# Evaluation Paper 18/3: An evaluation of reducing barriers to entry into the UK banking sector

December 2018

# FCA evaluation papers

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# Executive summary

## Post-Intervention evaluations inform our decision-making process

Evaluation is part of our Mission's decision-making framework. Testing the effectiveness of our remedies helps us make better decisions and add public value.

In April 2018, we published Discussion Paper 18/3 on our proposed framework for post-intervention impact evaluations. This is one of the ways we assess the impact of our interventions. Post-intervention impact evaluations differ from other approaches as they focus on quantifying the impact of our intervention.[1]

This evaluation examines the effects of the 2013 review by the FSA (the Financial Services Authority – our predecessor organisation) and the Bank of England (the Bank) 'A review of requirements for firms entering into or expanding in the banking sector' (*the 2013 review*) on firms entering the UK banking sector.

## The 2013 review of requirements for firms entering the banking sector

After the Office of Fair Trading (2010) and the Independent Commission on Banking (2011) published reports into competition and barriers to entry in the banking sector, the Treasury asked the FSA and the Bank to review the prudential and conduct requirements for new entrants to the banking sector to ensure they were proportionate and did not pose excessive barriers to entry.

The 2013 review revealed that concerns about barriers to entry were focused on:

- the **level of capital requirements for new banks and their ability to raise it**
- the **level of liquidity requirements** of new banks
- the **lack of certainty in the authorisation process** and the way in which the process was executed

The 2013 review focused on addressing these issues by:

- **reducing capital and liquidity requirements** for new banks at authorisation
- **improving the authorisations process,** in particular the level of up-front support and engagement provided to firms during the pre-application stage[2]

1 The proposed framework sets out how we intend to use ex post impact evaluation (EPIEs), or post-intervention impact evaluations, to assess the impact our interventions have had on consumers, firms and markets. Evaluations feed back into our decision-making and how best to use our diagnostic and remedy tools.

2 Banks are still required to meet the requirements under Financial Services and Markets Act 2000 (FSMA) including the requirement to satisfy the Threshold Conditions (TCs) at Schedule 6 to FSMA to obtain Part 4A Permission. The changes were not designed to lower these minimum standards for obtaining and retaining

- **introducing an additional option for the authorisation process,** referred to as 'mobilisation' which offers a more flexible approach to account for the variations in the applications received from firms[3]
- **streamlining information requirements** during the authorisations process so that the overall burden on firms is reduced (regardless of whether the firm opts for the mobilisation route)

These recommendations were made by the FSA and Bank but implemented by the FSA successor bodies, the Prudential Regulation Authority (PRA) and by us, the Financial Conduct Authority (FCA). Under the reformed system, banks are dual regulated and a bank is authorised by the PRA with the consent of the FCA.[4]

We expected the intervention to make the authorisations process cheaper and quicker for potential new banks, reducing barriers to entry and increasing the number of firms entering the UK banking sector. We anticipated this would lead to an increased competitive challenge to existing banks and benefits to consumers across a range of products.

This evaluation focuses on the benefits of this initiative on competition in the UK banking sector, and less so on the wider implications for prudential risks which relate to the activities of these new banks, and financial stability in general.

## We use a mix of qualitative and quantitative analysis to evaluate the impact of the intervention

There is no clear single and robust counterfactual for this intervention. We have developed a causal chain that explains how we would have expected the changes to the authorisations process would lead to increased competitive benefits to consumers. We have undertaken several discrete pieces of analysis to test key changes along the causal chain. If the analyses demonstrate that our expectations are met at the various stages of the causal chain, we can have some confidence, even in the absence of a single strong counterfactual, that any final positive impact is due, at least in part, to the 2013 intervention.

We focus on quantifying the impact of the intervention by analysing a mix of transaction-level data, regulatory submissions, other publicly available data and insights from firms themselves. This is summarised in Figure 1.

permission, but aimed to make the authorisation process more straightforward for those firms that met the TCs. Firms who do not meet the TCs are not authorised.

3 The applications received from firms may vary, for example, due to different banking models. The three stages of the mobilisation route are: pre-application support, assessment and authorisation (based on a shorter application that focuses on key essential elements), and mobilisation (where successful firms mobilise the remaining requirements such as capital, personnel, IT and other infrastructure). The mobilisation route is for firms that require the certainty of an authorisation before a significant capital outlay.

4 Under s.55F FSMA the PRA will grant a bank Part 4A permission (to carry out the regulated activity of accepting deposits) with the consent of the FCA. Applicant banks need to make a single application to the PRA, the lead regulator, and application is then assessed by the PRA and the FCA against their respective threshold conditions. The PRA is responsible for prudential regulation and supervision of banks, while the FCA regulates their conduct.

**Figure 1: A summary of our evaluation approach**

**Descriptive statistics**

**Analysed regulatory submissions** of **33 firms** which entered the UK banking sector in the **4** years either side of our intervention

To see whether there is a change in firm's deposit-taking and lending activities as a result of the changes to the regulatory requirements and authorisations processes

**Econometric Analyses:**

**Comparison of entry in the UK with 26 EU countries**

**43 firms*** authorised in the **UK** and **682 firms** authorised in **26 EU countries** over 8 years

We use entry across EU countries as a comparator group (albeit not a perfect one) to try and identify whether factors other than the 2013 changes may have facilitated entry. We have adopted a statistical approach called 'difference -in-difference' using data on firms authorised across the EU and UK.

**Comparison of product offerings**

**Econometric analyses of** **650,000** mortgages and **1,550** fixed-term deposit accounts

We use transaction data and market data from Moneyfacts to understand the impact entry has had for mortgages and fixed-term savings accounts

**Qualitative insights**

**Qualitative insights gathered from** **11** firms which have entered the retail banking sector since April 2013.

Interviewed firms to understand:
- views on the authorisations process and the impact it had
- how entrants are competing in the market
- benefits to consumers

* We compare the number of banks authorised in the UK to the number of Monetary Financial Institutions (MFIs) authorised in other EU countries. We have excluded the data observations for Ireland, treating the series as an outlier. Excluding Ireland has not affected our findings. Of the 43 banking permissions granted to firms in the UK, we only consider 33 firms to be entrants to the UK banking sector (see section 2).

**Source: FCA**

## The intervention has had a positive impact on entry but not yet a substantial effect on competition and outcomes for all consumers

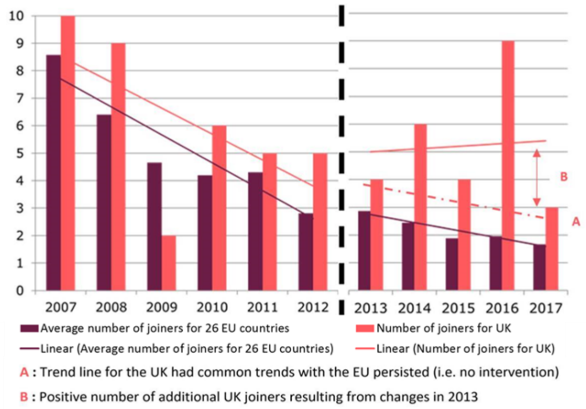
Overall, our ex-post evaluation shows that the intervention has had a positive impact on the number of firms entering the UK banking sector, and has provided better outcomes for some consumers. But, it has not yet had a substantial effect on competition and the broader retail banking sector. We summarise our main findings in Figure 2 below.

## Figure 2: A summary of our evaluation's main results

**The estimated impact of our intervention**

***Panel A: Comparison of entry in the UK and EU***

**Our difference-in-difference approach shows that in the 4 years since the 2013 there has been a marked increase in the rate of entry in the UK compared to entry pre-2013 and also compared to the 26 other EU countries pre-and -post 2013.**




***Panel B: Success of post-review entrants***

**- In the 4 years after the intervention post-review entrants gained almost twice the market share* of lending and deposits than pre-review entrants had in 4 years before the intervention. (But many of the pre-review entrants were not reliant on the deposit market extensively, as opposed to interbank or parent funds).**

**- Post-review entrants offer:**

- **between 30 and 100 basis points more on fixed-term savings accounts compared to other banks.**
- **an average of 25 basis points less on 2 year fixed-rate mortgages compared to other banks**
- **an average of 45 basis points less for 5 year fixed-rate mortgages compared to other banks**
- **specialised mortgages extending the product range beyond that offered by other banks**

**- Mortgage borrowers of post-review entrants saved c.£3m in interest payments, in the 1st year of their loans when comparing charges on similar mortgages in 2017.**

* Although the market share of post-review entrants remains below 1%.

**Source: FCA**

- **There is a more efficient authorisations process**. The time taken to assess firms' applications has gone down from 10.6 to 7.3 months. This is a result of changes to the authorisations process, as well as the extensive pre-application engagement between firms, the PRA and the FCA.
- **Rate of entry into the UK banking sector is higher** than before the 2013 review and higher than in other EU jurisdictions. While not all entry can be solely attributed to the changes in the authorisations process, firm interviews have indicated that the interventions have encouraged entry into the UK banking sector. In the 4 years since the 2013 review, the UK has seen an increase in the number of firms authorised relative to the average entry for the other EU jurisdictions.
- Post-review entrants have gained almost twice the market share of lending and deposits than pre-review entrants had in the 4 years before the intervention and have grown their deposit-taking and lending activities at a marginally faster rate than entrants before 2013. This increased growth rate may be due to several factors, of which the change to the regulatory regime is one consideration.
- However, in the 4 years since the intervention **new entrants have only gained a small share of the UK banking market sector**. The share of post-review entrants is c.0.5% of lending by all banks and c.0.8% of all banks' deposits by the end of June 2017. It may take several years for these firms to gain a significant share of deposits and lending.
- The increase in entry has in turn led to a **greater range of product offerings** in the retail market. This is often coupled with better interest rates. Post-review entrants offer between 30 to 100 basis points more on interest rates for fixed-term deposit accounts and have a lower annual percentage rate of charge (APRC) for the mortgages analysed. Comparing similar loans taken out in 2017,

mortgages by post-review entrants are an average of 25 basis points cheaper for 2-year fixed mortgages and an average of 45 basis points cheaper for 5-year fixed mortgages. This has generated **clear benefits for consumers**. For example, in the first year of their loans, data suggests that new entrants' mortgage borrowers saved around £3m in interest payments compared to taking a similar mortgage with an existing bank.

- However, there has **not yet been a substantial change to concentration in the retail banking sector**, nor do we have evidence of significant competitive responses (eg more attractive borrowing rates) by incumbent banks.
- Low barriers to entry **are a necessary but not sufficient condition for healthy competition**. The impact on competition in banking has so far mainly benefitted those consumers that have switched to the new entrants. The increased number of competitors has **not yet benefitted many customers of incumbents because barriers to expansion remain** which affect the ability of entrants to compete, especially for more 'sticky' consumers (hence the small combined market share of new entrants). Unless the larger incumbent banks feel a competitive threat from the new entrant, their customers will not benefit.

Could this be about to change? Interventions such as the recently introduced Open Banking initiative are designed to lower some of the long-standing barriers to switching and help smaller and newer banks to grow and achieve scale. Our Strategic Review of Retail Banking Business Models looks at the competitive advantages and disadvantages of incumbent banks' business models and the potential scenarios of change.

**Lessons learned**

We view evaluations as an opportunity to learn from our previous interventions and feed any insights into our current and future work. Our main lessons learned from this evaluation are:

- Lowering barriers to entry is effective and has a positive impact on entry, and delivered benefits to consumers. We have seen, for example, new entrants with significantly better offerings on specific products.
- However, ease of entry is a necessary but not sufficient condition for healthy competition. It takes time for lowering barriers to entry to affect market shares in a significant way because there may be other barriers to firms expanding to a more significant scale. Small scale or niche entry may not be enough to force incumbent banks to compete harder to protect market share.
- The changes introduced by the PRA and the FCA have improved the speed and transparency of the authorisations process and allowed for greater regulatory engagement.[5] While the requirements for new firms have not changed, the new approach to authorisation has had a positive impact on entry. This suggests clearer, transparent processes and engagement can have a significant positive impact on all our interactions with firms, as they make it easier and quicker for firms to understand and meet our expectations. This can affect levels of compliance, for example, as well as the authorisation of new firms into other sectors we regulate.

