1. Executive Summary

Virgin Money believes that the recommendations of the Independent Commission on Banking, if accepted and implemented, should lead to a significant improvement in competition in retail banking.

In our view, the recommendations would reduce barriers to entry and expansion, and some regulatory and financial disadvantages currently faced by new entrants relative to large established banks. They would also encourage greater use of the Internet, and this should reduce the need for new entrants to establish extensive branch networks.

These recommendations follow comprehensive reviews over recent years by the OFT of personal current accounts in the UK and of barriers to entry, expansion and exit in retail banking, and by the TSC of competition and choice in retail banking. Given the thorough analysis of issues relating to competition in retail banking that have already taken place, there is no reason to delay implementation of the ICB's recommendations on competition. We do believe that it seems sensible to delay the implementation of subsidiarisation for some limited period, to get the details right, and to delay the full implementation of higher capital requirements until 2019, to coincide with Basel III. The ICB has recognised that its proposals relating to competition should be introduced earlier, and has mentioned dates in 2013. However, some of the proposals to improve competition could be introduced very quickly, and it is desirable that implementation should not be delayed by stalling tactics by large banks, further reviews or regulatory process.

2. Background

A number of reviews have commented on the high level of concentration in UK retail banking, and have pointed to the need for greater competition, particularly in personal current accounts (PCAs) and in SME banking. The OFT and the TSC have noted the centrality of PCAs, to establish long-term customer relationships and cross-sell other products. However, the OFT has recognised that there are significant barriers to entering the PCA product market, including low switching, the need to establish branches (despite the growth in direct channels) and the need to have a strong brand. The OFT observed that barriers to entering PCAs restrict the ability of new entrants and smaller banks to expand in other retail banking products, such as saving and credit products.

In our submission to the ICB, we suggested that banks should be required to include estimates of interest foregone in annual statements to PCA customers, and that they should be required to introduce current account number portability, to address the perception (and, too often, the reality) that PCA switching will be problematic. We suggested that the ICB should support the introduction of simple financial products (as proposed in a Treasury consultation paper), including product categories for PCAs and basic bank accounts, and that an online price comparison site should be established for PCAs along the lines proposed for credit cards by the Conservative Party ahead of the general election. We recommended that the ICB should express clear views that competition being made a primary objective of the FCA would be beneficial, and about how an appropriate balance could be achieved between competition and financial stability. In our submission to the ICB, we welcomed the suggestion that banks might share capabilities to qualify for advanced treatment under the Basel regulations (which would generally lead to lower capital requirements than the standard approach), and suggested
how this might be done, starting with standard mortgages. In previous submissions to the OFT, TSC and ICB, we had pointed out that two other financial issues have also restricted the ability of new entrants to compete and expand. Firstly, although Individual Capital Guidance (ICG) given by the FSA to individual banks has not been made public, our impression is that new entrants, which have low risk business models but have only a limited track record, have been required to maintain higher capital ratios than established universal banks, despite their substantial trading activities. Secondly, because of their "too big to fail" status, large banks have enjoyed costs of debt finance and wholesale funding lower than they would have been without their guarantee, and probably lower than new entrants would have to pay, if they were to raise debt capital or wholesale funding. Our recommendation was that the levels of capital held by incumbents should be increased to meet the demands placed on new entrants, leveling the playing field.

3. Comments on key recommendations

We set out below our initial thoughts on key recommendations in the Final Report, and on their likely implications for Virgin Money. We consider first the ICB’s recommendations to improve competition, and then their recommendations to improve financial stability.

Recommendations to improve competition

Transparency

One reason for the low level of switching in the "gateway" product of PCAs is that, because of the widespread availability of "free" banking, there is not an obvious economic incentive for consumers to consider switching. However, "free" banking is not free, and the requirement to include estimates of interest foregone, along with a list of other charges, in annual statements to customers will make customers aware of their costs, and will "nudge" customers to consider switching. This should make it easier for new providers to enter the PCA market, and for banks to charge explicitly, for example through monthly or annual fees, if they wish to do so. (See paragraphs 8.71 to 8.73 of the ICB Final Report.)

