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Competition and the Provision of Banking Services to SMEs in the U.K.

John Ashton
Kevin Keasey

ABSTRACT. This paper examines the report produced by the Competition Commission on the provision of SME banking services in the U.K. The report is assessed in terms of underlying assumptions used to describe and assess how banks operate and perform. The Competition Commission suggested "remedies" are drawn from a specific economic model assumed to be representative of the U.K. banking industry. It is concluded the remedies proposed by the Competition Commission are misplaced and may impose a substantial future cost on both banks and SMEs receiving banking services. It is proposed that the ramifications of this case are substantial for the present system of allocating bank funding to SMEs, in both the U.K. and international economies where similar antitrust or competition guidelines are employed.

1. Introduction

The U.K. Competition Commission (the U.K. antitrust regulator) released the report, "The supply of banking services by clearing banks to small and medium-sized enterprises", on the 14th March 2002. This report was highly critical of the major U.K. clearing banks, suggesting, a complex monopoly prevails in the supply of banking services to small and medium sized enterprises (SMEs). The Competition Commission reported excess profits of £726m have been earned by the big four U.K. clearing banks (HSBC, Natwest, Barclays and Lloyds/TSB) in the provision of banking services to SMEs in England and Wales, between 1998 and 2000, a position deemed to work against the public interest.

This paper examines the Competition Commission report on the provision of SME banking services in the U.K. An analysis of the regulatory case made in the report is undertaken to illustrate issues pertinent to the funding of SME's both in the U.K. and other developed economies. Specifically, the plausibility of imposing certain assumptions when modelling bank activities and explaining particular features of banking operations are considered, particularly the separate provision of deposit and loan services. With these concerns in mind, the principal implications of the Competition Commission "remedies" for the future of SME bank financing are outlined.

The ramifications of this report, as to how banks should make lending decisions for SMEs, are international in their importance. Across the developed world, the regulation of competitive behaviour has become a point of increasing concern for many governments. Reflecting these concerns legal frameworks have developed in the U.K., and in many other countries to both limit and remove the potential for firms to abuse a dominant position within a market. Such policy concerns are documented in the Article 82 of the European Economic Community Treaty, Australia's Trade Practices Acts 1974, and the U.S. antitrust acts. As these regulatory frameworks share a similar approach to reducing the potential for firms to abuse dominant positions generally, and to reducing the use of price discrimination, long-term relationships and cross subsidy specifically, this recent regulatory case is deemed to have implications for SME bank financing internationally.

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John K. Ashton
School of Management
University of East Anglia
Norwich
U.K.
E-mail: J.Ashton@UEA.AC.UK

Kevin Keasey
International Institute of Banking and Financial Services (IIBFS),
Leeds University Business School
The University of Leeds
Leeds, LS2 9JT
U.K.

To achieve these goals the paper has the following structure. In Section 2 the principal conclusions and remedies presented by the report are summarised. In order to illuminate the underlying assumptions used by the Competition Commission in its assessment of bank activities and performance, the form and underlying rational of the "technology" underlying bank lending decision making will be explored in Section 3. As part of this discussion the transactional and relational approaches to lending decision making are discussed. The implications of the findings are presented in Section 4, and concluding remarks are offered in Section 5.

2. Concerns, conclusions and remedies of the competition commission report

A central concern raised by the Competition Commission report is the similarity of pricing and concentration in the supply of some U.K. banking services, such as liquidity services (including overdrafts, and short-term lending). The existence of similar pricing policies and such an industrial structure are viewed as indicative of restricted competition, which may lead to excessive profits. Subsequently the Competition Commission sought to quantify the extent of uncompetitive behaviour in the U.K. SME banking market through the measurement of "excess profit" obtained by banks in their operations. To achieve this goal, measures such as the "cost efficiency" or performance of clearing banks operating in the U.K. were quantified using accounting ratios. These measures of bank specific performance are then employed to determine the degree of excess profits from individual products and banks. Within such an assessment, emphasis is placed on the "difference" between costs and revenues of banking services offered by clearing banks, both for individual products and on a bank by bank basis (Competition Commission, 2002a, p. 136).

