



Treasury Committee

Oral evidence: [Retail Banking Market Review](#), HC 231

Tuesday 7 June 2016

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Members present: Andrew Tyrie (Chair); George Kerevan, Mr Jacob Rees-Mogg, Rachel Reeves, Wes Streeting

Questions 1 -73

Examination of Witnesses

Witnesses: **Professor Diane Coyle**, Founder, Enlightenment Economics, **Paul Lynam**, Chief Executive Officer, Secure Trust Bank, and **Caroline Barr**, Member, Financial Services Consumer Panel, gave evidence.

Q1 Chair: Good morning, and thank you very much for coming to give evidence to us. As you know, this Committee has been extremely concerned about the state of competition, or lack of competition, in the retail and the SME sector for a long time, and produced a pretty robust report about it five years ago, which—together with the work of the Parliamentary Commission on Banking Standards—was instrumental in securing the review by the CMA that we are now examining. The key question in front of us today is whether the CMA has cracked this, or not, and I would like to begin by asking Professor Coyle what has really changed since Cruickshank reported 20 years ago, telling us that retail banking competition was inadequate. Why has so little been achieved, if that is your view?

Professor Coyle: Thank you very much for the opportunity to come and discuss this with you, because I could actually weep with disappointment that this once-in-a-generation opportunity to fix a really important and dysfunctional market looks like it is being squandered. The situation has actually got worse since Cruickshank, not better.

The incumbents have multiple cost advantages, compared to the challenger banks. They have the central issue identified in the Vickers report and the parliamentary report about the “too big to fail” subsidy, which is as large as it ever was, or perhaps larger now. The capital requirements regime favours the incumbents over the smaller banks. There is the zero interest rate on the back book of inert deposits that has always been there, and is perhaps less severe at the moment than when interest rates go up, but that has not gone away. There is the cost of accessing the payment system, which is higher for challengers. There are multiple cost disadvantages for challengers as against incumbents. These are getting worse and not better, and I am really disappointed that the report focuses on some

demand-side changes that might make a marginal difference, but do not address all those central, structural problems in this market. The short answer to your question, “How have things changed?”, is that they have got worse.

Q2 Chair: Caroline Barr, from your perspective, do you agree with that, and what, if anything, do you want to add?

Caroline Barr: Yes. I come from the Consumer Panel, and I see these things from the consumer perspective. I would agree with Professor Coyle’s analysis there. From the consumer’s perspective, we see greater market concentration. There are challengers coming, but on the high street you still see the same brand names, or fewer. There has been no improvement in complaints handling. The PPI scandal and the failure to deal with that properly by the banks has left consumers disillusioned, and lacking in trust in the banking industry still.

Q3 Chair: Sorry to interrupt, but do you think they are right to be mistrustful, or is their mistrust misplaced?

Caroline Barr: No, they are right to be mistrustful. If you look at the CMA report in detail, the CMA is showing very little trust in the banking industry as well. Most of the measures or remedies that have been put in place, which you would normally expect the industry to lead on and implement, they have not trusted the banking industry to implement without at least some oversight from regulators or government.

Chair: I am sorry to have interrupted you. You were in the middle of a number of other points.

Caroline Barr: I was. Consumers continue to tolerate unfair practices and not change their bank accounts. We did our own consumer research last year, and we know that SMEs are particularly sticky when it comes to staying with their bank account. They say themselves that the banking industry is possibly unique in their ability to treat their customers badly, to be shoddy and inadequate in their service, and they know that their SME customers just will not move. The same can be said about personal customers, as well.

Now, competition should be about contestability. Is there a real risk that you are going to lose your business to a competitor? Contestability has not improved since Cruickshank, and, even after all of these inquiries, we still do not know how much profit banks are making out of their PCA and BCA customers. They have avoided coughing up that information, and no inquiry into competition in an industry can be complete if you do not know how much money they are making.

Q4 Chair: Never mind “complete”; it is not possible to make a start. Would you agree, or not, with the conclusion of the earlier Treasury Committee report from 2011 that at the heart of the problem for the retail market is the rip-off called free in-credit banking, which is nothing of the sort?

Caroline Barr: You mean the opaque transfer pricing product? Yes. The witnesses and myself were talking earlier about whether the free in-credit model is a cause or a symptom of the problem. It is a symptom of a problem here, but it does not help consumers to

exercise choice if they do not know how much they are paying, or what they are paying for. It also does not help if the terms and conditions between banks vary in their expression. We worked for months with the BBA Consumer Panel to try to establish harmonised terms and conditions, and they took it to the industry, and the industry rejected it because it simply was not in their interest to have harmonised terms and conditions.

Q5 Chair: We might explore some of these issues in more detail in a moment, but, first of all, I would like to take a look at the CMA's work, at least in outline. Professor Coyle described it as a big missed opportunity, or something rather stronger than that, as I recall—a once in a generation opportunity, missed. Mr Lynam, could you say something about the CMA's work on this and whether you think they have gone about it in the right way? If they have, which conclusions have they got right, in a nutshell, and where—if you think there are shortcomings—have they gone wrong?

Paul Lynam: I would like to echo Professor Coyle's gratitude for inviting me to give testimony. I would also agree with Diane's view that this is a huge missed opportunity. It is a disservice to the taxpayer, who—according to the Office for Budget Responsibility and, indeed, the outgoing Permanent Secretary to the Treasury—stands to lose tens of billions of pounds on the cost of bailing out the Royal Bank of Scotland and Lloyds. Yet they have done absolutely nothing whatsoever to address the huge concentration of risk in the banking sector, represented by the fact that the five biggest banks and Nationwide control 85% of the BCA market, 77% of the PCA market, and almost 80% of all of the lending markets.

When I look at what we, as the challenger banks, have tried to do to inform the CMA, we invited ourselves to see them for a roundtable in July last year, and we noted that previous competition investigations had been abject failures, on the basis that the concentration of market share had become more acute, not more diverse. We pointed out that George Osborne himself had referred to the concentration as verging on an oligopoly and, in our view, that the reason for the failure of the previous investigations has been a myopic view on current accounts and dealing with symptoms, as opposed to addressing the broader barriers to broad-scale competition across the totality of the banking markets.

We stressed to the CMA that the real barriers to growth of small banks, challenger banks and building societies were the disproportionate capital requirements; the huge funding cost disadvantages that big banks have over small banks; the inadequate access to the payments infrastructure; and our largely one-size-fits-all regulatory regime, whereby the law of large numbers benefit the big banks, because, for the small banks, the cost of regulation is a higher percentage of their total revenue.

We discussed all of that in quite deep detail, and then, on the back of the provisional findings in October, we cried foul, went back to meet Professor Smith and his panel and basically said that they had failed to address the root causes of the problem. The Committee and the Chair have given strong support to a requirement for more competition in banking, yet—notwithstanding representation by the challenger banks and people in this room—we got to the situation last month where the provisional remedies were once again outlined, and they failed to have any concrete recommendations in the context of addressing the capital disadvantages, the funding cost disadvantages and the increased tax

burden on the smaller banks represented by the surcharge. There was nothing in the context of giving more proportionate access to the payments infrastructure.