5 The PRA and FCA have their respective Threshold Conditions (TCs) which must be met by a firm at authorisation and on an ongoing basis. As such their TCs will form the basis of each respective regulator's assessment of your application. More detail on the PRA's and FCA's Threshold Conditions can be found here.

# 1 Overview and purpose of the evaluation

## The changes to the regulatory requirements and authorisation process

The reports published by the Office of Fair Trading (2010) and the Independent Commission on Banking (2011) into competition and barriers to entry in the banking sector recognised that regulation is only one of the barriers facing new banks. The FSA's position as the gateway to the UK banking sector meant it was important that the regulatory requirements were not unnecessarily burdensome and maintained the required standards for firms entering it. Subsequently, the Treasury asked the FSA and the Bank of England to review the prudential and conduct requirements for new entrants to the banking sector to ensure they are proportionate and do not pose excessive barriers.

The 2013 review sets out the findings from a review of FSA processes and rules, and describes changes that were designed to facilitate easier market entry. It covers changes to prudential requirements for a bank to be authorised, and the process through which these changes are applied. The 2013 review revealed that applicant concerns about barriers to entry were focused on: the level of capital requirements for new banks and their ability to raise it, the level of liquidity requirements of new banks, the lack of certainty in the authorisation process and the way in which the process is executed.

The changes introduced by the FSA and Bank in applying regulatory requirements to new entrants were along two dimensions: reforms to the authorisations process and a shift in approach to the prudential regulation of banking start-ups. In particular, the 2013 review focused on addressing these issues by:

- **Reducing capital requirements** for new banks at authorisation, and the subsequent 3 to 5-year period.[6]
- **Reducing liquidity requirements** for new banks.[7]
- **Improving the authorisations process** so that the FCA and PRA provide an assessment and complete decision-making process within 6 months of receiving a complete application form with supporting materials. To support firms in their application, firms get a significant level of up-front support during the pre-application stage.[8]

6 Page 9 of the 2013 review offers capital concessions at authorisation and in the subsequent 3 to 5-year period to those new entrant banks that the FSA/PRA judge can be resolved in an orderly fashion with no systemic impact. These changes permit new banks to set capital based on the projected balance sheet at a 12-month period. There are no Pillar 2 capital requirements, simply because the firm is new; and the Capital Planning Buffer (CPB) is set as the wind-down costs of the bank, typically the operating costs for the next 12 months.

7 All new banks benefitted from the reduction in liquidity requirements previously announced in the FSA's Policy Statement PS13/1; and the review set out no automatic new bank liquidity premium.

8 This approach is particularly suited to firms that have the development backing, capital and infrastructure to allow them to set up a bank at speed; (e.g. subsidiary of a bank or where the bank can use existing IT and other infrastructure).

- **Introducing an alternative route for authorisation** referred to as 'mobilisation', which provides a 3-stage route to authorisation to account for the variation in firms' applications.[9]
- **Streamlining information requirements** of the authorisations process so that the overall burden on firms is reduced (regardless of the route they pursue).

These changes aimed to reduce barriers to entry into the UK banking sector, enabling an increased competitive challenge to existing banks. They were not designed to lower the minimum standards for entry but aimed at facilitating entry for those firms that met the required standards. Banks are still required to meet standards that prevent undue risks to the financial system and consumers.

## Previous findings and views on the impact of the changes

In A review of requirements for firms entering into or expanding in the banking sector one year on the PRA and the FCA noted the revised approach to setting capital for new entrants had delivered in line with the expectations of the 2013 review. New banks held lower levels of capital when entering the market than would have been required under the old approach. In addition, the option of a mobilisation stage had been widely welcomed by firms, trade bodies and other market commentators as addressing their concerns. Furthermore, following the 2013 review, potential applicants had commented positively about the regulators' willingness to engage during the pre-application phase.[10]

In the speech Two years on from the March 2013 publication of 'A review of requirements for firms entering into or expanding in the banking sector' the PRA noted that feedback from new banks indicated that the new regime for authorising new firms was working and was seen as a more proportionate regime. The proportionate approach to regulating new entrants as well as the strength and transparency of UK regulation was expected to attract both UK and international entrants. Entrants were making inroads into the market, although it was recognised that it might take many years for them to gain significant market share. It was also noted that there had been a wider pool of applicants aiming to provide new services and products or using new technologies.

The Competition and Markets Authority (CMA), as part of its retail banking market investigation in 2016, noted bank authorisation had undergone significant change in recent years and enabled a more flexible approach, including the option for firms to become authorised with restrictions. The revised regulatory requirements and authorisations process had facilitated the entry by several new providers. The CMA found that recent (and prospective) entrants had welcomed the changes to the authorisation process. In addition, new and prospective entrants also benefited from the New Bank

9 The mobilisation phase is designed for firms that require longer lead times in terms of raising capital, or setting up infrastructure. These firms, while authorised, have restrictions placed on their permission which limits their market activity (particularly deposit taking) until the required capital and infrastructure has been put in place. That is, the PRA can grant authorisation but with a restriction that will enable the firm to mobilise the remaining requirements such as capital, personnel, IT and other infrastructure, all of which are easier for firms to develop if they have already been authorised.

10 The PRA will have regard to barriers to expansion in its supervisory approach, consistent with the principle to have regard to the need to minimise any adverse effect on competition.

Start-Up Unit, which provides support to entrants in the process of becoming a new bank and in the early years following authorisation.

The PRA's 'Second Annual Competition Report' (2017) commented that the composition of banks entering the UK had changed with several new banks authorised being UK banks. There had also been innovation in the business models of the banks authorised, with some banks providing retail banking services to customers entirely digitally.

## The evaluation and its aims

As stated in our Mission, evaluation is a critical part of getting our interventions right. Finding out the impact of past interventions helps develop a strong evidence base to guide our decisions. These decisions can include which issues to prioritise and how best to intervene to tackle harm.

We published a proposed framework outlining the way we measure the causal impact of our interventions in April 2018. The framework explains:

- why we do post-intervention impact evaluations[11]
- how we choose specific interventions to study
- how we ensure that our evaluations are robust, impartial, and, therefore, credible

This report follows the proposed approach to post-intervention impact evaluations, and is one of three pilot evaluations. This evaluation aims to build upon the findings of previous reviews, which mainly focused on the effect changes to the authorisation process has had on the number of firms seeking entry to the UK banking sector. The aim of this work is to understand:

1. the impact of the FSA and Bank of England's (Bank) interventions to lower barriers to entry in the banking sector in 2013 and
2. whether the intervention met its objective of increased competitive challenge to existing banks and benefits to consumers across a range of products

We do this by focusing on the main changes that we expected to see after the intervention; and less so on the wider implications for prudential risks which relate to the activities of these new banks, and financial stability in general.

## Report structure

- Section 2 sets out an economic framework for this evaluation
- Section 3 looks at changes to entry in the banking sector
- Section 4 comments on the banking services and product offerings of entrants
- Section 5 considers changes in the growth of entrants
- Section 6 explores the benefits from entry consumers experience
- Section 7 concludes with the main lessons that we have learned from this evaluation and
- a Technical Annex provides further details on the analyses in sections 3, 5 and 6

11 We refer to post-intervention impact evaluations, or ex post impact evaluations, as 'evaluations' in this report.

# 2 Approach to the evaluation

In this section, we set out how we have approached evaluating the impact of lowering barriers to entry to the UK banking sector, describe the methodology and the main sources of information we have used.

## The expected outcomes from the intervention

A causal chain, or pathway, or logic model, describes the causal mechanisms by which an intervention addresses the identified market failure and reduces harm, leading to costs and benefits. It does this by linking the intended intermediate and final outcomes with the intervention inputs, activities, processes and theoretical assumptions.

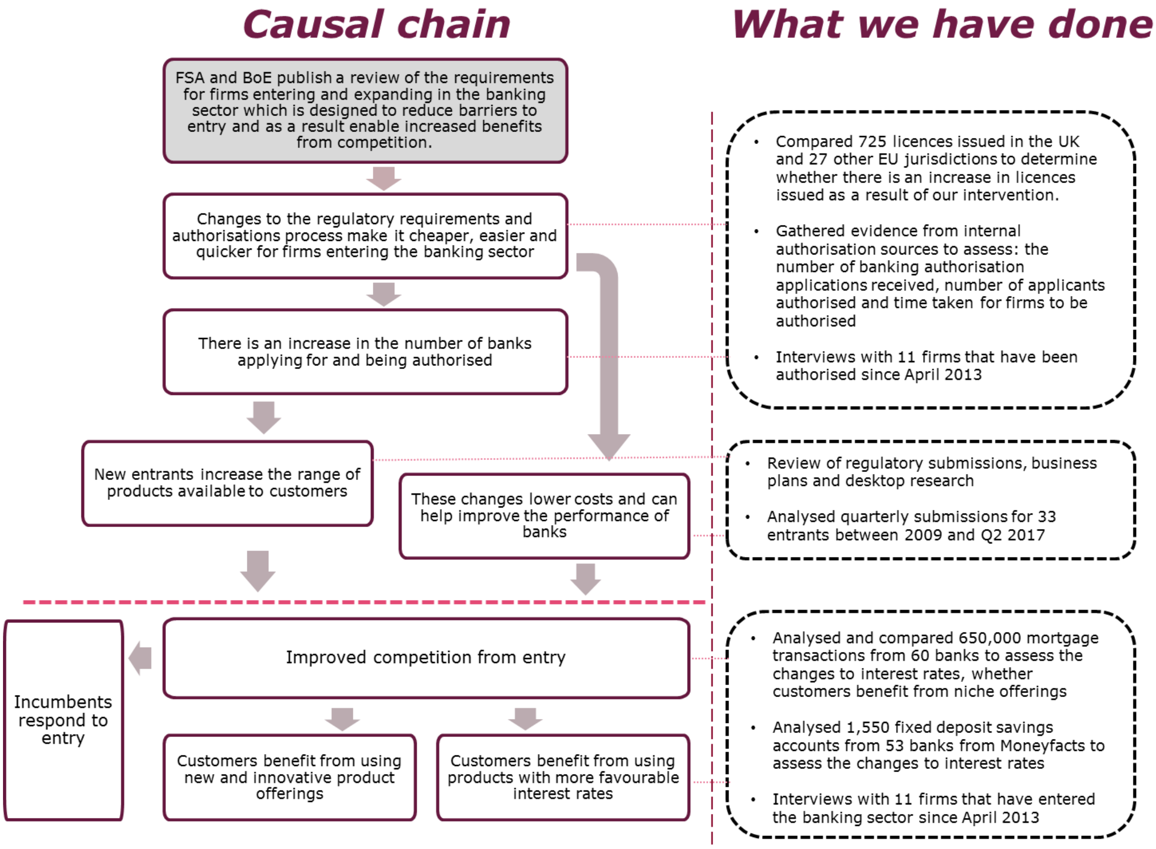
Figure 3 sets out a causal chain of the expected impact arising from the 2013 intervention and how we have analysed whether this has led to an increased competitive challenge to existing banks and benefits to consumers across a range of products.

Lower capital and liquidity requirements as well as a more efficient authorisations process result in lower costs for firms entering the UK banking sector. Lower regulatory costs and a more efficient authorisations process, in turn, help facilitate entry and increase the number of banks entering. As more firms enter the market, additional products are also offered to consumers.