The level of excessive profits for individual banks is derived from the difference between the "estimated" return on equity or assets for the provision of banking services to SMEs and the average return on all equity in the U.K.; these returns are 36 and 15 per cent respectively (Competition Commission, 2002a, p. 4). This accounting methodology indicates the big four banks have produced excess profit of £726m (Competition Commission, 2002a, p. 116) for the sample period 1998–2001 on their SME banking businesses. In addition, National Westminster is deemed to have a scale monopoly for SME banking services with their 25 per cent of this market, and the actions of the big four clearing banks are considered to be against the public interest (Competition Commission, 2002a, p. 119). Surprisingly, no excessive profits are observed in the Scottish and Northern Irish SME banking markets (Competition Commission, 2002a, p. 117).

The majority of excess profits from SME banking operations are considered to be produced by deposit and current accounts, services which pay low or zero levels of interest on deposited funds (Competition Commission, 2002a, p. 119). Loans and other credit services are viewed by the Competition Commission as being less comparable than services such as deposits, due to factors such as firm specific risk (Competition Commission, 2002a, p. 35). Equally, it is also reported that for some banks ". . . rates of return on overdrafts and bank loans were . . . below the cost of capital" (Competition Commission, 2002a, p. 136). It is assumed for the banking business the level of interest paid on deposits should fairly represent the underlying costs of banks borrowing these funds from alternative sources, such as the money markets (Competition Commission, 2002b, p. 137). Thus it is assumed that costs and revenues should be comparable within a competitive market, both for individual banks and SME banking services; an assumption which suggests individual banking services including deposits and loans are produced separately.

It is additionally proposed by the Competition Commission that there is a limited amount of "switching" by SMEs between alternative suppliers of banking services. While this claim is supported by the available evidence, there is ". . . no evidence that the clearing banks deliberately cause unnecessary delay in the switching process" (Competition Commission, 2002a, p. 29). The Competition Commission concludes that the ". . . limited degree of switching is . . . a key function in reducing competition in the market, irrespective of whether or not it results from any action on the part of the clearing banks" (Competition Commission, 2002a p. 31).

To ameliorate these problems of complex monopoly the Competition Commission has recommended behavioural "remedies", and a system of price control, to reduce the profitability of supplying SME banking services. The behavioural "remedies" will be used to improve the ability (or perception thereof) of SME customers to "switch" accounts between suppliers, increase transparency of pricing, "un-bundle" product provision when deposits and loans are supplied jointly and reduce barriers to entry to the SME banking market. The imposition of a system of price control will force banks to offer SME banking services without charges or alternatively, provide payment of a rate of interest at 2.5 per cent below the Bank of England base rate on all business current accounts.

3. Different forms of bank lending decision making

While it is not denied that high levels of concentration, low levels of switching and cross subsidy may be associated with uncompetitive behaviour in many markets, it is proposed these features are closely tied to how banks accommodate elements essential to its production of banking services, such as information, monitoring, risk and the joint production. In order to illuminate the importance of these different elements within banking activity, different forms of bank lending decision making will be elaborated. Such an example is important, as lending decision making is central to the operation of SME banking services and relies on a number of different lending "technologies". Equally, banks make lending decisions using a wide range of criteria or data and through employing a number of distinct methods for processing such data. By way of summary, four principal lending technologies employed for lending decision-making could include financial statement lending, asset based lending and credit scoring, which are all termed transactional or arms length lending technologies. The forth lending decision making technology to be considered is relationship lending, a technology of lending decision making which relies upon a "relationship" between the bank and the SME (Berger and Udell, 2002). In this section these four technologies and their underpinning rational are critically discussed.