We wrote to Professor Smith as a cohort of challenger banks, and he wrote back to us on 26 May. He says, “There is much on which we agree: the capital requirement differentials in low loan-to-value mortgages are greater than can be justified on prudential grounds; mortgages are the most profitable lending products for banks; and new entrants and smaller banks who do not benefit from lower risk weights in residential mortgages under the internal rating-based approach are at a competitive disadvantage. As our provisional findings set out, incumbent banks also have funding advantages over new banks.” Notwithstanding the fact that he is recognising all of these issues, the CMA has proposed no remedies to address these, which is why I believe it is a missed opportunity and a disservice to the taxpayer.

If I roll the clock back to the early noughties, I was working in a NatWest high street branch at the time as a young banker, and, in that decade, there were nearly 30 banks that failed, including BCCI and Barings. There was not a banking crisis in the 1990s, and the taxpayer did not lose any money. Creditors did; wholesale lenders did; bondholders did, but taxpayers did not, and the reason for this was that there was a level playing field in the 1990s. All banks, regardless of size, would have risk-weighted a 50% loan-to-value mortgage at 50%. The situation that pertains today is that a large bank would risk-weight that same mortgage at 3%; a small bank would do so at 35%. That is a 960% differential, and yet the CMA has proposed no remedies in that respect.

Q6 Chair: What you have just said in evidence is that they agree with you about the scale of the problem, but they have done nothing about it. An innocent observer, a man from Mars, listening to that—particularly if he was then handed this report to read—might put those two thoughts together, the reading of that and what you have just said, and conclude that the CMA had already allowed itself to find its way into the pockets of the banks, or that it had been hoodwinked by the banks in some way.

Paul Lynam: The largest banks, Chairman; not all banks.

Chair: Is that your view?

Paul Lynam: My view is that they have been drowned in data provided to them by the big banks, who have the most to lose from any competition investigation.

Q7 Chair: So they have been overwhelmed by evidence.

Paul Lynam: And that evidence has probably been targeted at them as a cohort of pre-eminent academics, as opposed to practitioners who understand the games that the banks play. The reality is that the focus here, in 409 pages, is all about how to improve switching. The amount of switching, according to banks, done in 2014 was 1.56 million. It was 11% lower in 2015. Increasing the level of current account switching is not going to address the concentration of banking market shares in the UK. Could I be so bold as to pose a question of the Committee? I am going to read out some names; I would be interested to know whether you can tell me what they all have in common.

Chair: We will not be doing the answering of the questions. We are not up to that sort of thing, you know. We are just about capable of asking them, but you are most welcome to answer them yourself.

Paul Lynam: I will answer them. They are Abbey National; Alliance & Leicester; Bank of Scotland; Birmingham Midshires; Bradford & Bingley; Cheltenham & Gloucester; Bristol & West; Britannia; Egg; Halifax; ING Direct; NatWest; and Woolwich. On 1 January 2000, these were stand-alone competitors in the UK. They are all now part of the “too big to fail” cohort. It has taken a couple of decades to get to this concentration of risk. It will take a couple of decades to unwind it, but that can only be unwound if there is a genuinely level playing field in respect of capital, funding and regulation. If you have that, a whole bunch of these tactical actions will be unnecessary, because normal market forces will apply.

Q8 Chair: It has been a very long reply, but a very interesting reply. If I may say so, you have not quite answered my initial question, which is this: if you all think the CMA has dropped the catch or done so badly, why it is that this vested interest—after all, the fact that banks are a powerful vested interest is scarcely news—has been so successful? Is it some weakness in the CMA, a new institution, or would the same have happened to the Competition Commission, having been passed this from the OFT under the old system? Does it have something to do with the deepening of the panel system? Perhaps, briefly—although we must move on—you could give some sense of why this has all gone wrong when there is such a head of steam behind doing something more rigorous or more far-reaching. Why have we not had more action?

Paul Lynam: I am sure my two colleagues would have a view, but my own view is this: if you compare the CMA to the Independent Commission on Banking, for example, the latter did include people like Martin Taylor, who were ex-practitioner bankers, who understood how the market operated. Therefore, the broader experience within that particular committee led to a more meaningful intervention than the CMA this time.

Q9 Chair: It has to do with the individuals themselves, rather than the structure. You are saying that they are academics, or whatever, and do not have that experience.

Paul Lynam: I am not aware that any members of Professor Smith’s team have spent a single day working in front-line retail, SME or corporate banking.

Q10 Chair: I am going to come to you briefly. You all want to pile in, I can tell, and I am going to pass the question on in a moment, although I am finding the evidence very interesting, speaking personally. Professor?

Professor Coyle: I will be very brief. It is always harder in a market inquiry where some of the aspects of the market depend on other players: here, it is the PRA, the payments system and the Treasury, because of the tax structure. That is all true, and the remedies focus on the bits that the CMA itself can handle, but I do not think that that is a reason for not focusing the analysis on the real issues, which they failed to do. I also wonder whether there is an overstretch issue here, because they have had the energy inquiry going on at the

same time, and the banking industry is large, complicated and has drowned them with data and lots of advice. I wonder whether they have been able to cope with all of that.

Q11 Chair: There must be more than a handful of people in the UK capable of doing an inquiry into a major industry, surely. After all, the panel system is designed to address exactly the problem that you have described.

Professor Coyle: You would have thought so, but we are now looking at a situation where we really need them to extend the inquiry. They have been trying to shorten these market inquiries, but they now ought to think about extending it so that they can revisit the analysis and address the fundamental issues. I hope that that is the direction that you will point them in, as well.

Chair: I do not know where we will go. It is extremely important that we find out what the CMA has to say, and we are going to do that in due course. It may have robust responses to a large number of the points that you are making.

Q12 Wes Streeting: Good morning. Thank you for coming in. I am going to start off with a series of questions about the competition aspects and how we drive more consumer competition. Your frustration with the lack of ambition in this review, and its failure to—as you put it, Professor Coyne—really nail the analysis of what is going wrong, if nothing else, is shown up when you look at the CMA’s retail banking market investigation figures about the degree of switching, or the length people have been with their current account provider. A majority of 57% have been with their bank for over 10 years, and 37% have been with their bank for over 20 years. In the past three years, only 8% of customers have switched. When you compare that to energy—which is another industry where we as parliamentarians and the public are rightly concerned about the lack of switching—31% have switched energy providers, so that shows the scale of the challenge we have.

I have a whole series of other questions, but my first is this: as you have been so strident in your initial response to the Chair, if you were writing the report, what kind of proposals would you have adopted that would have met the scale of the challenge? Who wants to go first?

Caroline Barr: Shall I go first? I am going to give the consumer perspective, as I said, and my fellow witnesses will give a different perspective. A lot of the problems that arise are there because consumers do not know what they are paying for, how much they are paying, and cannot predict how they are going to use their accounts. So often, the answer to the question, “How much will this account cost me?” will be, “It depends. I do not know if I am going to go overseas. I do not know if I am going to have payments in. I do not know if I am going to need to make a CHAPS payment.” There is an issue there about price transparency, as we mentioned earlier, with the free in-credit model.