Entrants offer improved or differentiated products to compete for custom. Consumers subsequently benefit from these product offerings. Incumbents respond to entry and change their offerings or prices. When competition works well, we expect it to drive down costs and prices, improve service standards and quality and increases access to financial services.[12]

12 For a further discussion on this, see Our Approach to Competition.

**Figure 3: Causal chain**




**Source: FCA**

## The counterfactual

To evaluate the impact of the 2013 review, it is important to consider the most likely outcome if it had not happened. However, we are only able to observe how the UK banking sector has evolved since the FSA and Bank's intervention. So, it is important to define what would have happened if the 2013 review had not occurred. This is our 'counterfactual'.

Overall, it is difficult to establish with any degree of certainty what the level of entry would have been had the FSA and the Bank not intervened.

The causal chain at Figure 3 explains how we would have expected the changes to the authorisations process to lead to increased competitive benefits to consumers. We have undertaken several discrete pieces of analysis to test key changes along the causal chain. If the analyses demonstrate that our expectations are met at the various stages of the causal chain, we can have some confidence, even in the absence of a clear single and robust counterfactual, that any final positive impact is due, at least in part, to the 2013 intervention.

For this evaluation, we assess entry into the banking sector before and after the 2013 review. There are several reasons why entry could have increased, even absent the intervention, such as changes in macroeconomic conditions or technological costs. Such considerations would also affect our baseline.[13] We try to net out other factors that would have affected bank entry irrespective of the intervention, by comparing entry in the UK against a comparator. We use the number of Monetary Financial Institutions (MFIs) in 26 other EU countries.[14] We are mindful that the macro-economic circumstances may have differed between the UK and the EU countries, which would limit the usefulness of the comparator. However, we consider that significant differences in the rate of entry between the UK and other EU countries would be at least indicative of positive changes in the UK market, including the 2013 review.

Similarly, we consider that without the 2013 review, the post-2013 entrants' performance would have continued to evolve in the same way as pre-review entrants. To identify the effects of the 2013 review on the performance of entrants, as far as it is possible, we compare the growth of entrants in each cohort to the other to see whether there is any change. In doing so, we compare the growth of the deposit taking and lending activities of entrants. We also compare the performance of entrants to incumbents to gauge the impact different market conditions may have had; for example, the market relating to mortgage products has varied between 2009 to 2017.

Government and regulatory strategy since the crisis has sought to tackle multiple contributing causes of weak competition and may have contributed to better performance by post-review entrants. This includes interventions such as the 7-day switching guarantee, the creation of the Payment Systems Regulator (PSR), CMA remedies from the retail banking inquiry (such as open banking) and the Payment Systems Directive (PSD2). Banks entering before 2013 may not have had the advantage of these regulatory interventions or market changes such as developments in technology.

Having established that the changes to the regulatory requirements and authorisations process have led to increased entry and better performance, we assess the extent to which customers benefit from post-review entrants. We compare the product offerings of post-review entrants to pre-review entrants and incumbents. In doing so, we focus on offerings within the retail banking sector.

## Establishing how well the intervention has worked

To provide a view on how well the intervention has worked, we begin by testing key outcomes against the expected impact of these interventions. Our expectations are set out in Figure 3, which shows how we expected the intervention to work to meet its intended objectives. We compare observed outcomes with what we consider the most likely outcome without the intervention.

Regarding the changes to the regulatory requirements for authorisation, no banks that have entered since April 2013 have failed. But they have all been authorised under benign conditions, and the resilience and sustainability of their business models over the full length of a credit cycle is yet to be tested.

13 No CBA was undertaken as the review itself did not propose new rules, and therefore, there was no obligation under FSMA to conduct a CBA.

14 MFIs encompass the following undertakings: central banks, credit institutions (including banks), other deposit-taking corporations and money market funds. The ECB notes that there 'are four events that could result in a financial institution joining the MFI sector: a) the establishment of an MFI because of a merger; b) the establishment of new legal entities as a result of the division of an existing MFI; c) the establishment of a new MFI; or d) a change in the status of a previous non-MFI, such that it becomes an MFI.'

For each row in Table 1, we set out: a question that, when answered, helps understand the extent to which the intervention has worked; our expectation and where, in this report, we present findings from our analysis to address the question.

### Table 1: Expected outcomes from the intervention that are tested in this report

| # | Question to answer | Expectation | Report section where findings are presented |
|---|---|---|---|
| **I.** | **Has there been a change to the number of banks being authorised?** | | |
| **1** | Has the rate of entry in the UK improved since the 2013 review? | Cheaper, easier and quicker authorisations process lead to more firms seeking and obtaining authorisation since 2013.[15] | 3 |
| **2** | Has the rate of entry in the UK improved relative to other countries in the EU? | If the changes we observe in the level of entry within the UK banking sector are driven by macroeconomic or technological changes, we would expect to see similar changes to the rate of entry in other EU jurisdictions (albeit we recognise that there have been some differences in macroeconomic conditions across the EU over this period). If we do not observe this then any changes to the rate of entry in the UK may, at least in part, be attributed to the 2013 review. | 3 |
| **3** | Has there been a change to the efficiency in the authorisations process? | Provided firms meet the required threshold conditions, the intervention is expected to result in a shorter time-period in which a bank gets authorised. | 3 |
| **II.** | **Has there been a change to the type of bank entering and the products offered?** | | |
| **4** | Has there been a change in the types of banking services and products offered by new entrants? | As more firms enter the banking sector there is a change to the mix of banking services and products offered to customers. | 4 |
| **III.** | **Has there been a change to the performance of entrant banks?[16]** | | |
| **5** | Have the deposit taking and lending activities of entrants grown? | Lower costs associated with entry mean that post-review entrants grow the deposits they receive at a faster rate compared to pre-review entrants. | 5 |
| **IV.** | **Do consumers benefit from the entry we observe?** | | |
| **6** | Do consumers benefit from entrants' offers on cash savings products? | Entrants attract deposits by offering higher interest rates or new and innovative products compared to incumbents and pre-review entrants. | 6 |
| **7** | Do consumers benefit from entrants' offerings on mortgage products? | Entrants attract borrowers by offering lower costs or new and innovative mortgage products compared to incumbents and pre-review entrants. | 6 |

15 If the 2013 review had not occurred then the rate at which firms enter the UK banking segment would have remained unchanged.

16 Studies in Portugal and the USA indicate that new banks or financial institutions tend to be less encumbered by past business practices and legacy issues and operate efficiently. See, Canhoto, A and Dermine, J. (2003). '*A note on banking efficiency in Portugal, New vs. Old banks'*, Journal of Banking & Finance, 27, 2087–2098); and Isik, I, and Topuz, J. C. (2017) '*Meet the "born efficient"* financial institutions: Evidence from the boom years of US REITs', The Quarterly Review of Economics and Finance 66, 70–99.

We first look at all the firms that were granted banking permissions (ie authorised as a bank). We do this to understand how the changes have affected the overall level of permissions granted. This forms the basis of our analysis relating to part I (or questions 1 to 3 above).

## Distinguishing between authorised firms and entrants

In analysing the impact of intervention, we need to be clear how we define an entrant. We identify as 'entrants' those firms that have established a new bank in the UK and have no ties to a broader UK banking group.[17] These firms are a subset of those firms granted permissions. This allows us to identify those banks which could have benefitted the most from the regulatory change. We do this because we are primarily interested in the effect the intervention has had on the operations of these firms, competition and outcomes for consumers, rather than the impact on firms that already had ties with the UK, for example.

The criteria we used to identify 'entrants' are whether they:

- are newly authorised banks,[18] and
- exited the mobilisation stage (if they opted for this route)[19]

Included in the above are existing firms that have previously been active in lending to customers and have subsequently been granted banking permissions, we consider them to be an entrant into the UK banking sector. Such firms' lending activities were already established at the point of becoming authorised banks, potentially accelerating their expansion. This could affect both cohorts of entrants.

We then remove:

- Banks which were required to subsidiarise (as they had exceeded the PRA's risk tolerance for third country branches) but had a pre-existing branch, as they were already operating within the UK banking sector and therefore have established operations.[20]
- Banks that have a relationship with other banks as part of a broader group structure. We consider the authorisation of these banks as further expansion into the banking sector by the broader group. Particularly as newly established banks which are part of a broader group may benefit from intra-group transactions.

17 The FCA handbook defines a bank:
(a) as a firm with a Part 4A permission which includes accepting deposits, and:
(i) which is a credit institution; or
(ii) whose Part IV permission includes a requirement that it comply with the rules in GENPRU and BIPRU relating to banks;
but which is not a building society, a friendly society or a credit union;
(b) an EEA bank which is a full credit institution.
We have not included non-banks in our analysis for this evaluation.

18 Banks which are not based in the EEA but enter the UK banking market by opening a branch or subsidiary are considered entrants, provided these firms do not have any operations already established in the UK.

19 Three firms were authorised but did not exit mobilisation and therefore never entered the market. Although these firms were authorised, we have not considered these firms as entrants.

20 This is a different set of firms to those in footnote 18.

- Newly created banks that are a product of mergers and acquisitions. These banks will be inheriting an established customer base and trading book. The performance of these firms will also be affected by the operations of the existing bank.
- Banks that have been created as a result of ring-fencing or restructuring activities.
- Banks passporting into the UK banking sector. Although they could also be considered entrants, this option is only available to banks which have already been authorised by another country within the EEA and not available to non-EEA firms entering the UK market. For those banks, passporting is an efficient process by which to enter the UK market and would not be affected by the 2013 changes.

It should also be noted that firms entering the banking sector which do not meet the criteria could have also benefitted from the 2013 intervention. We acknowledge that if the changes enable a banking group to structure itself more efficiently then benefits might accrue to consumers. Although the extent to which they may have benefitted is unclear.

The analysis in parts II, III and IV focuses on the benefits to entrants before and after the 2013 review.

## Information and data sources

To inform the evaluation, we sought to gather a wide range of evidence from a variety of sources. The evidence that we have relied upon can be classed into 5 main categories:

- data on pre-application meetings, the number of firms seeking and obtaining authorisation and the time firms take to get authorised
- regulatory submissions to the FCA; namely: FSA001 and FSA002 (regulatory balance sheet and income statements respectively) and PSD001 (product sales data on regulated mortgages)
- desk-based research and industry reports, including reviews by other regulators
- interviews with banks
- Moneyfacts data

More information on the different sources of evidence we have used during the investigation is provided throughout the report, where we have used this information and data as part of the evaluation.

## Methods used to evaluate the impact of the intervention

We have used different methodological approaches and data to test the pre-intervention expectations in Figure 3. We explain these three analytical methods in further detail below.

### Descriptive statistics

Descriptive statistics provide context on what has happened in the market. The data we use sets out the growth in deposit-taking and lending activities by banks.

We collected data from regulatory submissions from 33 entrants and 295 incumbents, regarding their income statements and balance sheets, between January 2009 and June

2017 (i.e. just over four years either side of the intervention date). We did this to help ascertain whether post-review entrants had experienced a faster growth rate than the pre-review cohort. We also compare changes in the growth by entrants to incumbents. We can, therefore, see whether changes in the growth of entrants are associated with the intervention.[21] We present this data in section 5.

We also use data on the cash savings and mortgage offerings by post-review entrants to better understand the types of products they are offering to customers and the associated interest rates.[22] We present this data in section 6.

## Econometric analysis

We use econometric analysis[23] to diagnose the extent to which there is evidence that, based on the available data, the intervention has led to changes in the market.

*Difference in difference*

To help us identify the impact the changes to the regulatory requirements and authorisations process have had on the rate of entry we use a difference-in-difference (DiD) model. A DiD model compares the rate of entry in the UK (which is affected by this intervention) to the rate of entry in the EU (which is unaffected by the intervention) before and after the intervention. By comparing the change in the rate of entry in the UK to the change in the EU, the model identifies the impact of the intervention in 2013. A divergence in the rate of entry between the EU and UK indicates that there has been a meaningful change in the average number of entrants in the UK since the 2013 review.