Switching

A second reason for low switching in PCAs is the perception by many customers that switching may be problematic, as indeed it is for many customers who do switch. We had suggested that this perception should be overcome by full account number portability, but we recognise that the temporary payment redirection system proposed by the ICB has been thought through well, with input from the Payments Council, and should address customer concerns about possible problems and resulting costs. We note that the ICB has left open the possibility of moving to full account number portability if the proposed redirection service is not effective in increasing the willingness of customers to switch. We believe this openness to consider full account portability, if it is proved to be required, is important. (See paragraphs 8.57 to 8.61.)
Online services

A third reason for low switching in PCAs is that comparing PCAs offered by different providers is not easy. These problems would be addressed by the ICB’s proposals that banks should have to make information available to comparison sites so that consumers can identify the most suitable products for them, that the FCA and/or Money Advice Service could create a price comparison tool, and that consideration be given to the establishment of “vanilla” current account products, with standardised features, which could easily be understood and compared by consumers. This last proposal is consistent with the concept of simple financial products suggested by HM Treasury, and it could include a product category replacing basic bank accounts. By making it easier to understand and compare PCAs online, these proposals should reduce the need for new entrants to establish extensive branch networks - provided that consumers can if they wish buy as well as research PCAs (particularly “vanilla” accounts with standardised features), online, and provide proof of identity, without having to go to a branch. (See paragraph 8.74.)

Regulation

To promote greater competition across retail banking, the ICB has reiterated its view that the FCA should have a primary responsibility for competition, and have suggested that this should be more clearly stated in a revised strategic objective for the FCA. This would address the TSC’s concerns that responsibility for competition is not clear, and our concerns that competition might be subordinated to financial stability - as it was, understandably, in the financial crisis - most notably in allowing the acquisition of HBOS by Lloyds TSB to proceed, despite the reservations expressed by the OFT. It would also give the FCA the necessary credibility and powers to ensure implementation of the ICB proposals, if they are approved. (See paragraphs 8.84 to 8.87.)

Market investigation reference

While sharing the ICB’s view that there are features of the PCA market which appear to prevent, distort or restrict competition, and while agreeing with its observations on the further concentration and reduction in choice that has occurred, we are optimistic that the proposals to increase transparency and make switching easier, to ensure that the LBG divestment becomes an effective challenger, and to ensure that the FCA had a clear responsibility for competition, would together, if approved, improve competition in PCAs and more generally in retail banking. However, we support the ICB’s proposal that a market investigation reference should be considered in 2015, if by then the LBG divestment has not become an effective challenger, if ease of switching has not been transformed or if a strongly pro-competitive FCA has not been established. (See paragraphs 8.88 to 8.94.)

Recommendations to improve financial stability

Subsidiarisation

Subsidiarisation should support financial stability by reducing the risk that problems in an investment bank might bring down the associated retail bank. The proposals for the governance and transparency of ring-fenced retails should lead to greater focus on the retail banking subsidiaries of large universal banks (which have seemed less glamourous
than their investment banks), and should lead to greater efforts by the big banks to compete in retail banking, particularly if there is a growing threat from new entrants. In addition, subsidiarisation, like Glass-Steagall, should reduce conflicts of interest in large universal banks, and help restore trust in retail banks. (See paragraph 9.2)

**Capital and costs**

The proposal to establish a shared database of historic credit information may allow new entrants to qualify for advanced treatment under the Basel regulations earlier than would currently be possible. The proposal that large banks should have higher levels of equity and primary loss-absorbing capital than small banks should create a more level playing field between the big banks and new entrants in the ICG given to banks by the FSA. Removal of guarantees should reduce the advantage in funding costs which large banks have enjoyed relative to new entrants. (See paragraphs 8.38 to 8.41 and 4.132 to 4.137)

Virgin Money
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