There is also the problem that the FCA has woken up to, which is the treatment of long-standing customers and how the principle of fairness, which is overarching in all of the FCA’s regulation, does not reach consumers in this market. The more you look at the banking industry, the more often you come to the issue of fairness not reaching the consumer who has been in that account, that mortgage product, that savings account or that credit card for more than the first year or two. The principle of fairness frankly does

not work, and we feel very strongly as a panel that there should be a duty of care on financial services providers to their customers. It exists in the law; it exists in medicine; it exists in accountancy; and it exists in every other profession where people hold themselves out to be professionals and where there is an information asymmetry, which is why they want to be seen as professional. There is a duty of care to your customer.

In this industry, it does not exist, and that is why they can justify to themselves charging extortionate amounts of money for unauthorised overdrafts that are now far more expensive than payday loans. From the consumer's perspective, there needs to be something stronger that makes the banks behave better. When we spoke to the CMA, they said, "It sounds as though what you really want is not for consumers to have to switch, but for their banks to treat them well." Yes, because we have a market where consumers do not switch, and they do not switch for really rational reasons. Competition should be working with the grain of how consumers behave, not trying to get tens of millions of people to change their behaviour.

Professor Coyle: I would strongly echo that. You would be mad to switch your account. Everybody has various accounts tied together. It might go fine, but it might go wrong; if it goes wrong, that is terrible, and there is no apparent difference between the banks that you are switching between. I can think of some things that might be done. I could think, for example, of banning unauthorised overdrafts, because, as Caroline says, that is no different from—indeed, it is worse than—going to a payday lender. I could think about insisting that every monthly statement carries a charge: either a charge that is transparent, or the difference between the zero interest that you are paid and some kind of blended interest rate that the Bank of England would publish, so every statement has that trigger point, rather than the very occasional trigger point that the report talks about. I could even say that, if you have very long-standing customers, you have to increase the rate of interest that you pay to them—so, if you have had an account sitting there for five or 10 years, you have to pay them a higher rate of interest. What kind of market treats the most loyal customers the worst? That is what happens in this market.

Q13 Wes Streeting: Mr Lynam, do you have anything to add?

Paul Lynam: Yes, Mr Streeting. The treatment of customers in any industry should be at the forefront of management's thinking, and it should not require people to tell us what to do. We should do it because it is the right thing. One way of ensuring that that is at the forefront is if customers have huge numbers of different opportunities to take their business elsewhere, because there is a genuinely effective competitive environment, and it is probably insightful to look at a completely different industry. If I contrast what has happened in banking in the last 10 years with what has happened in supermarkets, Aldi and Lidl have come and really shaken up the supermarket industry. Aldi and Lidl do not have to set aside 1,000% more capital to build a supermarket than Asda or Tesco; nor do they pay significantly more for their costs of funds, or their raw materials. They have come; they have given huge benefits to consumers; arguably, they have helped the economy to recover by driving down the cost of food and inflation. Yet, in banking, we have a situation where at the beginning of this year, the FCA investigation into the cash savings market highlighted that there is £160 billion of savings held with the largest banks, getting paid base rates or less, and in some cases nothing.

That dysfunctionality means that you have situations where, from last night's *Evening Standard*, a two-year fixed-rate mortgage from HSBC is available up to 65% loan to value at 1.16% per annum for two years. The challenger banks, this morning, are paying 2.2% to savers, so it is costing the challenger banks 89% more to fund themselves than the larger banks can lend money out at, and presumably make a profit.

This goes back to what I said in my opening response to the Chairman: if you have a genuinely level playing field, over time, savers will get paid more, and borrowers will also benefit. However, it is going to take time for that to progress, and it will only happen if the activities already recognised by this Committee, the Bank of England, the PRA, and latterly by the EBA take place. We, as a totality, need to do more to help foster competition, because it will help economic growth. That is important. I would seek a level playing field in respect of capital and funding, and a more proportionate regime for tax. The challenger banks have never asked for any favours; all we have asked for is equity. At the moment, we feel that the tax surcharge, as an example, represents us subsidising the reduction in the bank levy. If there is a level playing field in respect of the ability to make a profit, then there should be a level playing field in the way in which profits are taxed. That is not the case presently.

Q14 Wes Streeting: Thank you. Let us turn to some of the suggestions that the CMA themselves have made in their report. One of the aspects that they have looked at is promotional campaigns around switching services. Why do you think past campaigns have failed to generate more switching? Will this work, in short? In terms of use of nudges, we have seen some success in sending text messages to consumers when, for example, they go into an unauthorised overdraft or reach a certain level that they have agreed with their lender. Do you think that we can expect similar levels of success from the CMA's proposals to send prompts to encourage consumers to change their accounts?

Professor Coyle: I do not think so. It is rational not to switch, and the nudges work in contexts where consumers are "irrational" and you can prompt them to act in their better interest. Even though the likelihood of switching going wrong might be extremely small, if it does go wrong, it is a huge disruption, so, rationally, you might not want to take that risk, particularly if there is no obvious advantage in the product that you are switching to, because the large banks are so similar to each other.

Q15 Wes Streeting: Is that the uniform view?

Caroline Barr: The prompts for overdrafts that have been tested by the FCA, if you have mobile banking, look really promising, but, of course, it is only if you have money available to transfer that you can stop yourself from going into that situation. I do agree regarding switching accounts: people do not want to be changing their bank every five minutes. They think that their loyalty to their bank will be rewarded: so, if at some future date, things are going wrong and they need a personal loan, or need to renegotiate their mortgage, they think that the fact that they have a long-standing relationship with their bank will stand in their favour. Now, the truth is that it may not, but they do believe that staying with their bank will, in the long term, give them some reward. I do not think that

prompts will make any difference at all to changing accounts, but they will help those people who can do something about going into an unauthorised overdraft.

Q16 Wes Streeting: Some of the things that prevent consumers from switching are the really simple aspects, like the hassle of telling everyone your new current account number, for example. The CMA has estimated that the costs of implementing account number portability range from £1 billion to £10 billion, which seems like quite a range. Do the CMA's cost estimates sound reasonable?

Professor Coyle: It is very hard to figure out why there is such a large range, and I wonder if part of the problem is that the large banks have such baroque, crumbling IT systems. It may be that the opportunity to go to number portability will only come about when they make the investment that they need to make in modernising all their IT systems anyway. That is probably quite urgent, given the number of occasions we have seen on which they break down and people are blocked from access to their accounts for a number of days, but I would guess that that is behind the wide range that you are referring to.

Q17 Wes Streeting: Am I on the right track? Do you think that account number portability would make a difference to consumers, or are we barking up the wrong tree?