We therefore use data on 43 banks which were authorised in the UK and 682 banks authorised in 26 EU countries over 8 years to isolate the impact these changes to regulatory requirements and the authorisations process have had on entry. A further explanation can be found in the Technical Annex.

*Pooled Ordinary Least Squares*

To identify whether entrants offer products at more favourable prices, we use a regression technique called pooled ordinary least squares (POLS). POLS measures the impact various factors have on the interest rates offered by banks over a given time period. In doing so, it identifies the extent to which these factors affect the average interest rate which is offered. So we can assess, statistically, whether there is a meaningful difference between the offerings of post-review entrants and other existing banks within the relevant market.

We undertake econometric analysis of c.650,000 mortgages and c.1,500 fixed term deposit accounts to understand the impact this entry has had for consumers in these markets.  Further explanations are in the Technical Annex.

## Firm interviews

We also use insights from interviews with senior management from 11 new entrants to validate the outcomes we observe from the analytical approaches set out above.

The interviews focused on firms' experience of the authorisation process and the regulatory requirements since these changes were introduced, the extent to which it

21 We note that that throughout this time-period the interest rate environment has remained constant.

22 We consider these products as they are typically the biggest items for banks and entrants.

23 We use 'econometric analysis' and 'regression analysis' interchangeably in this report.

affected their decision to enter the market, and how they have sought to compete for custom within the retail banking segment.

# 3 Changes to entry into the banking sector

**Section summary**

Our analysis shows that:

- Comparing a 4-year period before and after the intervention in 2013, the rate of entry into the UK banking sector has increased from 4.5 to 5.6 banks per year. In contrast, since the review, each year has seen an average per country of 2.3 MFI joiners for 26 other EU jurisdictions.
- Compared to a baseline that we establish, we estimate that in the 4 years since the 2013 review there has been an increase in the number of firms authorised in the UK relative to the average entry for the other EU jurisdictions. Not all the entry observed can be attributed solely to the intervention.
- There is a more efficient authorisations process. We find that firms which meet the Threshold Conditions are more likely to be authorised within 12 months. 85% of firms were authorised within 12 months compared to just over half of applicants being authorised within 12 months before the intervention.[24]
- There is a reduction in the time taken to assess firms' applications from 10.6 to 7.3 months. This is a result of changes to the authorisations process as well as the extensive pre-application engagement between firms, the PRA and the FCA.

## Entry in the UK before and after the 2013 review

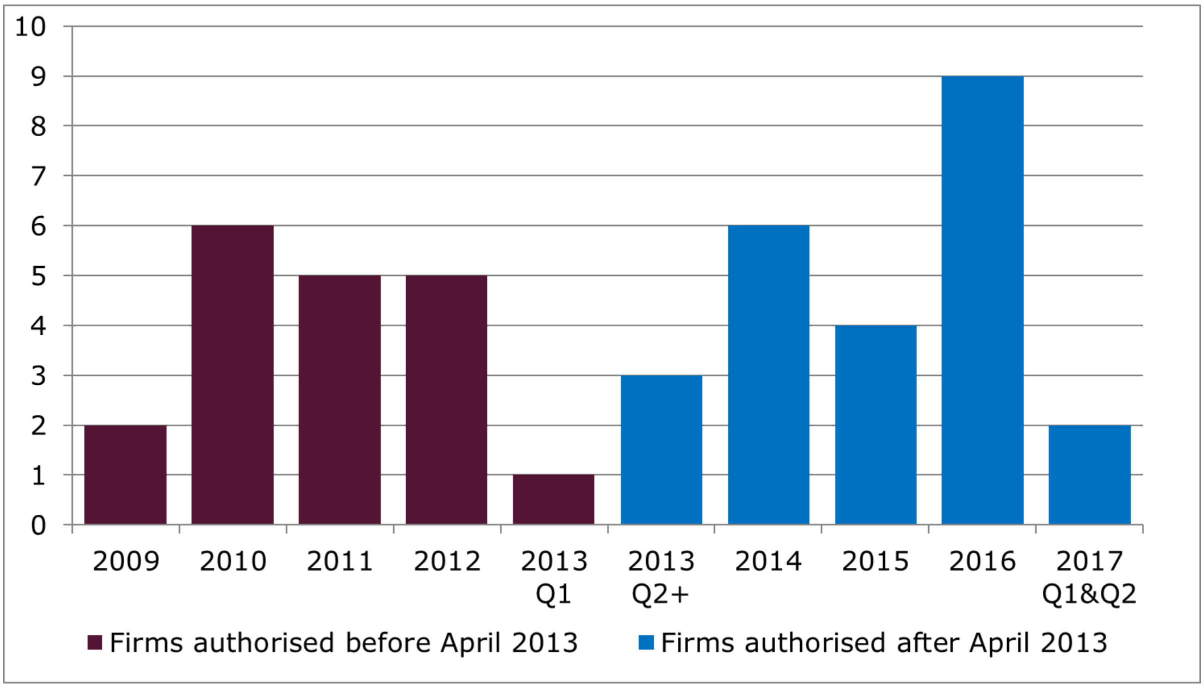
Previous assessments by the FCA and PRA indicated that the 2013 review led to an increase in the number of firms being granted banking permissions. Between 2009 and 2017 Q2, a total of 43 new banking permissions were granted. Of these, 19 were granted before April 2013, when the FSA and the Bank's intervention was implemented and 24 banks have been authorised since the intervention; as shown in Figure 4 below.

There has been an increase in the rate at which firms are obtaining banking permissions since the 2013 review. On average, there were 4.5 firms per year that were granted banking permissions in the four years preceding the 2013 review, and this has increased to 5.6 in the 4 years after 2013, with a significant increase in 2016.[25]

24 S.55V FSMA sets the statutory deadlines for determining applications for authorisation under Part 4A: 6 months for a complete application and 12 months for an incomplete application. Occasionally, applicants will withdraw an application and re-apply to restart the clock. In these instances, the time taken to assess the firm's application may be longer than 12 months.

25 Only 2 banks have passported into the UK since 2009 with deposit taking permissions, and both have done so after the 2013 regulatory change. So, the vast majority of deposit taking banks entering the UK have been authorised by the PRA with the consent of the FCA. We have not included these 2 passporting firms in this analysis.

## Figure 4: Overview of banks authorised




**Source: FCA analysis of authorisations data.** Note that the figures in the following three columns are not directly comparable with others: 2013 Q1 (one quarter), 2013 Q2+ (3 quarters) and 2017 Q1 & Q2 (2 quarters).

On the whole, it is difficult to establish with any degree of certainty what the level of entry would have been had the FSA and the Bank not intervened. There are several reasons why entry could have increased, even absent the intervention, such as: changes in macroeconomic conditions or technological costs. However, during our interviews with banks, they told us they considered the authorisations process under the FSA as a 'black box'. The changes proposed by the FSA and the Bank and introduced by the FCA and PRA have improved the transparency of the authorisations process and allowed for greater regulatory engagement.

Many of the banks we interviewed indicated that these changes to the regulatory requirements and authorisations process were a catalyst in their decision to apply for banking permissions; and were a determinant in deciding to apply for banking permissions rather than enter the UK banking sector through an acquisition.[26]

Most firms also indicated that they did not consider the regulatory requirements and authorisation process to be a significant barrier to entry.[27] Rather, many said the biggest challenge they faced was the ability to raise sufficient funding from potential investors. For some banks, introducing the mobilisation phase made it easier for them to attract the required level of investments as they were able to raise capital in tranches before they were authorised as a bank and again in mobilisation.

This evidence suggests that at least part of the increase in entry since April 2013 shown in Figure 4 is attributable to the review.

26 Some banks also indicated that they viewed the following as challenges to entering the banking sector: the ability to obtain agency banking services, sourcing the right IT solutions and recruiting the right personnel. Although, not all banks considered all these issues to be barriers to entry.

27 This is congruent with the CMA's finding that bank authorisations have undergone significant changes in recent years which have facilitated the entry by several new providers.

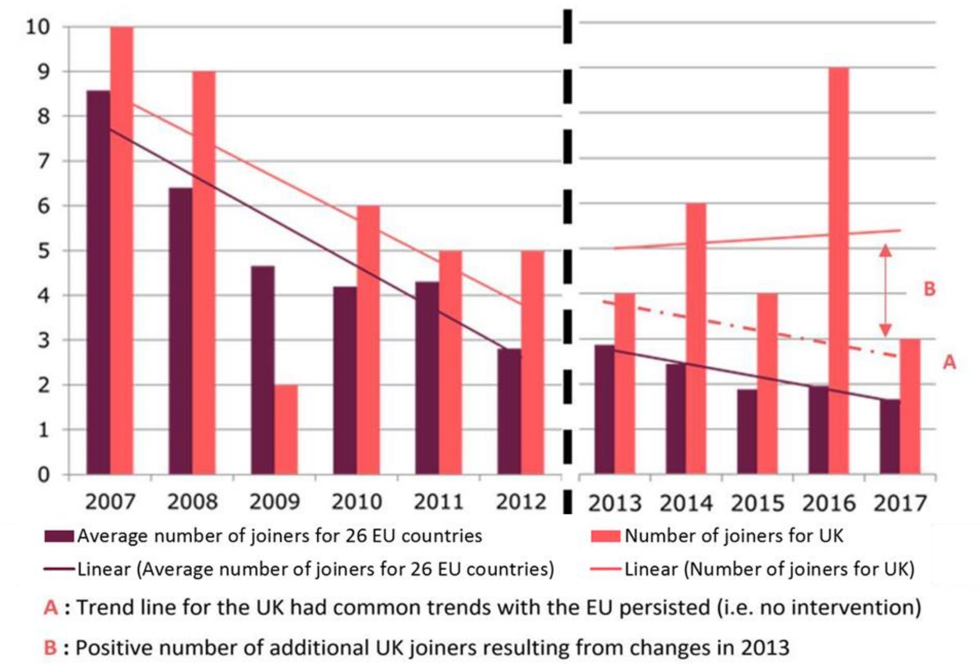
## A comparison of entry into the UK and the EU

Given the increase in the number of firms being authorised in the 4 years after April 2013, we compare the average rate of entry in the UK to other EU countries. If we do not observe a similar increase in the number of banking permissions granted in other EU countries during this time-period, then we consider that significant differences in the rate of entry between the UK and other EU jurisdictions may be indicative of changes in the UK market, including the 2013 review. Interviews with firms also suggest that there have been positive changes in the UK banking sector because of the intervention.

Data on the number of MFIs joining each EU country is submitted to the European Central Bank (ECB) by the respective central banks once a quarter. These data have been combined with the number of banking permissions granted in the UK.[28]

Figure **5** shows that the average number of banks authorised in the UK each year and the average number of MFIs entering across all other EU countries has declined between 2007 and 2013, in the aftermath of the financial crisis. As the level of entry in the UK and across the EU has declined at a similar rate between 2007 and 2013, there is a common trend between the average number of MFI joiners across other EU countries and the number of banks authorised in the UK during this period. We therefore use the average number of MFI joiners per country in 26 other EU jurisdictions as a comparator group for the UK.

**Figure 5: Banking licences issued in the UK and EU**




**Source: FCA analysis of ECB data and FSA/FCA data.** Note the data on banks authorised includes all firms that have been authorised in the UK, including both UK domiciled and foreign banks.

28 We noted that the ECB series for the UK does not match our own analysis of the number of banking licenses issued. The major difference between the MFI series and the FCA data is the timing of when banking permissions were granted. In aggregate, the number of MFI joiners submitted to the ECB is very similar to the aggregate number of banking joiners drawn from the FCA data for the 2009 to 2017 period. We have therefore replaced the UK MFI joiners' series with our own analysis of the number of banking licenses issued each quarter. We also noticed that there appear to be issues with the data for Ireland. So, we have removed the data observations for Ireland, treating the series as an outlier. Excluding Ireland has not affected our findings.

