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UK bank services for small business: How competitive is the market?

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Abstract

This study is the first to employ an econometric model to examine the pricing behaviour of British financial institutions with respect to key bank products/services offered to small and medium sized enterprises (SMEs) including current accounts, investment accounts, business loans, and mortgages. A mean group approach is used on a panel of monthly data to gauge individual banks' reactions to identify factors influencing the setting of deposit and loan rates, and to assess the competitive structure that best describes the UKs SME banking market. Though the results should be interpreted with caution, the empirical evidence is suggestive of a complex oligopoly. Policies directed at improving information and making it easier for small businesses to change banks/accounts would reduce inertia and improve competition among financial institutions.

JEL classification: G21; G28

Keywords: Complex oligopoly; SME inertia; Shadow deposit rates; Relative bargains/rip-offs

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1. Introduction

The issue of whether there is adequate provision of competitive banking services for small and medium sized enterprises (SME) has long been a contentious one, as reflected in the 1980 Wilson[1] report and more recently, investigations by Cruickshank (2000) and the Competition Commission (2002). This paper seeks to contribute to the literature by being the first to employ an econometric model to gauge the degree of competition in the UKs SME banking market. The mean group (MG) approach is applied to bank specific time-series data on interest rates and non-price features, to assess the pricing behaviour of British financial institutions (FIs) for a selection of key SME banking products. The results shed light on the competitive behaviour of UK banks and other FIs that supply intermediary services to small business, including how SME deposit or loan rates are adjusted to changes in LIBOR (the London Interbank Offer Rate), and the extent to which bargain and rip-offs exist among SME banking products. The econometric findings are used to comment on recent policy recommendations made by the Competition Commission (2002) and subsequent rules the banks agreed to implement.

The paper is organised as follows. Section 2 describes the data sources and methodology. Section 3 reviews the econometric results. Section 4 assesses policy, with a special focus on the Commission's recommendations in light of the econometric findings. Section 5 concludes.

2. Data and methodology

The definition of a small or medium sized enterprise (SME) used here is the one employed by the Competition Commission (2002): any UK firm with a business account and an annual turnover of up to £25 million. In 2002, 3.5 million SMEs met these criteria, accounting for 55% of employment and 45% of turnover.[2]

The main source of data for this study is *Business Money£acts*, a monthly publication produced by the Moneyfacts Group, which provides information on banking services used by SMEs, including key deposit and loan products. To address the questions raised here, the paper focuses on intermediary services and commercial mortgages. *Business Money£acts* had up to six years of monthly data on:

- Business Investment Accounts: These are business savings accounts, offering rates that vary with the size and term of the deposit. *Business Money£acts* reports deposit rates by tiers: £1, £500, £1000, up to £250,000. To avoid a potential time bias quoting tier rates,[3] representative deposit amounts were obtained using data supplied by the British Bankers Association. Table A1 in the website appendix[4] shows how these were

[1] Wilson (1980).

[2] Competition Commission (2002, chapter 2). The Bank of England (2002, p. ii) summarises the SME definitions provided by the Department of Trade and Industry, European Commission, Companies Act, the Federation of Small Business, and the British Bankers Association, all of which use various criteria to define and create sub-categories of SMEs.

[3] The reported tiers are not adjusted for inflation, which could cause a time bias. Problems arise with inflation and real deposit/loan growth, which means these tiers should, ideally, keep being adjusted upward.

[4] The results can be found at http://www.cass.city.ac.uk/faculty/s.heffernan Look for: *Website Appendix* for "UK Bank Services for Small Businesses: How Competitive is the Market?"