Paul Lynam: It depends on the product that you are trying to provide them with. Clearly, account number portability is current account-related, but it does not address all of the other services that a customer would use by way of borrowing or savings. The reality is—and you can witness it through the Williams & Glyn project—that the costs involved in putting new infrastructure into the larger banks are unknown. I suspect that that is a factor behind such a wide variation in the range.

The broader point is that account number portability and switching based on service failures are all well and good, but where will these people switch to? Most of the switching is between the larger, dominant players and, to be fair, the current account switching service does work quite well. It has been a positive step forward, but those who benefit from net switching gains are typically those banks who pay the largest financial incentive for people to open accounts, and these will be the biggest banks, because they have the deepest marketing budgets.

It goes around to this whole issue of the powers that the oligopoly have, relative to the modest powers that smaller banks have. Smaller banks, by dint of their size, almost have to behave in a different way than the larger banks. My savings customers at Secure Trust Bank get paid exactly the same rate of interest today whether they have been with me for one day or for five years. We do not differentiate between the prices on the back book and the prices on the front book, a) because it is not the right thing to do, and b) because, if we did, the danger is that our customers would move their money somewhere else. That does not appear to be the case with the greater levels of inertia that you see in the bigger banks, so account number portability might help to overcome that, but it is only one part of the broader market.

Q18 Wes Streeting: In your answers, a couple of you have touched on the added barrier of having a range of financial products attached to your bank, whether that

is an agreed overdraft limit or a personal loan as well as a current account. Many people may not be thinking about switching because they think, “I am so invested in this bank. I am indebted to my bank. I have this relationship.” Do you think that is a significant problem in dis-incentivising consumers to switch accounts, and, if so, what do you think the CMA should be proposing we do about it?

Professor Coyle: They should not be putting all the weight on consumer switching. You just need enough consumers to switch, and enough threat of new entrants taking away business, for the market to work properly. That is the fundamental problem. At the margin, it may be helpful to improve switching, but it is not fundamentally going to change the market.

Caroline Barr: Going back to switching, though, we mentioned that short-term incentives can make people switch their bank account, but that does not mean they are switching for the right reasons. It does not mean they are switching to a higher-quality account. This focus on the numbers of people switching ignores the fact that the quality of that switching decision could be poor. They could be going to a less good service or account for them. They could be going to a bank where customer service is less good than they are receiving at the moment. The CMA needs to focus more on the quality of that switching decision than it does on the numbers.

Q19 Wes Streeting: One of the reasons why I am asking so many questions about switching is because the CMA seems to have placed so much emphasis on switching, and, in effect, so much responsibility on the consumer for improving competition. Your questions seem to be implying that the CMA has its priorities wrong, and that there is too much focus on the consumer and not enough focus on the industry and competition. Have I drawn the right conclusion?

Caroline Barr: Absolutely. You totally have, and the little phrase that is coming out of industry at the moment—it is being used with us as a panel, it is being used at the FCA, and I imagine that it is being used at the CMA as well—is “consumer responsibility”, which is the reverse of duty of care. This is saying that consumers need to take more responsibility for the fact that the market is not working well, or that they have bought the wrong product or have stayed in a product beyond its teaser rate. Consumers are confused by the amount of data they receive. The CMA is expecting consumers to sit down on their computer when they come home from work in the evening, and go to the price comparison website for their fuel, their telecommunications, their mortgage, their car insurance, their pet insurance, their home and now their PCAs. Real life is not like that. If you read the papers today, a third of middle-class families would struggle to find £500 to pay a bill that was unexpected. People have more pressing issues. There are things that are right in front of their faces that need to be dealt with today, and that is why consumers behave like they do. It is not that they are disengaged; they are not disengaged. They just want their bank to treat them well.

Professor Coyle: Caroline put her finger on it earlier, when she said that there are just such profound asymmetries in information in financial services that you cannot rely on consumers being able to resolve those by themselves. It will not make the market work effectively.

Paul Lynam: Consumers have to have some form of responsibility. We are all consumers, and we have to take some responsibility for our actions. Equally, it cannot be a function of a properly competitive, effective market whereby the most loyal savings customers get the worst deal, and the most loyal mortgage customers also get the worst deal. The CMA has recognised that the large banks make the biggest amount of their profit margin through low-risk mortgage lending, and they are making higher rates of profit from low-risk lending than smaller banks doing high-LTV mortgage lending. That is the wrong way round. That should not be the case.

Q20 Rachel Reeves: I want to talk about a group of people who are, perhaps, particularly badly treated by the banks: the people who use unarranged overdraft facilities. The CMA report says that this group of customers are getting a particularly poor deal, and yet their recommendations seem to just be on transparency and asking individual banks to set their own monthly cap on charges. Do you believe that this could result in any better outcomes for those customers than they get currently?

Caroline Barr: At the margins, it could. For those consumers who end up in a mess with their accounts—and some do; they just lose track of their spending or they get a financial shock, and they can end up with hundreds of pounds' worth of charges at the end of the month—it will put a limit on it. But these measures will only work in a properly competitive market. In a properly competitive market, that monthly maximum charge would be competed downwards. We are expecting to see that either it will not be competed downwards that much, or it will be, and you will get a waterbed effect on charges, and charges elsewhere on the current account will go up.

Q21 Rachel Reeves: Your worry is that monthly caps set by the banks may reduce that particular charge, but you will see other charges, probably on the same customers.

Caroline Barr: We should also recognise that quite a few of the banks already have a monthly maximum charge anyway.

Rachel Reeves: Like RBS and Barclays.

Caroline Barr: That does not appear to have had any effect on the market. Having it made more prominent, and having it made a standardised feature that everybody recognises, could exert a little bit of pressure, but, again, it is at the margins.

Professor Coyle: I spent some years living in the US, where unauthorised overdrafts do not exist. They are not allowed, so your cheque will bounce rather than that happening. They are simply not appropriate, particularly for the kinds of customers who do get into that kind of financial chaos. It is much better to have them be called into their bank, have a discussion with the manager—such people still exist—and help them arrange an overdraft and sort out their financial chaos.

Q22 Rachel Reeves: You said earlier, Professor Coyle, that unauthorised overdrafts should be banned; that they are worse than going to a payday lender. Some people are saying that authorised and unauthorised overdrafts should have

the same charge structure, and Ms Barr is nodding her head. You seem to be suggesting something slightly different.

Professor Coyle: I am saying that, in effect, they all ought to be authorised, because if somebody does look like they are going into unauthorised overdrafts, they should be called in and the situation should be resolved, as you would care for a customer.

Q23 Rachel Reeves: Your suggestion is that either the cheque is bounced, or, if you allow the cheque to be paid, it is being authorised, so it should be treated like an authorised overdraft.

Professor Coyle: It should be a trigger for a conversation with the customer, to help them sort out their financial situation.

Q24 Rachel Reeves: If the cheque is allowed to be cashed, then it is, implicitly at least, authorised by the bank, so it should just be treated like an authorised overdraft.

Professor Coyle: That is one way of thinking about it.