Since 2013, a divergent trend has emerged between the UK and other EU countries. There has been an increase in the number of banks entering the UK while the average number of MFIs entering other EU countries has continued to decline. This suggests that the UK has seen a greater level of entry by banks.[29]

We recognise that these EU countries have experienced specific shocks which the UK was not subject to, such as the Euro-crisis. We consider it unlikely that these shocks have affected all 26 countries at the same time; i.e. the Euro-crisis would have impacted entry into the banking sectors in these countries in different ways and at different times. To control for the impact these shocks may have had on these countries, we have included country-specific GDP and dummy variables within the regressions.

Using DiD, we compare the permissions granted before the 2013 review (January 2009 to March 2013) to those granted after the 2013 review (April 2013 to June 2017) for the UK and EU, taking into account country-specific factors.[30] Our analysis shows there is an increase in the number of firms authorised to enter the UK banking sector beyond the number of firms who would have entered had the UK continued to follow a similar trend to the EU post-review. The trend observed in the full EU sample analysis broadly carries across to a subsample of EU countries with a comparable number of entrants to the UK (Italy, France, Spain, and Germany). Full details of our analysis are in the Technical Annex.[31]

That is, accounting for EU-wide and country specific factors we show that since the 2013 review the UK has experienced a comparative increase in the average number of banking permissions granted per quarter. It is evident that since the 2013 review, there has been a positive impact on entry into the UK. However, not all entry into the UK can be attributed to the 2013 intervention as some banks told us they were considering entering the UK banking sector anyway.

Notwithstanding the limitations of using other EU countries as a comparator, we consider that this piece of analysis, taken together with other findings, such as our interviews with firms, give us assurance that the 2013 intervention has had a positive impact on entry in the UK.

## A more efficient authorisations process

The intervention has also had a positive impact on the time it takes for firms to be granted permissions. Comparing a 4-year period either side of the intervention, it is evident that:

- **Firms which meet the Threshold Conditions (TCs) are more likely to be authorised within 12 months**.[32] (Firms that do not meet the TCs are not

29 For further details see Section 1 of the Technical Annex.

30 We recognise that there are differences between countries and therefore we use a 'fixed-effects' approach at the country level. That is, we attempt to account for factors which may influence the number of joiners in each country; such as changes in tax rates or the country's post-crisis rate of recovery. A more detailed discussion of the regression can be found in the Technical Annex.

31 As explained in the Technical Annex while the number of observations we have for the UK is not large, we are still able to conclude at a statistically significant level.

32 All applications need to be determined in 12 months. On occasion, applicants will withdraw an application and re-apply to restart the clock.

authorised). Since 2013, 85% of firms were authorised within 12 months compared to just over 50% of applicants being authorised within 12 months before the intervention.

- **The time taken to assess firms' applications has gone down.** Before 2013 it took an average of 10.6 months for a firm to be authorised from submitting their application, compared to a current average of 7.3 months. This reduction is a result of changes to the authorisations process as well as pre-application engagement between firms, the FCA, and the PRA.[33]

The changes to the authorisations process have increased the certainty and clarity of the applications process. Pre-application engagement, where potential applicants can discuss and receive challenge on their applications as well as obtain formal feedback, is an important part of this.[34] By having a clearer view of what is expected of them, firms can better plan for the process and development of their business. Since April 2013, the FCA and PRA have had around 40 pre-application meetings each year.

The mobilisation route has been widely used as a means through the authorisation process since it was introduced in 2013. 60 percent of firms authorised have opted to use this route. Of those banks using the mobilisation process, almost all of them have been UK domiciled (and not part of a broader banking group).

The first banks through the mobilisation route noted it was imperfect, although banks who used this option later found it a positive experience. Many banks valued the level of pre-application engagement, and found mobilisation allowed them the ability, for example, to attract the required level investments, source the right IT solutions or recruit the right personnel. However, there remained challenges to setting up a bank and becoming fully operational, such as other regulatory and operational requirements which needed to be fulfilled. Banks also told us that Internal Capital Adequacy Assessment Process (ICAAP) and (Internal Liquidity Adequacy Assessment Process) ILAAP documents required specific skills that were not easy to source. Almost all banks who entered since the 2013 review did not consider the regulatory requirements and authorisations process to be a substantial barrier to entry.

We conclude that these changes have made it easier for new banks to enter the market.

33 However, the time firms spend engaging with the FCA and PRA is not reflected in the current average of 7.3 months as this occurs before the application is submitted. In addition, those firms that opt for mobilisation, are not fully operational when they are authorised (whereas they would be under the old process).

34 It is expected that firms act on the feedback received during these pre-application meetings.

# 4 Banking services and products offered by entrants

**Section summary**

Our analysis shows that:

- There has been an increase in UK domiciled banks since the intervention. Almost two-thirds of all new banking permissions were granted to UK domiciled banks compared to 22% in the 4 years before 2013. This indicates an increase in the number of new banks establishing operations in the UK from scratch.
- There has been a shift towards entrants offering more retail banking products and specialised SME banking services.
- A number of innovative business models have arisen since the review.

Having looked at the total number of firms authorised, we examine the changes in 'entrants' to the UK banking sector.

Between January 2009 and the end of March 2013 there were 14 entrants, and since April 2013 there have been 18.[35] As well as an increase in entrants, there has been a change in the entrants' country of origin. Before the intervention 22% of entrants were UK domiciled, whereas almost two-thirds of post-review entrants have been UK domiciled. Overseas banks[36] are establishing operations in the UK through a branch or subsidiary, often to serve a corporate client base and operate in the wholesale segment of the market. UK domiciled entrants are in the main establishing a new bank aimed at providing banking services to a particular segment of the UK market. We focus on these services and products in this chapter.

## Banking services offered by entrants

Table 2 shows the different types of banking services offered by entrants. After the intervention, no banks offering investment banking services have entered. Rather, there has been a departure from wholesale banking services, typically offered by overseas banks, towards more varied retail banking offerings and specialised SME banking services. This is also reflective of a broader trend, since the post-financial crisis, with banks transitioning towards retail deposits as a more secure form of funding, as indicated by the Strategic Review of Retail Banking Business Models.

35 Although 24 firms were authorised, we only consider 18 to be entrants into the banking sector. See section 2 above, on how we identify entrants.

36 Overseas banks are those firms entering the UK which are not already established within the EU.

### Table 2: Banking services offered by pre-review and post-review entrants[37]

| Banking services offered | 2009 Q1 – 2013 Q1 | 2013 Q2 – 2017 Q2 |
|---|---|---|
| **Wholesale banking** | 4 | 1 |
| **Corporate banking** | 4 | 4 |
| **Retail banking** | 7 | 9 |
| **Specialised SME** | 2 | 4 |
| **Clearing bank** | 0 | 1 |
| **Investment banking** | 3 | 0 |
| **Private banking** | 1 | 1 |

**Source: FCA analysis of company websites and regulatory business plans**

The product offerings of overseas banks, which are establishing a branch or subsidiary, and UK domiciled banks tend to differ. Overseas banks are more likely to have an offering tailored to corporate clients, whereas UK-domiciled banks tend to focus on retail offerings to individuals and SMEs.

## Entrants' product offerings

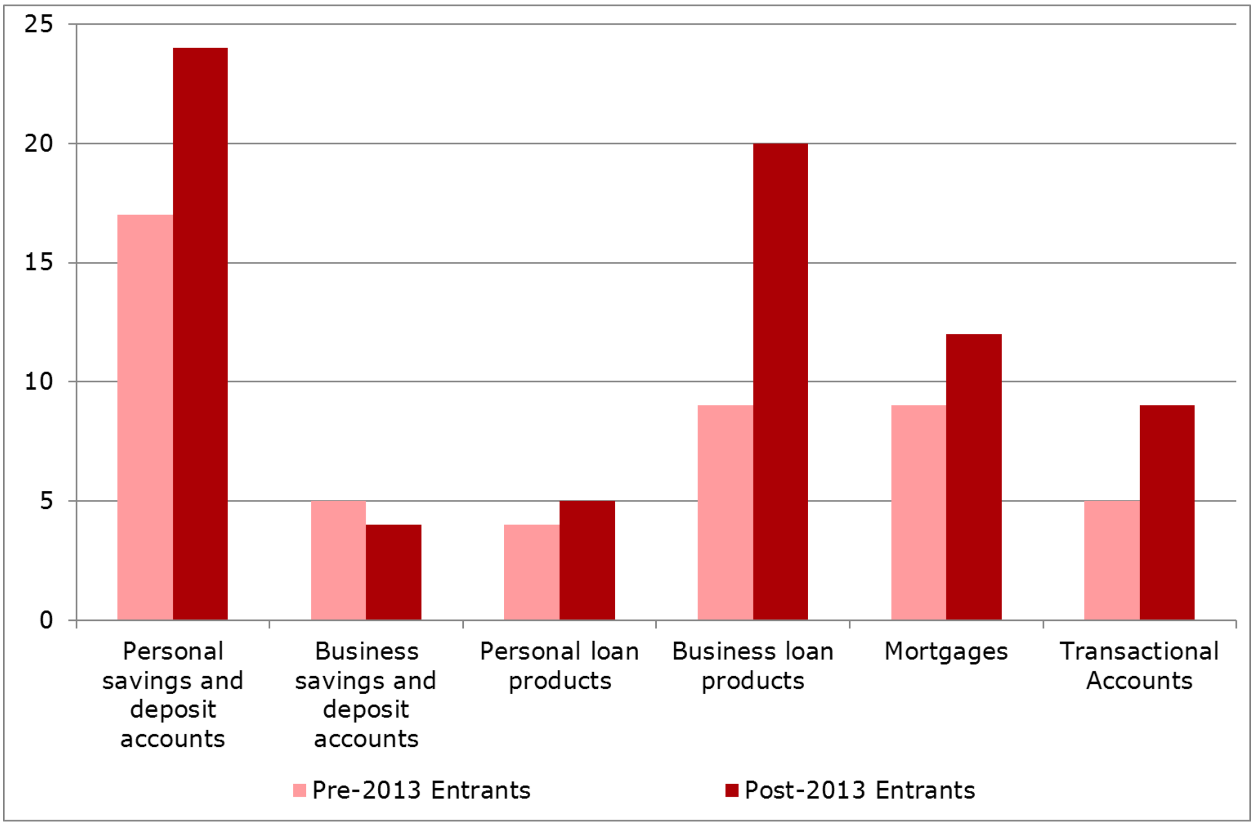
Given the focus of post-review entrants on the retail banking segment, there has been a change in the types of products entrants are choosing to offer consumers. Figure 6 compares the number of different types of offerings by pre-review and post-review entrants across different product groupings. Most notable is the increase in personal saving and deposit accounts offered by post-review entrants, as well as lending products for businesses. There has also been an increase in the number of entrants offering mortgage products to the market.

Few entrants have opted to provide transactional accounts (e.g. current accounts and pre-payment cards) as part of their product offering so little benefit has arisen in these areas to date, but these are now starting to appear.[38]

37 Table 2 includes prospective entrants who are currently in mobilisation.

38 We note that some firms may offer these types of accounts, but without deposit taking permissions (such as e-money providers); but as discussed above we do not consider them to be banks.

**Figure 6: Product offerings by pre-review and post-review entrants**




**Source: FCA analysis of company websites and regulatory business plans**

Alongside the increase in product offerings, a number of innovative banking models have arisen amongst the post-review entrants. Specialised banks have been entering the market targeting specific business segments with bespoke or niche service offerings. Some of these entrants were already providing different types of finance to SMEs before becoming a bank. Other entrants are finding new ways to attract customers, such as differentiating the service proposition offered to SMEs or focusing on particular types of businesses, such as payment service providers.[39]

Many of these banking business models are still in their infancy and are likely to develop with their product offerings. In addition, some post-review entrants have introduced a digital-only offering providing internet or mobile based banking services (e.g. some current account offerings) to their customers in the retail banking segment and do not have any physical branches.

