

Impact of the Independent Commission on Banking's Recommendations in Scotland

September 2011

Introduction

The Federation of Small Businesses (FSB) is Scotland's largest direct-member business organisation, representing around 20,000 members. The FSB campaigns for an economic and social environment which allows small businesses to grow and prosper.

We represent many small businesses for whom the banking crisis heralded several years of difficulty in accessing the finance they need on terms they can afford.¹ We therefore welcome the opportunity to submit evidence to the Economy, Energy and Tourism Committee on the impact in Scotland of the Independent Commission on Banking's (ICB) recommendations.

We believe that the ICB has made a significant contribution to the debate on how the industry should be restructured so that it is both safer and more competitive.

Overall, we broadly welcome many of its findings. However there are a number of points which we believe merit further examination.

Structure of the Banking Industry

We welcome the key recommendation to ring-fence the retail from the investment side of large banks. On capital requirements, we welcome the recommendations that

¹ Only 25% of FSB members in Scotland have applied for new loans in the twelve months to June this year. Of those who did apply for bank finance, 36% were rejected outright; 11% received a proportion; 39% received the finance they requested in full; and 14% are still waiting for a decision. Source: FSB Voice of Small Business Index, June 2011.

equity capital should be raised to 10 per cent for large UK retail banks and that loss-absorption capacity should be 17 to 20 per cent.²

We do not accept that this additional requirement will result in borrowing becoming more expensive.³ However, because the small business banking market in Scotland is dominated by two very large players – Lloyds Banking Group (LBG) and Royal Bank of Scotland (RBS)⁴ – businesses north of the border will be particularly affected by any attempt by such larger banks to use these changes to restrict access to, or increase the cost of, bank finance.

Competition: The Scottish Market

The report notes the Competition Commission's (CC) view that there are separate geographical markets in England & Wales, Northern Ireland and Scotland for, among other things, general purpose business loans.⁵ It also notes that the Office of Fair Trading (OFT) agrees.⁶

Paragraph 7.14 further notes that, "some regional markets in particular are significantly more concentrated than the national average." In Scotland, for example, "concentration levels for SME banking are high ... and significantly above the OFT and CC's threshold of 'high concentration'".

The report notes the Scottish market has a Herfindahl-Hirschman Index (HHI) of 3160 for businesses with a turnover of up to £25m.⁷ The OFT and CC regard any market with an HHI above 1000 as "concentrated"; anything above 2000 is seen as "highly concentrated".⁸

This is backed up by Scottish Government figures which show that the constituent parts of LBG and RBS⁹ account for 74.9% of the SME banking market in Scotland.¹⁰

² Independent Commission on Banking, Final Report, A3.5 (ICB hereafter)

³ For more on the arguments around ring-fencing and its impact on lending rates, see *Ring-fencing of Bank Capital*, FSB, September 2011 - <http://www.fsb.org.uk/policy/Publications>

⁴ See the following section for details on market concentration

⁵ Paragraph 7.14. Footnote 18 on page 170 references page 24 of the Competition Commission report *The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises* – at: http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm

⁶ The ICB report references page 51 of the 2008 OFT report, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc.* – http://www.offt.gov.uk/shared_offt/press_release_attachments/LLloydstsb.pdf

⁷ The HHI is a measure of market concentration which takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market. This definition is taken from page 39, CC and OFT joint publication, September 2010, *Merger Assessment Guidelines* – http://www.competition-commission.org.uk/our_role/ms_and_fm/pdf/100916_merger_assessment_guidelines.pdf

⁸ Page 40, CC and OFT, September 2010, *Merger Assessment Guidelines*

⁹ These are Lloyds TSB, Bank of Scotland and Halifax; and RBS and NatWest respectively.

¹⁰ Page 36, Office of the Chief Economic Adviser, Scottish Government, July 2009, *SME Access to Finance 2009* - <http://www.scotland.gov.uk/Resource/Doc/919/0084113.pdf>

The ICB report reminds us that this is neither a new problem nor one which was precipitated by the banking crisis and the resultant market consolidation. It points out that concentration in the Scottish market was, “noted in both the 2002 CC investigation, and the 2008 OFT study into the Lloyds TSB/HBOS merger.”¹¹

It is most welcome that the ICB has recognised the particular issues which persist in the small business banking market in Scotland. While accepting that an in-depth examination of market operations in every part of the UK would have been outwith the Commission’s remit, we would have been interested to hear more of their thoughts on how the situation in Scotland could be remedied.

It therefore remains the FSB’s position that the operation of the market in Scotland merits further examination by the competition authorities.

Competition: Real Choice

Following on from the discussion above, the ICB report also notes that, while the concentration of market share in Scotland, “will be somewhat alleviated by the RBS and LBG divestitures, the HHI will still be well above 2000.”¹²

Indeed, given that, as noted above, the market was far from perfect when there were more players in the pre-credit crunch era, the FSB has questioned whether simply having another, or several, new brand(s) on the high street will in itself address the lack of competition.

We have therefore argued that Scottish small businesses must have a genuine range of choice in financial products which meet their needs, not merely a choice of from whom to buy them.¹³ This is a matter on which we will continue to press the UK and Holyrood administrations.

Competition: Switching

We welcome the ICB recommendation that a cost effective approach be taken to the long-standing issue of making it easier to switch banks. We agree that switching should take no more than seven working days and that a seamless re-direction should take place for a year, at no cost to the customer.¹⁴

¹¹ Para 7.14, ICB

¹² Para 7.14, ICB

¹³ This is a matter on which we continue to work with other business representative groups, professional bodies and representatives of the financial services industry. For our recent joint statement on funding solutions for small businesses, see:

http://www.icas.org.uk/site/cms/download/technical/Proposed_Joint_SME_Funding_Statement_2_June_2011.pdf

¹⁴ Para 9.4, ICB

However, as discussed above, for an easier switching mechanism to have the desired effect on the market, business customers must have a realistic alternative to which they can take their account.

Timescales

The FSB is naturally keen to see these welcome changes implemented as quickly as possible, arguing that they should be in place before the end of the current UK parliament.

The ICB states that, “implementation should ... be completed at the latest by the Basel III date of the start of 2019.”¹⁵ While this seems a long way off, we also note their encouragement to government to end any policy uncertainty and enact reform measures soon. We would also support the Commission’s view that “banks should be strongly encouraged to implement any operational changes as soon as possible.”¹⁶

While not an official statement of government policy, we welcome the UK Business Secretary’s recent remarks that, “The Commission’s key findings ... must be put in place. Legislation will start soon and be completed in this parliament.”¹⁷ However, this is not the same as committing to the changes being in force by the end of this parliament and we would urge the UK government to adopt this as its target.

For further information on any of the points raised in this submission, please contact Colin Borland, e: colin.borland@fsb.org.uk; t: 0141 221 0775.

¹⁵ ICB, Page 15

¹⁶ ICB, Page 15

¹⁷ Speech to Liberal Democrat Annual Conference, September 19, 2011