Caroline Barr: There is almost no situation where an unauthorised overdraft turns up and the bank has not known that it is coming. So many of our payments are automated these days—whether it is a continuing payment authority, a direct debit or you are making a payment at a retailer—that banks are implicitly authorising any overdraft that you go into. Going back to whether they should be allowed or not, where a bank has done an affordability check and has set an overdraft limit, if a consumer goes over that, that should not be seen as a regular line of credit. There is a problem emerging here, and that is when the bank needs to make an intervention with the consumer.

Q25 Rachel Reeves: In your experience, Ms Barr, to what extent does that happen at the moment?

Caroline Barr: I do not know how much it is happening at the moment. I do not have the figures of how many people go into the unauthorised overdraft territory. My understanding is that these decisions are automated anyway: so little of lending is now in the hands of an individual banker. One of the problems that people highlighted in our research last year was that, when they are turned down for loans, nobody has an explanation, because it is not an individual making the decision; it is an automated process.

Q26 Rachel Reeves: One of your concerns is that people who are using unauthorised overdrafts regularly are vulnerable customers with financial difficulties, or at least chaotic finances.

Caroline Barr: Or very busy people who do not keep an eye on their finances. They could be well-off people, as well.

Q27 Rachel Reeves: Yes, but those people need some sort of help or conversation to manage their finances better. You do not think that, at the moment, that happens as a matter of routine.

Caroline Barr: No. Interestingly, I went to an EU conference recently, and, in Germany, if a consumer is using an expensive line of credit for more than, I think, six months, the institution that is giving them that credit has to give them advice on how to manage their finances better.

Rachel Reeves: That is interesting.

Caroline Barr: Also, if they have not done a proper affordability assessment on that consumer, then they have to lower the interest rate on the product that that consumer is using.

Q28 Rachel Reeves: Professor Coyle, my original question was about whether you thought there would be any better outcomes as a result of what the CMA seems to be recommending. Ms Barr said perhaps marginally, for some people. Do you share that view?

Professor Coyle: Marginally, yes. Things like the API, on which they spend so much time, might help at the margin if people trust third-party intermediaries with their financial information. I certainly would not, but maybe some will, and at the margin it might be helpful.

Q29 Rachel Reeves: Others—I would include myself in this, and I think *Which?* has suggested this as well—think that there should be a FCA-determined cap on monthly fees, as well as no distinction between authorised and unauthorised overdrafts. Do you think that either of those remedies would be useful?

Professor Coyle: Given where we are, a cap is helpful. However, to go back to the basic point, it is not addressing the fundamental lack of competition in the market, and, if there were a truly competitive market with challengers able to enter, with sustainable profits, then these problems would get competed away.

Q30 Rachel Reeves: Is that your view as well, Mr Lynam?

Paul Lynam: Yes. The reality is that very few of the challenger banks offer current accounts, and, by definition, they do not offer overdrafts, in part because of the stranglehold that the large banks have. They own the payments infrastructure, so we have to get their permission to access it, and then we have to pay them to access it. They are huge competitive barriers, in isolation.

To answer the question, I agree with my colleagues: the recommendations will have some marginal benefit. I would not want to be dismissive of them. Some of these are good ideas. Grace periods, prompts and maximum monthly charges are good things for consumers, but they are not going to drive a fundamental change in the UK competitive banking landscape.

Q31 Rachel Reeves: Professor Coyle, when Wes Streeting was asking questions about whether people should switch, you and Ms Barr suggested that it is not really rational to switch current accounts. When we have talked about customers who have unauthorised overdrafts, you are suggesting that it is competition that is key, in terms of driving down the charges structure. Is there any type of inconsistency there, or am I missing something?

Professor Coyle: No, I understand what you are driving at. It is a good question, but it is not that lots and lots of people ought to have to switch, all the time. Most of us might have a favourite shop that we go to for food, but we do not expect to have to change every week to keep competition in the market working. It is about contestability: the threat of credible new entry, which could take away lots of your customers if you do not up your own game, is what makes it effective.

Q32 Rachel Reeves: Ms Barr, you are nodding. Do you agree with Professor Coyle?

Caroline Barr: Yes, absolutely.

Q33 Rachel Reeves: Mr Lynam, you might not know the answer to this, but maybe you do. How many challenger banks offer current accounts?

Paul Lynam: I believe Metro Bank offers free-in-credit current accounts. I believe Tesco Bank offers a basic bank account, with a fee; Virgin, I believe, also charges a fee for its nascent product, and TSB offers a current account product.

Q34 Rachel Reeves: There are four challenger banks. You then have the big five, the Co-op and Nationwide.

Paul Lynam: And Clydesdale.

Rachel Reeves: Overall, how many people offer current accounts?

Paul Lynam: I do not have the exact answer, but probably getting on for 15, including some of the very small building societies.

Q35 Rachel Reeves: When you started in this industry, Mr Lynam, how many offered current accounts then?

Paul Lynam: Probably getting on for 40 or 50.

Q36 Rachel Reeves: That is really quite remarkable—about a third of the number now, compared to when you started in the industry, not very long ago but a few years ago.

Paul Lynam: Nearly 30 years.

Rachel Reeves: In 30 years, we have gone from about 45 to about 15 people offering current accounts.

Paul Lynam: A lot of that has come about as a consequence of mergers and consolidations. That has created a situation where those banks that provide a current account have condensed into five, six or seven large players. That is why small, incremental recommendations to drive more switching does not actually address the root cause of this.

Q37 Rachel Reeves: The root cause, in your view, Mr Lynam, and I think everybody's view, is having more contestability in the market and more competition.

Paul Lynam: Right.

Professor Coyle: One of the things that I found missing from the report was a real profitability analysis of where the profits are coming from at the moment and what would make it possible for challenger banks to make a sustained profit and stay in the market. As we heard earlier from the list, there have been one or two who have tried and have got out of the market again; ING Direct was one of the examples that I know a little bit about. That does not seem to be there. How many customers would have to switch to make it profitable for challenger banks to stay in the market? That analysis just is not there.

Q38 Rachel Reeves: Mr Lynam, for you, it is about the amount of capital the banks have to put aside. Is that the key thing for challenger banks?

Paul Lynam: No, it is a combination of different factors. The amount of capital is hugely important, because that is the single most expensive resource that a bank has, but, clearly, the way banks work is that they help to balance between those in surplus and those in deficit, whether it is consumers or businesses. Having a comparable cost of funds would enable the challenger banks to provide a broader range of lending products to a broader range of consumers and businesses.

Some of the challengers, including ourselves at Secure Trust Bank, are better described as a specialist lending business, because we are not genuinely trying to challenge the larger banks. In fact, the whole “challenger” moniker was probably handed down by the big banks to create the impression that there is a lot of people challenging for them, which is not the case. We, and all of the other challenger banks, by and large, as well as the non-banks, are effectively in the 20% of the market that the big banks do not want to service, in part because they do not have the same capital advantages. The consequence of that is, by definition, we are missing out on the opportunity to compete for the other 80% of the consumers and the businesses.