39 Previous findings by other bodies, such as the CMA, have identified a lack of competition within the SME banking segment. So, entry which focuses on the SME segment is a welcome development in the market.

# 5 The growth of entrants

**Section summary**

Our analysis shows that:

- Post-review entrants grew deposit-taking and lending activities at a quicker rate than the pre-review cohort of entrants. As well as the authorisation process, other market factors and regulatory interventions may have contributed to this increased growth.
- Post-review entrants account for around 0.5% of lending by all banks and c.0.8% of all banks' deposits by the end of June 2017. These shares remain low and it may take several years for these firms to gain a significant share of deposits and lending.
- The overall impact of entry on competition and the broader retail banking sector has not yet been substantial.

We consider whether post-review entrants are growing at a faster rate compared to the pre-review cohort.[40] We measure growth by increases to the amount of deposits taken and outstanding loans and balances. First, we look at whether post-review entrants were able to raise relatively more in deposits when compared to pre-review entrants. We then compare lending undertaken by each cohort.[41]

## Deposit-taking activities by entrants

At the end of 2013 and 2017, entrants in each cohort held a total of £4.8bn and £8.7bn worth of deposits respectively. Figure 7 shows a breakdown of total customer deposits for each cohort of entrants.[42] It is evident that post-review entrants have raised considerably more retail deposits in aggregate in the first 4 years of their operation relative to their pre-review counterparts. Most deposits raised by post-review entrants are retail deposits, whereas pre-review entrants have been reliant on both retail and corporate deposits. Also, as shown in the Technical Annex, post-review entrants have grown retail deposit-taking activities at a quicker rate than the pre-review cohort of

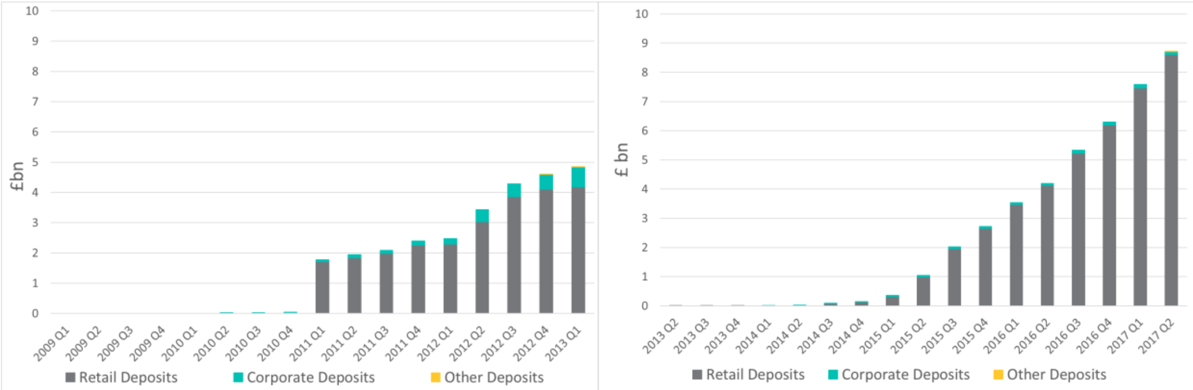
40 Looking at accounting metrics for entrants, such as operating revenue (cost) growth, total costs to total assets and operating leverage, it broadly appears that post-review entrants are more efficient than pre-review entrants. However, given the limited time that post-review entrants have been operating in the market, we were not able to make a definitive comparison. As noted above, studies in Portugal and the USA indicate that new banks or financial institutions tend to be less encumbered by past business practices and legacy issues and operate efficiently.

41 Figures are inflation adjusted to 2017 Q2 values.

42 Total customer deposits comprise of: retail deposits excluding e-money, corporate deposits (deposits from non-bank firms) and other deposits (and does not include e-money and intra-group items). Total customer deposits exclude wholesale deposits. We noted that pre-review entrants received a substantial level of intra-group deposits.

entrants over the first 2 years of their average lifecycle. We note of course that post-review entrants have a stronger focus on retail deposits than pre-review entrants.

**Figure 7: Customer deposits – pre- and post-review entrants**

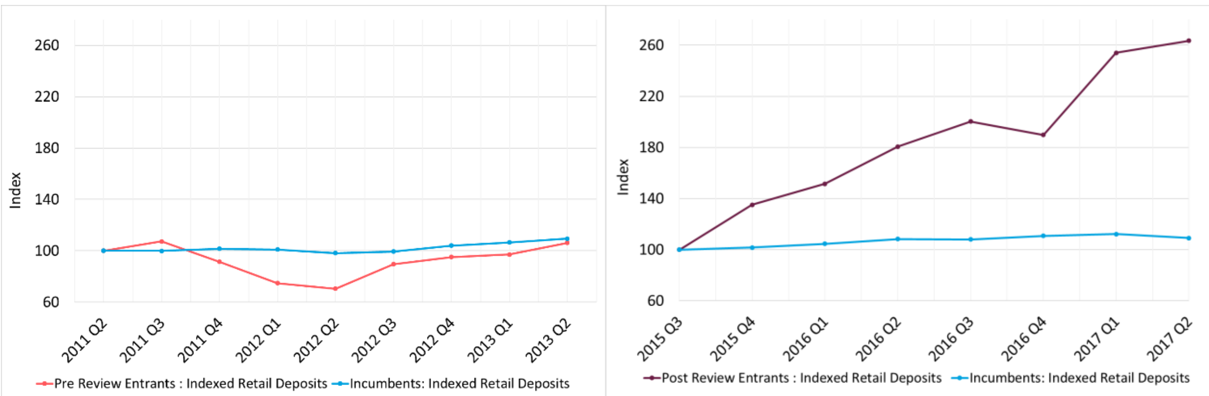



**Source: FCA analysis of FSA001 submissions**

As the number of entrants differs in the 2 periods, Figure 8 shows the average growth in retail deposits for each entrant cohort. The index below[43] shows the growth in deposits for each cohort in the last 2 years for each of the respective periods.[44]

Post-review entrants have, on average, experienced much faster growth in retail deposits compared to the pre-review cohort. In two years, the average post-review entrant had more than doubled the retail deposits they held in 2015 Q3. In contrast, the average pre-review entrant had not increased retail deposits held. As incumbents grew their retail deposits at similar rates in each of the respective time periods, market conditions are not a substantial factor which would have (favourably) impacted the growth of one cohort of entrants more than the other.

**Figure 8: Average growth in retail deposits received by entrants**



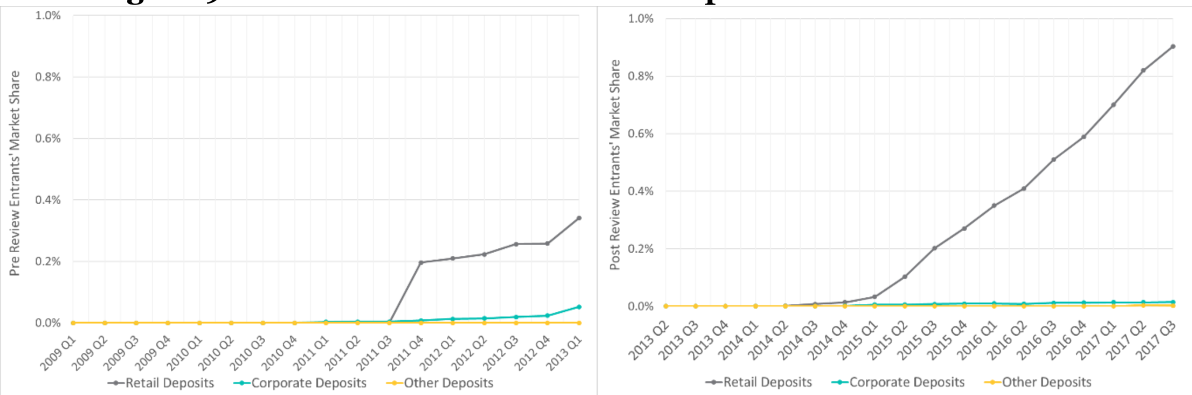

**Source: FCA analysis of FSA001 submissions**

43 The index is a measure of the average growth by entrants over a specified time-period. The index starts at a base of 100 for a given year. The deposits (lending) is then shown by the percentage change from 100 for each subsequent quarter.

44 The last two years of each period are selected as this provides an indication as to how entrants are performing once they have established themselves in the market. It also factors in that entry is spread over each of the respective periods, so focusing on the last two years of each period allows us to capture the activity of entrants once they have established themselves in the market.

Figure 9 shows the deposits taken by each cohort of entrants as a percentage of deposits taken by all banks. At the end of Q1 2013, pre-review entrants accounted for 0.4% of all bank retail deposits, and 0.1% of other deposits. Comparatively, post-review entrants account for 0.8% of bank retail deposits and 0.7% of other deposits by Q2 2017, but did not experience similar growth in relation to corporate deposits. This is expected as many of the post-review entrants are newly established banks and have not actively targeted business (savings) accounts.

**Figure 9: Entrants' share of all banks' deposits**




**Source: FCA analysis of FSA001 submissions**

The market growth exhibited by post-review entrants in retail deposits is almost double that of pre-review entrants and underpins the stronger retail offering of recent entrants. New entrants almost exclusively focus on retail deposits. From Figure 9 it is evident that newer entrants are gaining market share from incumbents at a quicker rate.

However, this increased growth can also be attributed to other factors. Government and regulatory initiatives since the crisis have been a holistic effort aimed at improving competition in the retail banking sector. These initiatives could be helping overcome some barriers to expansion and increasing the rate of uptake of products offered by entrants who entered after the 2013-review when compared with the pre-review cohort.

Our Strategic Review of Retail Banking Business Models shows that new entrants have yet to pose a significant risk to incumbent banks. Major banks have scale advantages that have helped them to sustain high market shares in deposit markets, and high switching costs for customers have made it difficult for new entrants to acquire significant numbers of customers. The recently introduced Open Banking initiative is designed to lower some of the long-standing barriers to switching and help smaller and newer banks to grow and achieve scale. The success of this initiative is yet to be seen, but in combination with other measures – such as the interventions evaluated here – has the capacity to increase competitive challenge in retail banking and drive benefits to consumers.

While entrants' market shares have grown at a slightly faster rate and to a slightly higher level, the overall extent to which entrants have penetrated the market has been limited indicating that it takes time for entrants to increase their market share. Looking at the stock of deposits underplays the impact new entrants have on the market as new banks don't have a back-book in their stock and incumbents have a large stock of deposits. However, the increased number of competitors have not yet obtained many customers from incumbents because barriers to expansion remain which affect the ability of entrants to compete for new customers, especially for more 'sticky' consumers (hence the small combined market share of post-review entrants); nor have they attracted a significant number of new customers to market.