3.1. *Transactional technologies for lending decisions*

a. Financial statement lending decisions are made from the strength of income statements and the firm's balance sheet. Such a lending technology requires firms to have suitably audited and transparent accounts. This technology is more suited to larger firms with long histories and may not be an appropriate technology for SME lending decision-making.
b. Asset based lending decisions are based on the quality of available collateral for a loan, such as the firms' inventory and account receivables. This type of lending is available to all firms, yet requires a high level of collateral to be pledged. Such lending is often expensive for banks which have to monitor the on-going value of collateral.
c. Credit scoring is a method for making lending decisions which uses statistical techniques to analyse appropriate data. This technique requires a lot of data both about the firm (including income statements and balance sheets) and the firm owner, and it also needs to factor in the experience gained from lending to other firms. While this technology is widely used for consumer lending, this data intensive technique is relatively new within the U.K. for SME lending. In common with financial statement lending, this technique is appropriate for firms with long histories, which may reduce its importance as a tool for SME lending.

It is posited that due to cost, data and collateral or security reasons that transactional methods of lending decision making are not best suited to new or risky SME lending decisions. It is proposed that these transactional methods may be best suited to lending generally larger quantities of capital to firms with long financial histories and high levels of collateral (Berger and Udell, 2002). Conversely, SMEs may often only have short, continuous histories of financial data, little collateral and require relatively small amounts of lending. As such, transactional methods of lending decision making may not be suited to all forms of banking lending to SMEs.

3.2. *Relationship lending decision making*

To overcome these difficulties in lending decision making, a "technology" termed relationship lending or banking is often employed by banks throughout the world, and is viewed by many as particularly well suited to small firm lending decisions. This form of banking technology is of particular note, in that it has been widely advocated to overcome many of the problems associated with bank activity including, adverse selection, information asymmetry, monitoring and intermediation risks. Relationship lending or banking (Boot, 2000; and Binks and Ennew, 1997) relies on both financial and "soft" or personal data about the firm owner and the firms' local reputation. The relationship, built through repeated contacts between a dedicated bank official and the firm owner, allows the bank to gain exclusive access to firm level financial data. This relationship lending technology provides expensive, yet often good, information, to help underpin lending decisions to SMEs.

The dimensions of a banking relationship include the scope or number of products and the duration or quality of the relationship. When relationship lending technology is employed, it is often expected that the firm gives the bank exclusive access to data and provides deposits at low cost. Thus the longer the relationship, the greater the incentive for banks to both invest in developing SME banking data into useful information for lending decision making. Equally, through the development of firm data within a long-term relationship, bank lending may be made which would not have been granted under different bank lending technologies.

A further aspect of relationship banking is the cross-subsidy which flows from deposit to credit provision. In return for cheap core deposits and long term relationships, it is widely proposed that banks will grant credit when it otherwise would not be granted and "lean into the wind" or informally insure SMEs during times of economic difficulty (see Berlin and Mester, 1998a). In fact these issues are clearly identified by the Competition Commission which stated "Many third parties to whom we spoke confirmed that SMEs generally believed it important to maintain a relationship through which they could be confident that the bank would be sympathetic to future funding needs, particularly if short-term difficulties arose." (Competition Commission, 2002a, p. 28).

3.3. *What assumptions underlie the different lending decision making technologies*

There are, of course, many different interpretations of what a bank is and does which do not concur with this conception of the bank adopted by the Competition Commission. For example, banks offer services in markets, which are characterised by features such as risk, liquidity, indirect taxation, and imperfect information. It is argued that the cost based understanding of a bank employed in the Competition Commission report does not account for such features and alternative perspectives of bank activity may have been overlooked.

A range of different models for describing bank activity exist, as micro economic and macro economic views of banks differ. In the micro economic sense, a bank produces services that are sold in a marketplace. In the macro sense, banks act as a producer of money itself. These conflicting properties have led to difficulties in the modelling of a bank's activities. In an economy, many institutions accept or borrow funds from the public, firms and money markets. These funds are then essentially transformed and re-lent to borrowers at a rate of interest. This form of intermediation is a principal and defining aspect of the production process of banks. To illuminate this perspective a number of different academic approaches to modelling bank activity have been developed.