Q39 Rachel Reeves: Very briefly, I would like to ask about the issue of small business banking, another really important issue. Small businesses seem to have even less choice about who provides their banking facilities. The CMA seems to think that the answer there is getting Nesta to run a competition to set up some sort of price comparison platform, to help small businesses make the right decision. Do you think that that is the right approach, or do you think there is a better one?

Paul Lynam: If you create a price comparison website, those entities that will win will be those with the least capital requirements and the lowest cost of funds. It might give a benefit to consumers, assuming that the four or five people in that situation compete effectively, but it does nothing to help all of us other banks, challenger banks, small banks, and building societies provide more lending to SMEs, because of the funding and capital disadvantages that we suffer.

Professor Coyle: Paradoxically, price comparison sites put all of the emphasis on those league tables: the top 10 tables. If you can afford to subsidise products to go into the top 10 tables, you win business. It is counter-productive, sometimes.

Q40 Rachel Reeves: What do you think the CMA should have recommended, or regulators should do, in this field?

Professor Coyle: We are sounding like a stuck record, but they should create a level playing field so that some new entrants can go after that small business sector effectively. As you say, it is even more concentrated than the consumer sector.

Q41 Rachel Reeves: Does anyone want to add anything?

Caroline Barr: They should also ensure that the principle of fairness does apply to the customers who find themselves in these situations.

Paul Lynam: One of the situations that we found post-crisis was that the larger banks were providing less credit to SMEs than to corporates. That has created an opportunity for banks like ourselves, Shawbrook, Close and others to fill that vacuum. The reason for that is the amount of capital that a large bank needs to set aside for SME lending, relative to a small bank, is broadly the same, so those large firms that were capital-constrained went instead to the very low capital-consumptive mortgage lendings, and arguably deprived SMEs of credit. That is not a situation that we want to be in again come the next crisis, which is why there is a need, for societal benefits, to have a more diverse capability to provide SME credit through a broader range of banks.

Q42 Chair: People watching this hearing might think that we are providing under-arm deliveries, but the truth is that all we are really doing is asking the questions that our constituents, and millions of consumers, want to have asked on their behalf. It is an extraordinary state of affairs that almost everybody seems to agree with what is being said here, in varying ways and from different angles, except two groups: the CMA and the banks. We need to explore, in the remainder of this hearing and with the CMA hearing to come, how we can have arrived at a situation where only the CMA and the banks are disagreeing with such a widespread view. I asked that question of you in the beginning, Mr Lynam. Have you anything to add to what you said earlier on it?

Paul Lynam: I am as frustrated as most people with this. I do not intellectually understand why the CMA is not playing back to us, as interested parties, what they have heard from the banks seeking to challenge the incumbents. To be fair, the Chancellor has set up the challenger bank high level advisory group, which meets with the Treasury once a quarter to investigate ways in which we can inject more competition. The Bank of England has written to the EBA, calling for a more proportionate approach to the regulation of small banks, especially in respect of capital.

Mr Osborne echoed exactly those words in his Budget statement, and yet the CMA has issued a press release that says, “What is really holding them”—i.e. the challenger banks—“back is their inability to highlight to customers how new offerings compare with their current deal”. The challenger banks have never said this to the CMA. The challenger banks have said that what is really holding us back are the capital, funding, taxation and infrastructure disadvantages, so quite why they are saying what they are saying, I really do not know, Chair.

Chair: We are going to get onto a very closely related field now.

Q43 Mr Rees-Mogg: Good morning. Before I come on to my main questions, Ms Barr, may I ask you a couple of things? I have been in the financial services

industry all my professional life. I refer to my declaration of interests: I have an investment management business. I am completely bound by two things. One is knowing your customer, and the other is treating your customer fairly. On the issue of existing customers and fees, I chair the Fair Fees Committee, and, if we have a new customer come in, there are some contractual obligations not to offer them lower fees than people already have. But we take the view that, under treating your customer fairly, we cannot offer a better deal to a new customer than to our existing customers. I do not understand why the banks are not obliged to follow the same rules as everybody else in the financial sector.

Caroline Barr: Yes.

Mr Rees-Mogg: I was just stunned listening to you, thinking, “What have I been doing for the last 25 years? Have I been applying rules that are not really there, or do banks have some special opt-out?” Know your customer is the same thing; it ties in with overdrafts. We do not deal with private clients because we are not regulated to, but if we did, we could not take on clients for whom emerging market investments were unsuitable. Why are banks allowed to make overdrafts for people who cannot pay them back without any recourse? How did this regulatory system come about?

Caroline Barr: The problem that the FCA has is that it simply could never have the resources to deal with the amount of wrongdoing that goes on, and therefore it can only touch the tip of the iceberg. A huge amount of wrongdoing is going on. The business models that the banks have are fundamentally in conflict with what is in the interests of consumers. It is about cutting costs: that means closing branches, not investing in training your staff, not investing in new IT systems, and getting profit where you can, so you get people in with teaser rates for your savings accounts and then, when they are not looking, knock them down and do not tell them. Eventually, somebody opens their annual savings statement and realises that they have £2.50 on a £2,000 investment or savings product. The focus of regulation has been very much on selling, that front bit of the process: “Did you know your customer when you opened the account? Did you check what their needs were?”, or, if it is a more complex investment, “Did you check that this was appropriate for them?” Further down the line, you can do what you like, because no-one is looking. The FCA is waking up to this now; I think it is part of their business plan. It is looking at the treatment of long-standing customers, but the problem is that this is endemic across the industry. It is in pensions, it is in all with-profits funds and it is throughout all banking products. Mortgage prisoners are a prime example.

Q44 Mr Rees-Mogg: The regulations are there; they have just not been used so far. The treating your customer fairly principle applies just as much to a bank as it does to a small financial company.

Caroline Barr: It should do.

Q45 Mr Rees-Mogg: That is extremely helpful, and very reassuring. If I can move onto the issue of too big to fail—perhaps, Professor Coyle, you might answer this—do you think that there are still banks in the UK that are too big to fail?

Professor Coyle: Certainly.

Q46 Mr Rees-Mogg: I guessed that you would say that. The amount of capital that they have to hold has gone up, and there are bail-in requirements, but this has not gone far enough; still, if a big bank got into trouble, the Government would have to bail it out.

Professor Coyle: Without question.

Q47 Mr Rees-Mogg: I completely agree. Does that give them an implicit subsidy, both ways round: both that the consumer knows that their money is safe and therefore demands a lower interest rate than the consumer would demand from a challenger bank, but, also, they are effectively getting deposit insurance above the £75,000 level for free?

Professor Coyle: That is probably the more significant, quantitatively. This is a very large, implicit subsidy and reduction in cost for those large incumbent banks, and it has clearly got worse, rather than better. The concentration has continued to increase; the systemic intertwining of the banks has not decreased at all. The last figures that I saw indicated that it was £200 billion or £300 billion already, and I am sure that that implicit subsidy has not gone down.

Q48 Mr Rees-Mogg: How would you tackle this subsidy? Is it possible to get rid of it by breaking up the bigger banks, or, if you wanted a level playing field, would you merely have to extend the subsidy to smaller banks?