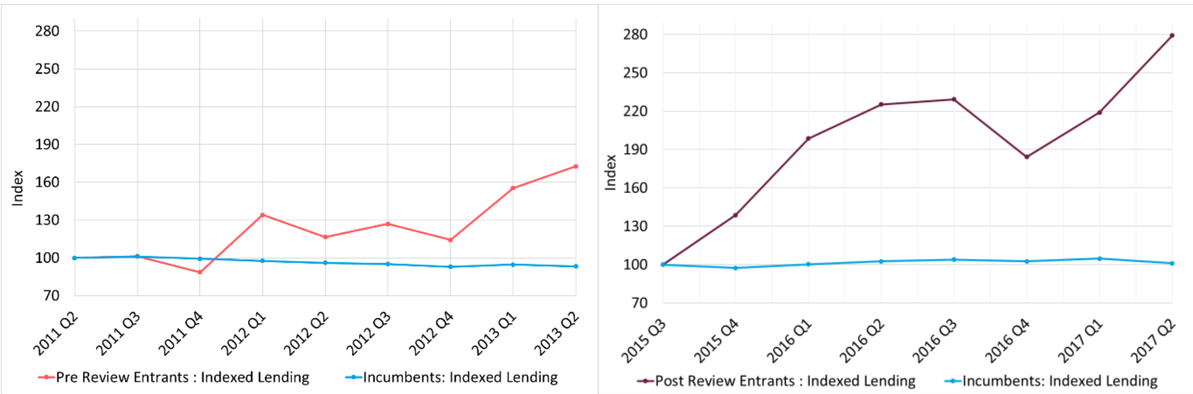
## Lending by entrants

Pre-review entrants were lending £7.4 billion as at Q1 2013, whereas post-review entrants were lending just under £8.5 billion. As entrants have attracted more deposits their lending has increased. We note that for both groups, a component of the growth in lending will be driven by firms which were doing lending activities before becoming a bank. The proportion of these banks differs across cohorts.

As shown in the Technical Annex, post-review entrants have grown their lending activities at a quicker rate than the pre-review cohort of entrants over the first 2 years of their average lifecycle.

Since the number of entrants differs in the 2 periods, Figure 10 shows the average growth in loans and of advances outstanding (the stock of lending) for each cohort entrants. Post-review entrants have, on average, experienced much faster growth in loans compared to the average growth for pre-review entrants. In contrast, lending by incumbents has decreased slightly in the period 2011 to 2013, by 6.7%. Market conditions are likely to have differed in these periods and contributed to the slower growth of pre-review entrants relative to the post-review cohort.

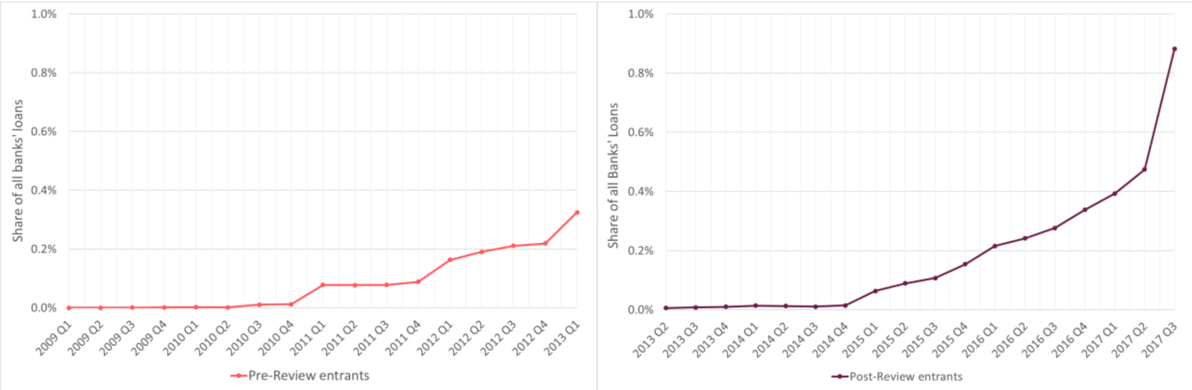
**Figure 10: Average growth in lending by entrants**




**Source: FCA analysis of FSA001 submissions**

The growth in lending balances is also reflected in the share of total bank lending. Figure 11 below shows that at the end of Q1 2013, pre-review entrants had just over 0.3% of all outstanding loans and advances to customers by banks. In contrast, at the end of Q2 2017, post-review entrants had approximately 0.5% of all loans and advances to customers by banks.

## Figure 11: Loans and advances to customers (balances outstanding)




**Source: FCA analysis of FSA001 submissions**

We conclude that post-review entrants have experienced faster growth in lending, which has translated into a bigger gain in market share from incumbents when compared to pre-review entrants. However, market conditions may have affected the lending activities of pre-review entrants.

Looking at the stock of lending underplays the impact new entrants have on the market as new banks don't have a back-book in their stock and incumbents have a large stock of lending. New banks could have a large share of new lending but a tiny proportion of the stock of lending. Our Strategic Review of Retail Banking Business Models also shows that major banks have scale advantages that have helped them to sustain high market shares in lending markets. Our analysis suggests that it takes time for entrants to increase their market share with regards to lending activities. Firms told us there were barriers preventing them from expanding or entering other markets (such as, for example, the ability to attract customers or the cost of funding). This would indicate that the overall impact of entry on competition and the broader retail banking sector has not yet been substantial.

# 6 Benefits to consumers

**Section summary**

Our analysis shows that:

- Lowering barriers to entry is a necessary but not sufficient condition for healthy competition. Entry has mainly benefitted those consumers that have switched to, or sought to use, new entrants.
- Customers using cash savings products offered by post-review entrants experience offerings which offer between 30 and 100 basis points more on fixed-term savings accounts when compared to other banks.
- Entrants are likely to offer specialised mortgages which are not offered by other established banks.[45]
- Comparing similar types of mortgages, those borrowing from new entrants realise cheaper offerings than those offered by existing banks. Evidence suggests that in the first year of their loans, those borrowing from entrants saved around £3m in total interest payments.

Many of the post-review entrants are active in retail banking and we focus on this sector in this chapter. We consider whether post-review entrants have better offerings compared to other banks. First, we look at the type of cash savings products offered by post-review entrants and whether these offerings have a higher interest rate (gross annual equivalent rate) to attract deposits compared to other banks. We then compare the mortgage products offered by post-review entrants to those offered by other banks to see whether consumers benefit from a lower annual percentage rate of charge (APRC) on mortgages. We focus on these 2 product areas because entrants have not always included transactional accounts (e.g. current accounts and pre-payment cards) as part of their product offering so fewer benefits have arisen to date.

## Cash savings

In determining the impact entrants are having in the cash savings market, we consider the different deposit products and the interest rates offered on these products during 2017. We then use regression analysis to compare the interest rates offered by post-review entrants to those offered by other banks to ascertain whether these banks have a more competitive offering.

We use Moneyfacts data to compare the savings products offered by banks.[46] Almost 90% of cash savings products offered by post-review entrants in 2017 were fixed-term

45 Although these specialised mortgages may have been available through non-banks.

46 The dataset contains 44 incumbents which offer 1,141 fixed term products, 7 post-review entrants offering 384 fixed term products and 3 pre-review entrants offering 36 fixed term products. It should be noted

savings products, which offer a guaranteed interest rate for savings with a fixed-term length. Looking at fixed-term savings products, Table 3 shows that post-review entrants on average:

- offer products which have longer fixed-term lengths compared to other banks
- offer higher interest rates when comparing products across the same fixed-term length
- keep fixed-term products on the market for shorter periods of time

### Table 3: Fixed-term savings product offerings

| Products offered | Post-review entrants | Pre-review entrants | Incumbents |
|---|---|---|---|
| **Average fixed-term length (across all products):** | 2.4 years | 1.2 years | 1.6 years |
| | | | |
| **Average interest rate by term length:** | | | |
| **1-year fixed term** | 1.6% | 1.2% | 1.1% |
| **2-year fixed term** | 1.8% | 1.3% | 1.3% |
| **3-year fixed term** | 2.0% | 1.5% | 1.6% |
| | | | |
| **Average duration product is offered on the market (months):** | | | |
| **1-year fixed term** | 3.8 | 4 | 4.2 |
| **2-year fixed term** | 3.5 | 4 | 4.0 |
| **3-year fixed term** | 3.8 | 5.3 | 4.3 |

**Source: FCA analysis of Moneyfacts Data**

To take account of the different features of fixed-term savings accounts, which may have also influenced the interest rates offered, we use POLS regression analysis on around 1,500 fixed term deposit accounts. We assess whether there is a significant difference between the interest rates offered by post-review entrants to other banks.[47] Full details of our analysis are in the Technical Annex.

that the product comparison does not include all banks. For the 2017 analysis which follows, the sample consists of 44 incumbents, 1 pre-review entrant and 6 post-review entrants. A more detailed discussion of the dataset can be found in the Technical Annex.

47 The econometric analysis takes account of factors which may be observable (eg whether the product is offered within a branch or online), but does not consider unobservable variables (eg geographical variation).

The analysis shows that post-review entrants offer significantly higher interest rates on fixed term savings products;[48] these products offer between 30 to 100 basis points more than the interest rate offerings of incumbents. This finding is supported by firm interviews, where entrants who offer cash savings products indicated that consumers are sensitive to interest rates, and to attract customers they ensure their products feature prominently in best buy tables.

As noted in the cash savings market study, the need for new entrants to offer higher interest rates is a sign of the challenges they face in attracting and retaining customer deposits from other incumbents. New entrants have to be able to make a viable business model on the basis of offering these higher deposit rates.

## Mortgage lending

In determining the impact entrants are having in the mortgage market, we consider the features of different mortgages on offer and whether there is a difference in the APRC consumers paid in the first year of their mortgage. We note that the mortgage offerings differ across post-review entrants, with some firms providing specialised mortgages. These types of mortgages are reflective of the different banking models of post-review entrants (and their lending activities prior to becoming a bank). We compare APRC offers on the mortgages sold by post-review entrants to those sold by pre-review entrants and incumbent banks. In doing so, we control for the different mortgage features, by using econometric techniques to ascertain whether post-review banks have a more competitive offering for consumers.[49] Lastly, we consider the extent to which consumers have benefitted from these offerings across the UK.[50]

Examining the mortgages originated by post-review entrants in 2017, we find that these firms have offered a wide range of products. In particular, more than 40% of mortgages originated by post-review entrants have features that are generally associated with specialist lending; such as, reversion to LIBOR rate, second charge mortgages[51] and bridging loans.[52] This has introduced a change to the types of mortgages which are typically offered by banks, and is driven by those entrants that were already in the mortgage-lending sphere before becoming banks.

Table 4 presents the share post-review entrants have of mortgages originated by banks in 2017 for selected loan features. It shows that post-review entrants have had a particularly strong presence in bridging loans, interest roll-up mortgages[53] and second charge mortgages. So, it is not surprising that these mortgages account for a meaningful share of the loans originated by post-review entrants. In addition, these product-specific

48 These results are statistically significant. See the Technical Annex.

49 The sample contains mortgages sold by 52 incumbent banks, 5 post-review entrants, and 3 pre-review entrants. So, the findings presented in this section are driven by the activities of a small number of firms.

50 Our analysis focuses on the benefits of this initiative to consumers and on competition and less so on the wider implications for prudential risks, such as 'pricing for risk' and financial stability in general.

51 Second charge mortgage contracts are loans that are secured on a property that already serves as collateral for another mortgage.

52 Bridging loans typically have shorter terms and serve as a temporary financing solution for borrowers.

53 Under an interest roll-up mortgage, a type of interest-only loan, neither capital repayments, nor payment of any of the interest accruing under its terms, are required or anticipated until it comes to an end.

shares of lending are in stark contrast to the overall share of bank mortgages by post-review entrants, which was around 1.5% across the UK in 2017.

### Table 4: Share of mortgages originated by different groups of banks in 2017, by selected product features

| | Post-review entrants | Pre-review entrants | Incumbents |
|---|---|---|---|
| **Bridging loan** | 74% | 0% | 26% |
| **Interest roll-up mortgage** | 57% | 0% | 43% |
| **Second charge mortgage** | 25% | 7% | 69% |
| **Shared equity mortgage** | 5% | 0% | 95% |
| **Extra money withdrawn for debt consolidation** | 4% | 1% | 95% |
| **Mortgage advanced under a government supported initiative** | 4% | 0% | 96% |

**Source: FCA analysis of PSD001 submissions.** Note that rows may not sum to 100% due to rounding. This table excludes mortgages which were originated by non-bank mortgage lenders.