3.4. *The rational for transactional lending decision making technologies*

Initially, neo-classical models emphasise the short-term costs and revenues from bank activity at a micro economic level and may be closely linked to the conception of bank activity employed by the Competition Commission. For example the Competition Commission assumes profits are a function of revenues and costs. A further feature of neo-classical models is the emphasis on deposits and loans being supplied distinctly. Thus we can state outputs from such a banking system

consist of discrete non-monetary services, such as the manipulation and administration of customers' accounts and monetary services, such as loans (Hancock, 1985). These neo-classical models, although widely used to model bank production (see Berger and Humphrey, 1997), have been criticised for failing to fully incorporate the influence of factors such as risk, information and time. Equally these models adopt a "narrow banking" perspective of financial intermediation and view deposits and loans as separate outputs or inputs to a model of bank activity.

3.5. *The rational for relational lending decision making technologies*

A development in modelling bank activity has been provided by frameworks which forward risk and monitoring (Diamond, 1984), information asymmetry and adverse selection (Sharpe, 1990) as key elements of bank activity. These models, which are less widely employed than neo-classical models, take both a longer term perspective of bank activity, in addition to incorporating concerns generally outside neo-classical models of bank activity. Central to the academic explanation for the widespread implementation of relational methods of lending decision making are a number of issues including, risk, monitoring, the use of information, joint production of banking services and empirical support for benefits of relationship lending. These issues are addressed in turn.

a. *A risk and monitoring model of banking activity*

Risk is central to bank activity, as a bank making loans has to monitor debtors both at inception and for the duration of the loan contract to reduce the potential for loan default. As such lending or intermediation is victim to imperfect information, the costs of monitoring a debtor or customer are real. To reduce or internalise these risks the provision of depository services, the collection of information on both individual debtors or customers and a large number of debtors in the broader economy is required. The overall costs of assessing the risks associated with lending to SMEs and acquiring information about individual SMEs may consequently be reduced through the provision of depository services. The information provided from such depository services will then assist prediction of the future behaviour of SMEs and reduce the risks involved in lending. The process of intermediation is, therefore, eased through the continued provision of deposit services by the financial institution.

b. *Information based models of bank activity*

It has been widely suggested that small firms struggle to raise external finance because of their inability to provide sufficient information. This position has led many small firms to become dependent on bank lending. In return banks invest in SME information to overcome information difficulties and absorb risks associated with new and small firms. For such an initial investment, banks attempt to recoup these costs over the medium term through charging above competitive levels for some banking services. In a similar vein, it may be observed ". . . that a bank which actually lends to a firm learns more about the borrowers' characteristics than do other banks" (Sharpe, 1990, p. 1069). The implication of this perspective is while banks may be observed to compete vigorously for new business, firms often stay with the same bank for long periods of time, as they become ". . . informationally captured" (Sharpe, 1990, p. 1070) by their bank. Within such an environment the firm's present bank will generally be able to make the best offer for banking services due to a "monopoly" over the information relating to the firm. In consequence a problem of adverse selection makes it difficult for competing banks to offer a potential customer better terms and conditions on banking services than the bank presently providing depository services. Thus without providing deposits, competing banks will have difficulty attracting good SME customers without also attracting poorer, riskier and higher cost customers. As such, effective competition within lending markets is constrained (Allen and Gale, 1997).

c. *The joint provision of deposit and loan banking services*

The risk, monitoring and information models of bank activity suggest loans and deposits are joint products or at least strong cost complements. Such a situation presents the question "why do banks

link the interest rates or pricing of credit and deposit services?". A number of different theories have been presented in explaining such bank behaviour. Kashyap et al. (2002) suggest the costs of providing short term or more liquid deposits includes the costs of holding a pool of liquid funds to meet future demands on demand and at short notice. These funds are held at a cost of forgone interest and act as a product overhead cost. This pool of funds may also be shared with short term credit products such as overdrafts or lines of credit, where similar funds may be requested at short notice, suggesting joint production of both deposit and credit products. Alternatively, it has been suggested by some commentators (Tarka, 1995), that the presence of indirect taxation on deposit interest also plays a part in the cross subsidisation of credit services through under priced core deposits. Under such a system, tax may be payable on interest receivable on deposits; through paying low or no interest on deposits and reducing the levels of interest payable on credit services, the bank is effectively reducing the tax liability of individual customers.

d. *Empirical evidence as to the benefits of relational bank lending technologies*

