of ex ante rules, in addition to the normal provisions against anticompetitive agreements and abuse of a dominant position. The most effective way of achieving this is to set up a licensing regime, similar to that in place for other utilities, and to establish a new body to supervise this regime. The Review recommends that:

the Government should bring forward legislation to establish a payments systems commission (PayCom), charged with supervision of a payments system licensing regime. It should be independent of the competition authorities, other regulatory commissions, and of the industry.

the licensing regime to regulate competition in payments markets should have the following features:

- *participation in payment systems should be a licensed activity. All participants in payment systems should be subject to a class licence, written by the Treasury;*
- *PayCom should be granted effective powers to monitor compliance with the class licence and to impose sanctions. The sanctions should be in line with those contained in the Utilities Bill, currently before Parliament;*
- *there should be a process of appeal.*

the Government should put in place licence conditions to secure the following outcomes:

- *price transparency;*
- *good governance;*
- *non discriminatory access;*
- *efficient wholesale pricing;*
- *fair trading.*

Avoid creating regulatory distortions

40. Government itself can be a source of competitive distortions in the payment system. The Review therefore recommends that:

the Government should ensure that it does not unnecessarily stifle competition by restricting access to UK payment systems, either through its direct regulatory activities or in negotiating international agreements with other Member States.

Act as an intelligent consumer of payment services

41. The Government can also drive efficiency by acting as an intelligent and proactive consumer of payment services. Increased competition in payment markets will make it easier for government to do this. The Review therefore recommends that:

the Government should develop a strategy for acting as an intelligent consumer of payment services across all of its functions. The Office of Government Commerce should be responsible for monitoring performance.

RETAIL MARKETS: PERSONAL AND SME

42. The Review carried out detailed investigations of competition in the supply of the banking services to personal customers and SMEs. The Review found that competition was not working effectively in any of the markets studied.

43. In the markets to supply banking services to personal customers, the Review found that:

- the supply of current accounts is highly concentrated and holds the key to competition between suppliers in many other product areas;
- consumers perceive significant barriers to switching current accounts;
- few consumers are aware of the terms and conditions of the products they hold, pointing to significant information problems;
- consumers have inadequate representation and redress.

44. However, there are some encouraging signs of increasing competition and new entry in some product groups, for example mortgages, personal loans and credit cards. As yet, however, entry has only had a limited impact on the prices charged by the established banks.

45. The markets to supply banking services to SMEs are much less competitive than those which face personal customers. The problems associated with switching, information, representation and redress are more significant there. Furthermore the markets to supply these services are extremely concentrated, and barriers to entry are high. In the absence of government intervention, the prospects for effective competition in these markets are remote.

46. The Review formulated its recommendations for retail markets in the light of the above competition assessment. The following principles apply with equal force to both personal customer and SME banking markets:

- avoid over regulation;
- ensure adequate redress and customer representation;
- empower consumers through information.

Avoid over regulation

47. The Review did not consider there to be a good case for detailed product regulation in the supply of banking services to either SMEs or personal customers. This type of regulation imposes higher costs for the industry which then feed through to higher prices for consumers. It stifles innovation and blunts incentives to compete. The Review recommends that:

the Government should announce an intention not to designate the supply of banking services as regulated activities under the provisions of the FSMB.

the Government should, in the near future, publish objective and proportionate criteria for determining whether particular banking services should, in exceptional circumstances, be designated as regulated activities. These criteria should be used to evaluate any future demands for regulation. In its review of the operation of the FSMA, the Government should reappraise its decision to designate the sale of mortgages as a regulated activity against these criteria.

Ensure adequate redress and consumer representation

48. The current arrangements for customer redress and for customer representation to bodies such as the FSA and the Financial Services Ombudsman need strengthening. There is a need for a strong, independent consumer voice at the heart of the regulatory system. The structure of the new Financial Services Ombudsman scheme needs reforming to reduce the role played by the banking industry, and to enable banks from outside the UK to join the scheme on a voluntary basis. The Review therefore recommends that:

in its review of the operation of the FSMA the Government should consider establishing an independent Financial Services Consumer Council covering all financial services, not just those which are supplied in the course of carrying on activities regulated by the FSA.

the Government should ensure that the rules of the new Financial Services Ombudsman Scheme specify that the Ombudsman will draw up consumer guidelines, after consultation with interested parties, including consumers, the OFT, the FSA and the industry. The Ombudsman should then use these guidelines to determine whether a banking supplier's actions are 'fair and reasonable'.

the Government should ensure that the new Financial Services Ombudsman Scheme allows voluntary membership to firms offering banking services to UK consumers, by whatever means, from outside the UK.