One beneficial impact of this focus has been extended access to mortgages through a willingness of post-review banks to take on lending risk beyond the current appetite of more established banks; particularly as some post-review entrants were offering specialised mortgages prior to becoming a bank.[54] In this sense, they do not compete directly with existing banks but rather against specialised mortgage lenders.[55] Naturally, this has come at a cost with the increased risk being reflected in the product price.

When looking at whether entrants offer cheaper mortgages, our pricing analysis focuses on a subset of loans that have two-year and five-year fixed rates. In doing so, we exclude loans with LIBOR tracker reversion rates and regulated second charge mortgages as the number of comparable loans by incumbents is limited, when considering 2- and 5-year fixed-rate loans only. The remaining mortgages allow for a robust comparison of pricing across groups. This sample covers approximately 85% of loans by existing banks and a third of post-review entrants' loans. See the Technical Annex for a discussion of the relevant considerations.

To assess the total cost of borrowing for consumers, we calculate the Annual Percentage Rate of Charge (APRC) for each mortgage sold.[56] This measure accounts for any fees (including intermediary fees) that the consumer may pay in addition to the interest due. While consumers may pay a lender's fees either up-front or over the life of the loan (ie

54 During firm interviews it was noted that firms would focus on identifying new types of customers they could lend to.

55 We do not explore whether firms who were already lending mortgages before they became banks have changed their mortgage product offerings since becoming a bank.

56 This approach adapts the methodology set out in the FCA's Occasional Paper 35 "Six of One …? Choice of Intermediary in the UK Mortgage Market". See the Technical Annex for a further explanation of the methodology used.

‘roll-up’ the fee), we assume fees are rolled-up. We also assume that customers re-mortgage after the initial deal period which is necessary, as reversion rates are not available in the data.

Taking this into account, Table 5 compares the average APRC across 2- and 5-year fixed mortgages in 2017. It is evident that post-review entrants have originated loans with lower APRCs than the other groups for both 2- and 5-year fixed mortgages.

### Table 5: Average APRC for 2- and 5-year mortgage offerings

| Products offered | Incumbents | Pre-review entrants | Post-review entrants |
|---|---|---|---|
| **2-year fixed: average APRC** | 2.24% | 3.65% | 1.95% |
| **5-year fixed: average APRC** | 2.44% | 2.17% | 1.88% |

**Source: FCA analysis of PSD001 submissions**

While the statistics above allow us to compare the average price of mortgages, it does not account for differences in product and borrower characteristics across incumbents, pre-review entrants, and post-review entrants. We use regression analysis to take such factors into account when assessing whether there is a significant difference between the interest rates offered by post-review entrants to other banks.

The regression analysis controls for observable factors in the data, such as borrower income and the loan-to-value ratio, but may also be affected by unobserved factors. See the Technical Annex for a further discussion on the econometric analysis and the different specifications used for the regression analysis (models 1-3 in Table 6 below).

The results from our regression analysis are shown in Table 6 below. It can be seen, that the APRC for 2-year fixed mortgages by post-review entrants is around 25 basis points lower than incumbents, on average, although the statistical significance of these findings varies depending on the different assumptions used in the econometric models. Post-review entrants are significantly cheaper when compared to the offerings by pre-review entrants.

Table 6 also shows that, all else being equal, post-review entrants offer 5-year fixed mortgages that are around 45 basis points cheaper than incumbents. This difference in APRC is statistically significant across the different econometric models used.

## Table 6: Regression analysis

| | 2-year fixed mortgages | | | 5-year fixed mortgages | | |
|---|---|---|---|---|---|---|
| | Model 1 | Model 2 | Model 3 | Model 1 | Model 2 | Model 3 |
| **Post-review entrants** | -0.28† (0.24) | -0.28† (0.24) | -0.23† (0.18) | -0.45*** (0.07) | -0.44*** (0.07) | -0.46*** (0.06) |
| **Pre-review entrants** | 1.50† (0.85) | 1.50† (0.85) | 1.24† (0.63) | -0.06 (0.09) | -0.05 (0.08) | -0.01 (0.05) |
| **Borrower features** | Yes | Yes | Yes‡ | Yes | Yes | Yes‡ |
| **Mortgage features** | Yes | Yes | Yes‡ | Yes | Yes | Yes‡ |
| **Postcode controls** | No | Yes | No | No | Yes | No |
| **Interactions** | No | No | Yes‡ | No | No | Yes‡ |
| **Adj. R-squared** | 0.67 | 0.68 | 0.67 | 0.70 | 0.71 | 0.72 |
| **Observations** | 415,175 | 415,175 | 415,175 | 231,856 | 231,856 | 231,856 |

**Source: FCA analysis of PSD001 submissions**

The 'Yes' and 'No' entries in the table indicate whether a particular set of features has been controlled for in a particular regression specification. For example, borrower features include factors such as borrower income; mortgage features accounts for loan features such as whether it is a joint mortgage, and postcode controls account for geographical differences on the outward postcode level.

‡ The model uses the most informative principal components of these features. See the Technical Annex for a discussion of the principal component analysis (PCA) used in Model 3.

*** indicates that the findings are statistically significant at a 1% level, ** is significant at 5%, * is significant at a 10%

† indicates that the estimates are significant at a 1% level, in some specifications. See the Technical Annex for a discussion of statistical significance.

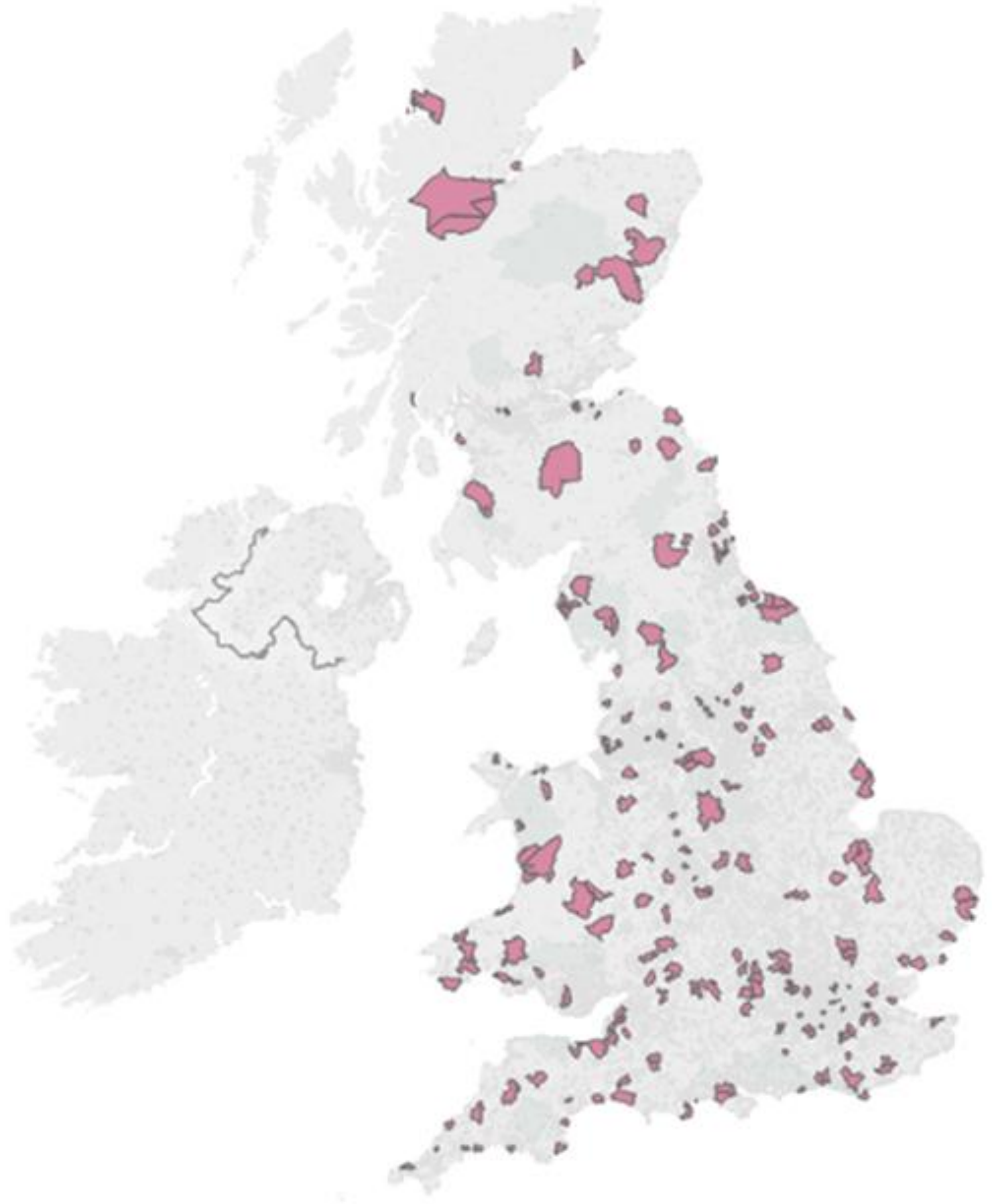
Using the findings from the econometric analysis, we approximate how much less interest borrowers from post-review entrants paid during the first year of their mortgage, compared to the counterfactual that they had taken out the same loan with an incumbent. For the loans analysed, the evidence suggests that, in total, in 2017, borrowers from post-review entrants paid around £3m less interest during the first year of their loans, compared to those who borrowed from the incumbents.[57] While we do not estimate future savings, we would expect entrants to offer some savings to consumers at the margin.

We also considered whether certain geographic areas within the UK were benefiting more from the offerings of post-review entrants. The data and firm interviews indicated that these entrants rely almost entirely on intermediaries to originate loans. Figure 12 shows

57 Across specifications, the estimated interest difference remains positive and in the region of £3m.

those areas in which new entrants are originating more than 3%, or double their national share, of mortgages sold.[58] Such areas are distributed widely across the UK, suggesting that post-review entrants' use of intermediaries has allowed them to reach customers independently of their location.

### Figure 12: Areas where post-review entrants accounted for more than 3% of regional sales in 2017



**Source: FCA analysis of PSD001 submissions**

58 Our analysis includes mortgages in Northern Ireland. However, it appears that entrants have not accounted for more than 3% of bank loans in any outward postcode area in Northern Ireland in 2017.

# 7 Lessons learned

The lessons learned from this evaluation are a function of the intervention in this specific market. Our lessons here may not read across directly to, for example, a similar intervention in another market. Nevertheless, they provide useful insight in helping us anticipate potential ways of reducing harm and the likely impact in doing so.

## Table 7: Main lessons learned from our evaluation

| # | Lesson learned | Comments |
|---|---|---|
| 1 | **It takes time for lowering barriers to entry to affect market shares in a significant way** | Lowering barriers to entry is effective and has a positive impact on entry, and delivered benefits to consumers. We have seen, for example, new entrants with significantly better offerings on specific products. This intervention is a necessary but not sufficient condition for healthy competition. The impact on competition in banking has so far mainly benefitted those consumers that have switched to the new entrants. |
| 2 | **There may be other barriers to firms expanding to a more significant scale** | The increased number of competitors has not yet benefitted many customers of incumbents because barriers to expansion remain. These affect entrants' ability to compete, especially for more 'sticky' consumers (hence the small combined market share of new entrants). The small scale or niche entry may not be enough to force incumbent banks to compete harder to protect market share. |
| 3 | **Clearer, transparent processes and engagement can have a significant positive impact on all our interactions with firms** | Firms said the authorisations process under the FSA was a 'black box'. The changes introduced by the Bank and PRA/FCA have improved the transparency of the authorisations process and allowed for greater regulatory engagement. While the requirements for new firms have not changed, the new approach to authorisation has had a positive impact on entry. It has made it easier for firms to understand and do what we expect from them. This can affect levels of compliance, for example, as well as the authorisation of new firms into other sectors we regulate. |

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