Benefits of this form of lending decision making may be explored by examining the requirements of relationship lending; the joint provision of deposits and loans and the provision of deposits at low cost. Empirical evidence on this subject has been provided by considering the association between the liability structure of banks, particularly the proportion of core deposits, and the lending behaviour of banks. Primary research questions tested within this literature include: first, to what degree does a bank in receipt of core deposits, such as SME current and deposit accounts, act to insulate SMEs from adverse shocks within the wider economy (Berlin and Mester, 1998a, b); and second, what is the relationship between core deposits and the provision of distinctive banking services (Allen and Gale, 1997)? The available empirical evidence has indicated that in the U.S. the receipt of core deposits has influenced bank behaviour. It is suggested that when core deposit receipts are high, banks will be more likely to "smooth" interest rates and ameliorate the excess of economic shocks by removing short-term spikes in the open market costs of lending.

Conversely, where banks have relatively lower core deposits, such smoothing, which may act as a form of informal protection or insurance, is substantially reduced (Berlin and Mester, 1998a, b). Of equal note is the positive relationship between the relative proportion of core deposits held by a bank where ". . . access to core deposits permits a bank to make contractual agreements with borrowers that are infeasible if the bank must pay market rates for its funds" (Berlin and Mester, 1998a, p. 30). This position may be of particular interest for the U.K. SME banking market where the large clearing banks employ relationship lending, are in receipt of cheap core deposits and are charged with uncompetitive behaviour.

e. *Summary of the academic rationale of relationship lending*

To summarise, credit products and deposit services are often supplied jointly to overcome a range of bank specific problems. Such problems, including adverse selection and information asymmetry (Sharpe, 1990), monitoring of debtors (Diamond, 1984), interest rate overheads (Kashyap et al., 2002) and indirect taxation (Tarka, 1995) are central to the productive activity of banks. As such, the joint production of loans and deposit services may provide wider positive externalities which are outside the frame of reference of the Competition Commission report and not acknowledged within their assessment.

It may be concluded that bank relationship lending is often perceived to have broader benefits to both SME customers and banks, many of which have been empirically quantified within the international academic literature. The duration or quality of a banking relationship is seen to have positive association with the availability of bank credit in many different countries and across academic studies; equally the degree of concentration in banking markets has been observed to have a positive association with availability of bank lending (see Ongena and Smith, 2000). Of central concern is that the removal of the foundations of relationship lending, including low cost deposits may fundamentally alter the way in which banks lend funds to SMEs.

4. The wider implications of the competition commission remedies and concluding remarks

Within this section the principal remedies of the Competition Commission report on U.K. SME banking services will be assessed in terms of their future implications for bank lending to SMEs, and concluding remarks will also be drawn. An emphasis of this assessment is the potential conflict between the underlying assumptions of the Competition Commission assessment of banking profits and the "technology" underlying much of bank operations in SME banking services. One of the central assumptions is the suggestion that the joint provision of deposits and loans brings little benefit. This narrow banking perspective, closely associated with neo-classical models of bank activity, may ignore many aspects of bank production including risk, monitoring and information; characteristics which may be ameliorated by the joint provision of deposits and loans. Through the introduction of interest charges on such deposits, the viability of the joint provision of banking services is undermined. It is considered that such changes to the present form of bank operations will have substantial ramifications for both the underlying technology used to make lending decisions, and consequently the overall quantity and quality of bank lending available to SMEs.

A central feature of relationship banking and the major criticism present within the Competition Commission Report has been the relatively low level of interest paid on SME deposit and current accounts. The pricing of SME deposit and current accounts is undoubtedly above the costs of provision and the source of most bank profits from SME banking services. This is viewed by the Competition Commission as a market distortion and exercise of market power detrimental to the public interest. Conversely it is reported by the Competition Commission that some banks offer credit products at, or even below the efficient or competitive market rate. This position appears to suggest cross-subsidisation may be present between SME net depositors and net debtors. Within the Competition Commission report some of the clearing banks explicitly state that any change to the cost of deposits will lead to change in the charges for other banking services, including credit services (Competition Commission, 2002a, p. 136).