49. There needs to be greater recognition that small businesses often experience similar problems with their banks to personal customers and require a similar system of redress. To this end, the Review recommends that:

the Government should ensure that small business access to the Financial Services Ombudsman Scheme is not restricted by imposing a limit on the number of staff employed by the business.

the Government should ensure that the turnover limit for determining small business access to the Financial Services Ombudsman Scheme is at least £5 million.

the Government should ensure that the rules of the new Financial Services Ombudsman Scheme specify that the Ombudsman will draw up SME guidelines after consultation with interested parties, including small businesses, the OFT, the FSA and the industry. The Ombudsman should then use these guidelines to determine whether a banking supplier's actions are 'fair and reasonable'. This applies equally to personal consumers and small businesses.

Empower customers through better information

50. Knowledgeable consumers provide the best incentive to effective competition. With the right information, consumers can take responsibility for their own financial well being, shop around and exert the pressures on suppliers which drive a competitive and innovative market. There are a number of actions that government can take to improve information conditions in retail markets. The costs are small, and the potential gains from catalysing competition large.

51. There are a number of ways in which information provided to customers could be improved. For example, the Government has already introduced standard CAT products for some products such as Individual Savings Accounts. These apply to those products which meet Government standards for Cost, Access and Terms. Another approach is to produce tables of comparative performance. A third is to require specific disclosures to be made to customers at particular time. The key is focused information that helps customers choose between competing suppliers. Consumer education also has a vital role to play in producing active and informed consumers.

The FSA's scope to publish the most informative data on financial services is limited. In particular, it is not clear that it can require firms to provide information for publication. The Review recommends that:

in its review of the operation of the FSMA, the Government should consider giving robust legal powers to the FSA to acquire information from suppliers of retail financial services, including information relating to those services which are not supplied in the course of carrying on regulated activities, for the purpose of publication for the benefit of consumers.

52. There is nevertheless much the FSA can do to build on its existing information initiatives, using the idea of a benchmark. There is, however, an important difference between the Government's CAT standards and the Review's proposal: the Review does not

believe that the Government should set a price guide or limit for benchmarks. This can only serve to distort competition, rather than illuminate the choice between the offerings of different suppliers. In the supply of banking services to **personal customers and SMEs**, the Review recommends that:

to facilitate price comparison, the Government should introduce benchmarks for a wide range of retail services. Unlike the current CAT standards, these benchmarks should not specify price caps.

the FSA should publish comparative tables which, among other things:

- *rank all benchmark services by supplier, according to price;*
- *group non benchmark services into categories and rank these according to price, highlighting any material differences between services.*

For SMEs, these tables should additionally:

- *rank SME current account services (at standard tariff and a range of negotiated prices) according to price;*
- *show prices and terms for relevant geographic markets and not just on a UK basis.*

53. Better information relating to complaints against firms would also help consumers to make judgements about which supplier to choose. The Review recommends that:

the FSA should compile and publish comparative tables of, among other things, the number of complaints by personal customers or SMEs:

- *received by firms;*
- *received by the Ombudsman about individual firms;*
- *upheld by the Ombudsman against individual firms, including the total value of settlements made against each firm.*

To the extent this information cannot be obtained by voluntary means, it underlines the need for the FSA to have robust legal powers to require firms to disclose information which is of value to consumers.

54. In the supply of banking services to personal customers, the Review also recommends:

the consumer guidelines set by the Ombudsman should, where necessary, include disclosure requirements for all banking services. Given the particular information problems the Review has identified, the Review recommends that these include:

- *redemption penalties on mortgages and loans, which should be clearly expressed to the consumer in monetary terms at the time of purchasing the loan;*
- *information relating to credit card statements, which should state clearly that if the account is not fully cleared, interest will be charged on the total value of the statement, not just the outstanding balance; and that interest payments increase the longer payment is delayed (even before the monthly payment date). Statements should also make clear that interest will be charged on a daily basis, and show actual daily and equivalent yearly interest rates. Finally, the front of all credit card statements should state the amount of interest payable if the minimum payment is received on the last day for payment;*
- *standards of service for switching current account supplier.*

And, for SMEs:

- *agreed margins and the basis on which interest payments are calculated in all bank statements. This should make explicit the average cleared balance; and APRs should always be stated so that rates are comparable;*
- *standards of service for switching current account supplier.*

the Government should encourage the FSA in its promotion of financial awareness amongst the population. Such promotion should provide consumers with a means of making informed choices about allocating their finances between different types of financial services and different suppliers.

In order to discharge these recommendations, and in recognising that some groups of consumers need more help in making choices than others - specifically small businesses and those who are currently excluded from financial services - the Review recommends that:

the FSA should rebalance the resources it devotes to consumer awareness, to give more attention to the information problems experienced by SMEs, and people on low incomes, especially those currently excluded from banking services.

55. As well as providing better information to SMEs about banking services, competition could also be sharpened by making more information about SMEs available to potential suppliers. This would help to reduce entry barriers into banking markets by making it easier for new entrants to construct credit scoring models. The Comprehensive Business Register currently under consideration will provide a useful platform for this. The Review recommends that:

the Government should publish the Comprehensive Business Register as soon as possible and it should include: location of business, sector, date the business began trading, turnover and VAT record.

