TSB Bank plc

Response to the CMA Issues Statement

Introduction

1. TSB welcomes the opportunity to comment on the CMA's statement of issues in the retail banking market investigation ('the Issues Statement') published on 12 November 2014. As explained in its submissions during the Office of Fair Trading ('OFT')/CMA and Financial Conduct Authority ('FCA') market study, TSB supports the decision to refer PCAs and SME banking for a market investigation. TSB believes that competition does not work effectively in these markets and action is necessary to remedy the current situation.

2. This response is structured as follows. First, we provide some brief background on TSB's position as a new entrant. Second, we describe the key competition problems in the PCA and SME banking markets from TSB's perspective. Third, we comment briefly on the Issues Statement, looking at the issue of market definition and then at the three theories of harm described in the Issues Statement.

3. TSB notes that the Issues Statement covers both PCA and SME banking and that the same theories of harm are identified for both markets. TSB provides both PCAs and SME banking services but has a much more significant presence in PCAs than in SME banking. In this response TSB focusses on PCAs but, in general, TSB believes that the same or very similar competition problems arise in SME banking, particularly with regard to the smallest customer firms which exhibit similar traits to retail customers.

4. In this document TSB identifies the issues it believes that the CMA should investigate. In summary, TSB broadly agrees that the CMA has identified the relevant issues in its Issues Statement. In further submissions, as the investigation progresses, TSB expects to provide more detailed submissions and evidence on the competition issues in PCA and SME banking markets.

Background on TSB

5. TSB was created in 2013 as the result of "Project Verde", following the 2009 State aid decision by the European Commission which found that the UK government's financial assistance to Lloyds Banking Group ('LBG') constituted State aid. As a condition for approving this State aid, the European Commission required LBG to dispose of a standalone

UK retail banking business meeting certain criteria. TSB was therefore created with the explicit intention of increasing competition in the retail banking market.[1]

6. TSB was launched as standalone retail banking brand on 9 September 2013, with 631 branches. These branches comprise 164 former Cheltenham & Gloucester ('C&G') branches (which did not, until the first half of 2013, have the capability to provide current account services), all 185 former Lloyds TSB Scotland branches, and a further 282 former Lloyds TSB branches in England and Wales.

7. TSB was built as a standalone bank with significant growth potential. Approximately 46% of the population of Great Britain live within two miles of a TSB branch. TSB was created with multi-channel distribution capabilities supported by a resilient systems infrastructure provided on a commercial basis by LBG.

8. TSB provides banking services to individuals and to small businesses. Unlike most of the incumbent banks, TSB does not provide commercial banking services to larger companies, and does not provide investment banking; nor does it operate outside of the UK. At 31 August 2014 TSB had approximately [redacted].[2] Its suite of personal banking products comprises PCAs, savings products, mortgages, unsecured personal lending products, and certain insurance products.

9. While TSB provides banking services to business customers, its capability in this market is limited to smaller businesses than is the norm in UK banking. TSB's approximately [redacted], while many business banking customers are in fact clubs, societies, and charities.

10. During the earlier stages of Project Verde, as the business to be divested in line with the European Commission's State aid requirements was being designed, and in particular as part of the negotiations for the sale of it to the Co-Operative Banking Group ('CBG') that did not in the event proceed, a number of changes were requested to the original perimeter of the business being divested, which were agreed to by the European Commission. These changes – making the mortgage portfolio smaller and removing Intelligent Finance customers and C&G fixed term deposits from within the perimeter – reduced a funding gap in the originally designed divestment business. However, they also reduced the overall size of the divesting business, bringing down the balance sheet in particular to c.£22 billion.

11. In June 2013 the Chancellor of the Exchequer asked the OFT to review the impact on competition of the proposed State aid divestments by LBG and RBS in retail and SME banking. On 11 September 2013, the OFT published recommendations to implement measures designed to help enhance TSB's ability to compete and its financial strength,

[1] State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, C(2009)9087, 18.11.2009, para.188.

[2] CACI, CACI Current Account and Savings Market Database, which includes current, packaged, youth, student, and basic bank accounts, and new account openings excluding account upgrades, August 2014.

particularly in a low interest rate environment.[3] These recommendations, which were accepted by HM Treasury and LBG, included a temporary reduction in the costs of the transitional services agreement under which LBG provides key services to TSB, and an agreement to a short term transfer to TSB of the "economic benefit" of a portfolio of residential mortgages, designed to enhance TSB's profitability by more than £200 million in aggregate in the first four years of TSB's existence. LBG also agreed to provide TSB with an additional £40 million common equity tier 1 capital to enable future customer acquisition and to develop its branch network.