Professor Coyle: It is something that will have to be eroded over time. The break-up option does not look very attractive: it is complicated; it is costly; and it is not clear that it would improve competition substantially. Making sure that the market is genuinely contestable, so that over time the market shares of new banks increase, will have to be a 10 or 20-year process, as I think was said at the beginning.

Q49 Mr Rees-Mogg: You are broadly in agreement with the CMA that breaking up the larger banks would not be the best policy to follow; it is about trying to establish policies that encourage the slow evolution of challenger banks, rather than reducing the size of the bigger banks.

Professor Coyle: Probably, yes.

Q50 Mr Rees-Mogg: Do you think this is realistic? With such a concentration as there is, do you see how the smaller banks can get to the size of the RBSs of this world, even in 20 years, particularly given the point Mr Lynam has made about the different capital requirements that are so skewed in favour of the larger banks?

Professor Coyle: There are several elements to the cost advantage of the larger banks, and one of them is too big to fail, but the capital requirements are another, as are the cost of accessing payments and the tax regime. There are lots of ways into this, and, even if you decide that too big to fail is something that will have to be eroded slowly, the others might be addressed.

Going back to the Chair's question about why we have ended up with a report that does not seem to be addressing the problems, there is clearly a co-ordination issue. There are

lots of bodies involved: the Treasury, the PRA, the European authorities and so on. This report was an opportunity to point this out and say, “This is the co-ordination that needs to be done.” It is not within the power of the CMA to remedy all of those, but somebody needs to say, “We have to address these multiple cost disadvantages.”

Q51 Mr Rees-Mogg: With too big to fail, during the banking crisis, everything was too big to fail. However small it was, it was rescued. Is the implicit subsidy effectively there for the smaller banks, but nobody is admitting to it, or is it genuinely not there, and has there been a change since 2008?

Professor Coyle: It is very hard to say, if we had a situation like 2008 again, whether the systemic links would turn out to be just the same. My sense is that some of the smaller banks now would be allowed to fail, but customers’ deposits are safeguarded. That might well be allowed to happen. I do not know.

Q52 Mr Rees-Mogg: Do you think, in 2008, that the initial savings were an economic requirement or a political requirement?

Professor Coyle: I am sorry?

Q53 Mr Rees-Mogg: Northern Rock was saved early on in the process. You had to save RBS, but did you need to save everyone in Northern Rock? Was that more a political decision than an economic decision?

Professor Coyle: The thing that you need to protect is customer’s deposits, and the thing that needs to change, compared to 2008, is that other bondholders and shareholders do suffer the consequence of it. That is the change that we need.

Paul Lynam: On the subject of people like Northern Rock and Bradford & Bingley, their shareholders lost everything. The customers were saved, but those investors were not. That is different, obviously, to Lloyds and to the Royal Bank of Scotland.

Q54 Mr Rees-Mogg: Yes, but do you think that the challenger banks effectively have a similar guarantee for all their deposits at the moment?

Paul Lynam: No—86% of my customers have exactly £75,000 on deposit with me, because that is what is covered by the Financial Services Compensation Scheme. I suspect that most of the other challenger banks will have a similar customer profile, and the challenger banks pay for the coverage provided by the Financial Services Compensation Scheme.

Q55 Mr Rees-Mogg: Your customers basically believe that they are only covered to £75,000, whereas the customers with the big banks assume that they have unlimited coverage.

Paul Lynam: I would have thought that that is the case.

Q56 Mr Rees-Mogg: That is another part of the implicit subsidy.

Paul Lynam: They will have seen empirically that the largest systemic banks have been saved and the smaller banks have not. That is a rational thing for them to do. In the broader question regarding the subsidy advantage that the large banks have, their dominance over the best quality assets—low-LTV, low-risk mortgage assets—represents a huge virtuous circle for them. They have the collateral available to access things like funding for lending, whereas the banks that cannot provide that lending do not. As of the end of March, Lloyds Bank alone was using 55% of the total drawings of the funding for lending. That is not a scheme that the challengers have that kind of proportionate access to. You also have a situation where those high-quality assets enable them to borrow more cheaply on the wholesale market. For free-in-credit current accounts, there will be a huge advantage when base rates start to rise for those large banks, which represents a competitive threat to smaller banks.

Q57 Mr Rees-Mogg: Low rates actually give assistance to the challenger banks, because they are saving on current accounts.

Paul Lynam: Yes.

Q58 Mr Rees-Mogg: The CMA said that Nationwide—and this is for you, Mr Lynam—was the only financial institution that responded to its consultation in favour of structural remedies. Why do you think that other people did not suggest that this was the answer to the problem?

Paul Lynam: Nationwide has a rather more straightforward and simple banking model, relative to the five large players that they compete alongside. There may be an element of that in their thinking. I was asked to run the SME bank for RBS and NatWest in 2008. As a consequence of that, I was then asked to run the Williams & Glyn project, which I declined to do, and left in 2010 to take on this role. I agree with the CMA that breaking up the large banks is not the answer: it is too difficult, and, as we see from Williams & Glyn, by dint of its state ownership, the taxpayers lost a lot of money through that project. I just do not think that it is the right thing to do.

Q59 George Kerevan: I share your disappointment, shall we say, with the CMA report. Can I test some of the statements in the report, though, Mr Lynam? The CMA says that it could not find strong evidence that the surcharge on bank profits was a barrier to entry or was a limitation on the challenger banks. Why do you think it came to that conclusion?

Paul Lynam: Because, when it made that announcement, the banking tax surcharge had not come to be, so, by definition, there would be no evidence. As a consequence of the interim and then the final results published by the banks during 2016 and early 2017, my strong suspicion—as evidenced by reports from people like Sheffield University and Ernst & Young, or EY as they now are—is that the surcharge will generate significantly more revenue than it was targeted to. Hopefully, that will give the opportunity for the calibration at the £25 million entry level to be adjusted.

Q60 George Kerevan: Just to be strictly clear, can I ask Professor Coyle: if we did introduce differential rates of taxation, could that not be judged as unfair to the major banks?

Professor Coyle: Clearly, you always introduce differences at the margin when you have this kind of tax structure, and looking at something that did not have step changes or sharp cut-offs for the threshold might be a way of addressing that. Something that calibrates the threshold rather than making it a one-off step, or calibrates the rate, might be a way of minimising those kinds of issues.

Q61 George Kerevan: You will get the best of both. I understand, Mr Lynam, that, in response to the public argument that emerged over the new tax surcharge, the Government have initiated quarterly meetings with the challenger banks.

Paul Lynam: That is right.

Q62 George Kerevan: Where do we stand with that process?

Paul Lynam: There is a genuine recognition by the Treasury, the Bank of England and the PRA that there are competitive distortions. Tax is one of those, and there is a genuine willingness to seek to address those, but, at this stage, we have yet to see the talk translate into walk.

Q63 George Kerevan: There have been meetings.

Paul Lynam: There have been meetings every quarter, yes.