As we have discussed, relatively under priced deposits play a central role in cross subsidising the costs of providing credit services for SMEs. Equally, these cross subsidies are also believed to run from older and more profitable SMEs, to younger, riskier and troubled SMEs. Accordingly, the provision of bank deposits at low cost both extends the range of services available to SMEs, and increases the propensity of banks to "lean against the wind" for their SME customers in times of economic uncertainty. It is proposed the imposition of a government price setting regime will greatly increase the cost of core deposits for U.K. clearing banks. Consequently, as access to low cost core deposits is removed, it is to be expected that U.K. clearing banks have incentives to both reduce the range of banking services provided to SMEs and remove the informal insurance provided to SMEs during periods of external economic instability. This perspective has been already recognised by the banks in responding to the "remedies" within the Competition Commission report, for example:

> "In responding to the hypothetical remedies we put to them, Barclays and some other clearing banks said that any reduction in revenue for current or deposit accounts could lead to a reduction in their willingness to grant loans at current interest rate margins or at the margin at all. It was further argued that the clearing banks at current levels of profitability would stand by the SMEs in bad times even if it were not commercially sound to do so". (Competition Commission, 2002a, p. 136)

Further negative consequences arising from the removal of joint production of deposit and loan services include a reduced ability in the collection of information to make lending decisions and to subsequently monitor the behaviour of debtors. The suggestion that through the removal of joint provision of deposits and loans, more competition may be engendered is suspect, as banks, which hold deposits for SMEs, will always have a relative advantage in terms of information for lending purposes.

To summarise, the removal of the foundations of relationship banking would be expected to reduce the quantity of loans forwarded to young and risky SMEs; an outcome which is contrary to

the wider public interest. The provision of bank deposits at low cost both extends the range of services available to SMEs, and increases the propensity of banks to "lean against the wind" for their SME customers in times of economic uncertainty. It is also proposed the imposition of a government price setting regime, will greatly increase the cost of core deposits for U.K. clearing banks. Consequently as access to low cost core deposits is removed, it is to be expected that U.K. clearing banks have incentives to both reduce the range of banking services provided to SMEs and remove the informal insurance appreciated by SMEs during periods of external economic instability.

5. Concluding remarks

While the arguments presented by the Competition Commission in support of the proposed remedies may contain an intuitive appeal, it is worth drawing out the assumptions which underpin such an assessment of excess profits and a lack of competitiveness. The Competition Commission suggested "remedies", for U.K. SME banking seemed to be based on the assumption that the neoclassical perspective of bank production is representative of the U.K. banking industry. This model is balanced on the presumption that the long duration of banking relationships and the joint production of deposits and loans have negative consequences. It is proposed that this neoclassical conception of the firm (underlying the entire assessment of competition) conflicts with the relationship lending "technology" which is widely employed by banks to make lending decisions.

It is, therefore, concluded that the Competition Commission assessment of the provision of banking services by clearing banks to SMEs, directs scant attention as to how banking services are actually "manufactured". In turn this may have led to an underestimate of the complexity of SME banking markets and consequently provides an unstable platform from which to make such wide ranging policy decisions. In essence, it is suggested that the model of firm behaviour employed by the Competition Commission is not be suited to the assessment of banking, an industry viewed by many to be characterised by specific idiosyncrasies.

Central to these arguments is the question; can an uncompetitive practice have wider economic benefits (Mueller, 1996)? In this particular regulatory case, it is indicated that the particular form of relationship decision making for bank financing decisions may be such an example. Here we have observed practices which can be perceived as uncompetitive, such as long term relationships with customers, cross subsidy of other distinct product areas, and discriminatory pricing. While the Competition Commission has correctly identified such features as being associated with uncompetitive behaviour in other markets, it has failed to consider the function that such practices play in the wider provision of bank finance for SMEs. That said, such a perspective would indicate a need for a substantial re-assessment of how decisions pertaining to the regulation of competition in markets are formed. Equally this view challenges the assumption that competition exists as an economic goal above all others and indicates other criteria, such as wider economic welfare or efficiency, require consideration when reviewing industries as fundamental to the generation and operation of markets as banking.

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