12. In view of the critical nature of the services provided by LBG, the OFT also made a series of recommendations in relation to the agreements under which LBG provides services to TSB, including the appointment of a long-term independent monitoring trustee (subsequently established under the FCA's Skilled Person regime) to monitor the operation of the various agreements, and for the FCA to take on this role from the Initial Public Offering.

13. TSB received full operating autonomy within LBG from 1 January 2014. In June 2014, TSB underwent an Initial Public Offering, in which LBG sold 38.5% of its holding in TSB. A further holding of 11.5% was sold in September 2014, such that LBG currently owns 50.001% of TSB – although TSB has full autonomy as a standalone bank, pursuant to a relationship agreement with LBG. The deadline from the European Commission for full divestment of LBG's interest in TSB is 31 December 2015, which may be extendable to 30 June 2016 or 31 December 2016 in certain limited circumstances (related to a significant market shock that could adversely impact on the disposal of LBG's remaining interest).

14. TSB's ambition in the current market context is to grow its share of the total PCA market to 6%, matching its current share of the UK's retail bank branch network. Although this strategy will take some time to deliver, TSB's early performance since its launch has been promising, particularly with regard to the three component parts of its growth strategy:

- To grow personal current accounts – TSB has been able to secure approximately 9% of new PCA accounts between February and July 2014 primarily through the launch of its Classic Plus current account and an associated marketing campaign and has seen net growth in current accounts every week since the business was launched in September 2013 – albeit that overall switching activity in the market remains muted.

- To grow customer lending – TSB is on track to launch a mortgage broker distribution channel in January 2015, although lending growth through this channel is likely to be gradual, taking a few years for the business to reach £4 billion of gross lending, or c.3% share of the market at its current size. TSB'*s* mortgage brand consideration score remains low, though has improved over the first nine months of 2014 from 4% to 9%. TSB also saw SME lending balances decline as customers transferred back to

[3] OFT, Letter to the Chancellor of the Exchequer, 11 September 2013 https://www.gov.uk/government/publications/letter-from-oft-to-chancellor-recommendations-on-lloyds-banking-group-and-royal-bank-of-scotland-divestments, p. 14-16.

Lloyds because their banking requirements could not currently be met by TSB's business banking proposition.

- To enhance the TSB proposition – TSB operates in a mature environment against well-established incumbents, and brand value therefore plays a key role. To compete more effectively, TSB is enhancing its brand proposition by investing in a number of programmes such as further enhancing its digital channels, including the recent launch of its public website, and upgrading its branches, having refreshed 135 so far this year. TSB is also seeking to differentiate its customer service, and its efforts are starting to be recognised – in a recent survey by *Which?* magazine on customer service by UK brands, TSB was the only high street bank ranked in the top quartile.

15. Notwithstanding implementation of the measures recommended by the OFT and some of the positive progress made by the business since the launch of TSB as a standalone business, TSB still faces significant challenges in growing to the point where it can be a genuinely disruptive challenger in the market, not least as a result of the initial design of the Verde business, and the amendments to that design agreed to for CBG before the withdrawal of its bid for the Verde business, such that TSB's balance sheet is relatively small in the context of the scale of its infrastructure.

Competition problems

16. TSB believes that competition problems in the UK retail banking market can be described by reference to two closely related characteristics of the market, and that for these characteristics to be effectively countered or addressed requires challengers of sufficient scale and financial strength to be able to offer a sufficiently compelling offer to potential customers:

- First, inertia among customers means that established incumbents are able easily to retain retail customers.

- Second, retail banking involves significant fixed costs, and consequently incumbents are able to exploit significant economies of scale and related advantages.

17. Both of these issues are explained below.

Consumer inertia

18. Opportunities to attract new customers are limited because customers rarely switch bank accounts. Although various regulatory interventions have attempted to remove barriers to switching, these initiatives have so far had limited success and current levels of switching are still low when compared to other markets. For example, the CMA has found that, following the launch of the Current Account Switching Service ('CASS'), annual switching rates for PCAs have risen to 3%, but this is still low compared to other sectors (30-35% in car insurance, for

example).[4] A recent study by the Payments Council on account switching indicates that only 2.4% of the consumers surveyed had switched in the last 12 months.[5]

19. TSB is aware that during previous investigations switching data has been criticised by incumbent banks. For example, incumbents have argued for the need also to take into account multi-banking, where customers have accounts at multiple banks and can move their custom between these banks, and the natural evolution as a result of new customers entering the market for the first time and accounts closing following death, as factors that raw switching data ignores. However, TSB considers that, even taking these factors into account, switching remains low. For example, as explained below, incumbents enjoy scale and incumbency advantages that make it difficult for new entrants to compete for new accounts. As a result, incumbents continue to acquire most new accounts, so including this natural evolution of the account population has little impact on any analysis of switching or on incumbent market shares. TSB notes that in the last decade there has been no disruption to the market that has fundamentally changed consumer outcomes or led to material increases in the share of "stock" of all PCAs held by new entrants (excluding the results of mergers and acquisitions, and of divestments).