Q64 George Kerevan: On the issue of capital requirements, or capital standards, as a barrier to entry, the CMA report came to no real conclusion, because it said that it could not find sufficient evidence to come to a conclusion. Did that surprise you?

Paul Lynam: I am not sure that they have said that in isolation. They have recognised in their announcements last month that the large banks' most profitable product is mortgage lending, and they make significantly greater profit margins on low-risk, low loan-to-value lending than smaller banks do on high-risk, high-LTV lending, which, as I say, should be the other way around. This is in their own report, which by definition seems to suggest that there is a problem.

George Kerevan: Indeed, it would.

Professor Coyle: They have a paper on capital requirements, noting that there is this chasm between the standardised and the internal ratings approaches, which clearly advantages the incumbents. They do not seem to agree on how much that matters, and there is a footnote in that document that says that two of the members, including the chairman, thought that this was a serious competitive issue. It would be really helpful if they would air that properly, rather than just having a footnote saying, "We cannot decide how important this is."

Q65 George Kerevan: We may, in due course, ask them. Again, just to get a balance in the argument, the larger banks might argue that their businesses are very differentiated and diversified, and therefore, in many ways, they pose less systemic risk than small and medium banks. How would you respond to that?

Paul Lynam: By definition, small banks are not systemic. As I said earlier, we did see nearly 30 banks fail in the 1990s, including large-ish banks the size of BCCI and Barings, without dragging down the whole economy. That is simply because we did not have six firms controlling 80% of the market. The issue is, if you get back to a much more diversified market, then potentially, that is societally beneficial, because the taxpayer will be able to allow banks to fail without being put on the hook for having to bail them out. I do not necessarily agree that the bigger banks have some divine right to exist, simply because they are big. What cannot be in any way, shape or form defensible is the situation where, if I try to write a 50% loan-to-value mortgage for Diane, I would have to risk-weight that at 960% more than a large bank providing exactly the same loan to exactly the same person, taking exactly the same credit risk. That cannot pass the common sense test.

Professor Coyle: It is exactly the reverse to common sense. In my mind, the big banks should have higher capital requirements than smaller ones, because they pose the systemic risk. I do not understand why we have ended up with the opposite regime.

Caroline Barr: The larger and more complex the organisation, the more difficulties you have in setting an effective risk policy and making sure that it is carried out.

Q66 George Kerevan: That brings me on to another issue: typically, the larger banks are allowed to use their own internal models to calculate their risk-weighted capital, and regulators seem happy with that. Again, being fair, you could ask, “Why do the challenger banks not develop their own internal business models that would allow them the same scope?”

Paul Lynam: The regulators are not happy with the IRB models. In fact, the Basel Committee on Banking Supervision published a consultation paper in March, which is looking to reduce the variation in those risk weights. Whether that comes to pass or not remains to be seen. Entry into the IRB approach is available to all banks, but the entry cost is prohibitive. Effectively, you would need to hold between five and seven years’ worth of data, ideally through an economic cycle, to justify why your individual, bespoke risk weights should be set at a certain level. By definition, if you have to set aside nearly 1,000% more capital for low-risk, low-LTV mortgage lending, holding that for such a long period of time would have a huge economic cost. You would be losing money for a huge amount of time, and therefore, in theory, you can get this, but in practice you cannot, which is why so few banks have the advanced model.

Q67 George Kerevan: What can we do about that?

Paul Lynam: One way that we have suggested as a cohort of challenger banks is that the six biggest firms control 80% of the market; when you add in the next four, the 10 largest firms control nearly 90% of the lending market in the UK, and all of these firms are on the advanced methodology. One option would be for the regulators to allow all of the other players to use the average risk weight of these 10 players. By definition, those firms that have a genuinely lower than average risk profile would continue to have the benefits, but everybody else would be able to compete on a much more level playing field.

Q68 George Kerevan: That would reduce the capital barriers, would it?

Paul Lynam: Correct.

Q69 George Kerevan: How fast do you think we could implement such a scheme?

Paul Lynam: The issue is that the Basel standards are global. Interestingly enough, when you look at the US approach, there are something like 7,500 banks in the US, and all, other than the systemic banks, are governed on a bespoke basis, either by the state regulator or the Fed. The Basel standards are only applied to the systemic banks in the US. In the UK, as is the case in the other 27 member states, the Basel standards are applied in full by the EEA across Europe. How quickly things might move would depend on how you could renegotiate that situation.

Q70 George Kerevan: Coming to my final point, many of the practical proposals in the CMA report rely on the FCA implementing and policing new standards, and so on. Is that passing the buck?

Caroline Barr: No. It is the FCA's role, and arguably what it is asking the FCA to do is to set a higher threshold for what is fair than it has implemented in the past.

Q71 George Kerevan: Given that, does the FCA have the resources and capability to do that?

Caroline Barr: I am afraid that that is a question for the FCA; I do not represent the FCA. It has some incredibly high-quality people. I know that it has worked very closely with the CMA, and these recommendations would not have been put in there if they had not considered the resources issue.

Q72 George Kerevan: There is a sense, Professor Coyle, in which the FCA is being asked through the CMA to increase its role in promoting competition, which is, of course, written into its rules. It is almost inviting the FCA to be more proactive in promoting competition, and, since you have identified competition as the key issue here, rather than switching, does it not open up issues about the resources that have to be available to the FCA to implement that?

Professor Coyle: I do not know what resources it has. It is fine to involve it, and, as I said a little while ago, there is a co-ordination issue. Lots of people need to address different aspects of this problem to create a properly competitive, level playing field. I do not mind the CMA asking the FCA to take this role, and I am sure that the FCA is absolutely willing to do so. My regret is that the CMA has not focused on all of the other bits of the jigsaw in the same way. It has put so much weight on this, as opposed to the other bits of the problem that we have been talking about this morning.

Q73 Chair: In January, I wrote on behalf of the Committee to the Acting Chief Executive of the FCA, asking, among other things, for much greater resources to be put into IT infrastructures, to deal with the exposure that the public currently has—among other things—to delays in paying bills, inability to obtain access their own money for periods and the risk of unauthorised access to their accounts. In earlier evidence, Professor Coyle, you suggested that we should add an extra item

to that list, which is that the poor quality of the IT systems is a major impediment to competition, to current account portability and the scope for switching. Have I understood your evidence correctly on that point?

Professor Coyle: I am not a banking IT expert, but my impression is that the character of the banks' IT systems is one of the obstacles to account number portability.

Chair: We will not detain you now, but, if any of you have suggestions on whether to take that issue forward, and if so, how, we would be very grateful. If you have not had an opportunity this morning to raise issues that you feel should be raised with the CMA or with others, subsequent to this hearing, would you please let us know? We are very grateful to you for having given evidence to us this morning. It has been enlightening, even if on this occasion it has been a rare case where people come before us with whom we are quite likely to agree before you have started, but that is because almost everybody agrees on this subject, except, as I say, that rather narrow group, whom some would say have an interest in the subject. Anyway, thank you very much indeed for coming.