Take action in monopoly markets

56. The Review considers that the recommendations so far, combined with the encouraging market dynamics, will be sufficient to drive forward competition in personal customer markets. It is not possible to draw this conclusion about SME banking markets. Unlike in the personal sector, there are just a few firms dominating local markets throughout the UK with no real prospect of entry. The competition problems are so significant that a change to the market structure may be the only way of achieving an effectively competitive marketplace. The only mechanism for delivering such a change to the structure of an industry is action following a complex monopoly reference to the Competition Commission.

57. It is to be expected that a complex monopoly investigation would have a range of outcomes. At a minimum, an investigation would provide a framework for the consideration of merger proposals in the form of firm conclusions on the definition of the relevant economic markets and problematic degrees of concentration. An investigation could also recommend a range of behavioural remedies, for example: preventing firms extending the scope or the density of their activities in specified geographic markets; obliging a firm to offer money transmission services to competitor's customers on a non-discriminatory basis; or the disclosure of prices paid to particular groups of SMEs in the relevant geographic market.

58. An investigation would also consider structural remedies in the form of divestment. These could require that, in the problematic local markets, the one or two firms contributing most of the concentration problem divest a viable SME money transmission and lending business; or that all the SME business of a firm should be divested. The Review considers that behavioural remedies are essential in all SME markets and that the structural remedy of divestment may be required in some.

59. The Review recommends that:

the Secretary of State should exercise his powers under section 51(1)(b) of the Fair Trading Act 1973 to refer the matter of the existence, or possible existence, of a complex monopoly situation in relation to the supply of money transmission services and other related banking services (including the provision of debt and savings services) to small and medium sized business in the UK.

MARKET FAILURES

60. The Review identified two possible failures in retail markets that might not be addressed by more effective competition in banking markets: the provision of small scale equity to high potential SMEs and access to basic banking services by those on low incomes. The following recommendations outline how the Review considers Government should address these issues.

Tackle the underlying market failures in SME finance

61. The Review found two main weaknesses in the supply of finance to high potential SMEs in the UK:

- there is insufficient supply of small scale risk capital for high growth companies; and
- public equity markets for smaller companies are insufficiently vibrant.

62. By contrast, there is no evidence of a shortfall in the supply of debt finance to SMEs. Yet many of the initiatives set up by successive governments in this area, such as the Small Firms Loan Guarantee Scheme (SFLGS), are aimed at increasing the supply of debt, rather than equity. The Review considers that Government policy should be refocused in order to better target the areas of market failure: insufficient small scale risk capital and illiquid equity markets for small firms. To this end, the Review recommends that:

the Government should progressively switch financial support from the SFLGS towards a greatly enlarged venture capital fund (VCF) programme. This should be put on a permanent financial footing.

the Government should examine all of its current and proposed policy interventions that are inappropriately focused on debt, such as bank finance for knowledge based businesses, with a view to redirecting the resources to equity support for SMEs.

the Government should significantly enlarge the Regional Venture Capital Fund scheme and make it a permanent feature of support for SME financing. The scheme should have the following characteristics:

- *VCFs should operate on as commercial a basis as possible, and so offer strong incentives to attract growth firms;*
- *VCFs should have to satisfy strict quality and financial probity tests, focused on relevant venture capital and specific sector knowledge and experience;*
- *the scheme must be run by experienced venture capitalists, free to recruit and motivate a talented team, and operate to a framework legal contract negotiated with the DTI.*

the Government should consider privatising the stakes which it will build up in VCFs.

the Government should make further moves towards a low, simple, CGT regime.

the Government should ensure that there is in place a procompetitive listing regime, consistent with governing EC directives. This should provide a minimum level of statutory regulation and so enable exchanges to compete on the type and degree of market regulation they impose for commercial reasons.

Provision of basic banking services

63. The Review also considered the competition issues associated with the supply of banking services to customers on low incomes, often on benefit. In particular, the Review investigated whether the increased competition in banking markets that would follow the implementation of the Review's other recommendations, would be sufficient to ensure an adequate supply of basic banking services to low income customers.

64. The lack of information on the provision of basic banking services is a particular problem. To remedy this, and to help speed the delivery of this service, the Review recommends that:

the Government should give top priority to developing a benchmark for basic banking services.

65. There should be no need to intervene in the provision of basic banking services, but any intervention should seek to bring competition gains, and not distort competition by engineering permanent cross subsidies. Nor would it be beneficial to consumers if the Government sought to negotiate with the banks to deliver a 'free' service, for the reasons outlined in Chapter 2. The Review therefore recommends that:

if the Government considers it necessary to intervene in the provision of basic banking services, it should define a universal service and tender for the lowest subsidy required to deliver the defined service.

Government as purchaser and provider of services

66. The Review recommends that, as part of its strategy for acting as an intelligent consumer of payment services:

the Government should ensure that:

- *the delivery of benefits, where not made through automated credit transfer, uses existing electronic networks - for example ATM and cashback;*
- *Government agencies which make payments to individuals are allowed to make the investment necessary to allow all recipients the option of receiving benefits through ATMs or cashback facilities.*