20. In any case, it is important to note that even if challengers were to obtain a higher share of the "flow" of newly opened accounts this may have little impact on shares of the "stock" of all accounts. As noted above, for example, following the launch of its Classic Plus PCA product, TSB has been able to secure approximately 9% of new PCA accounts between February and July 2014.[6] However, because switching rates remain low, this share of "flow" does not translate into a significant increase in its share of the "stock" of all PCA accounts, and is unlikely do so in the near future without a significant increase in switching activity.

21. In TSB's opinion, a key factor that prevents higher levels of switching is that customers have no "prompt" to make them consider switching. In contrast to, say, insurance, a PCA does not run out and need to be renewed. TSB believes that bit is important to understand the different reasons that consumers cite for leaving one current account provider versus choosing another. For example, the Payments Council's 2014 quantitative study on account switching found that only 38% of the surveyed consumers who had not switched in the last 12 months would be willing to switch accounts if they felt it would be beneficial for them, i.e. even the knowledge that there may be benefits to switching would be unlikely to precipitate a switch for more than 60% of respondents. Further, only 8% of such consumers were likely to switch accounts in the next 12 months.[7] TSB in fact believes it is likely that consumers will typically overstate their own likelihood of switching, and this figure is likely to be unrealistically high in the current market.

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4 Reference Decision, para. 3.33.

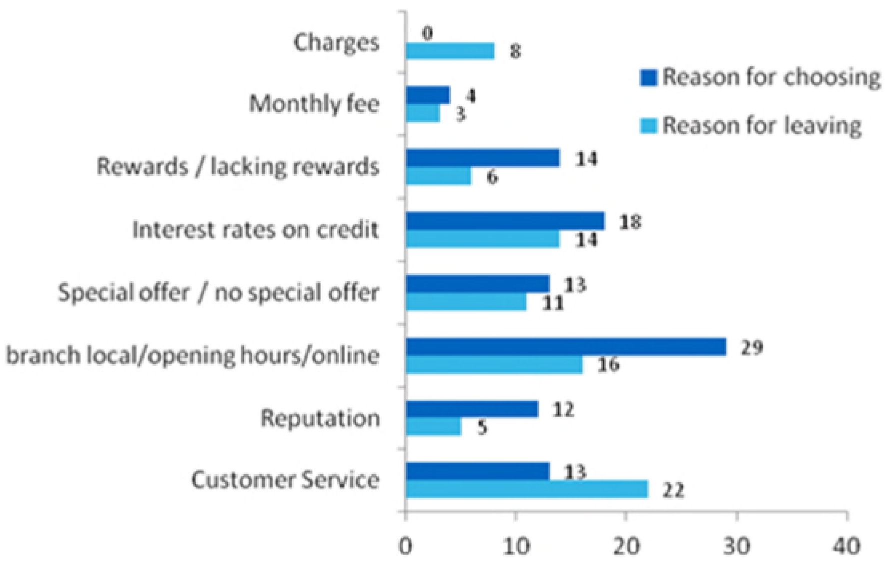
5 "Account switching: Quantitative market research results", Payments Council, July 2014, p. 5.

6 CACI Current Account and Savings Market Database, which includes current, packaged, youth, student, and basic bank accounts, and new account openings excluding account upgrades.

7 "Account switching: Quantitative market research results", Payments Council, July 2014, p. 14.

22. This suggests that the “prompt” to switch accounts is typically a negative experience, such as particularly poor service, and only then is there a decision driven by positive judgements about which is the best new provider, e.g. on the interest rate paid on deposits, or convenience of branch location. Figure 1 below illustrates the different drivers for leaving and choosing a new current account provider.

Fig.1 Reasons for leaving and choosing PCA provider



Source: TNS Current Account Switching Index, September 2014

Economies of scale and incumbency advantages

23. The preconditions for a new entrant to exert an effective competitive force in the retail banking market were identified by the OFT in its analysis of the likely competitive impact of the Project Verde and Project Rainbow divestments in September 2013.[8] TSB believes these preconditions remain valid today.

24. In order to compete effectively, the OFT suggested that a challenger bank requires the ability to generate profit to invest in growth, and the ability to innovate and differentiate its offering against incumbents. To provide this profitability a challenger requires sufficient scale, including a sufficiently large and high quality branch network and a sufficiently large customer base, including the likelihood of having a mix of customers consistent with having the incentive to compete – this incentive to compete being driven in part by the presence of

[8] OFT, Letter to the Chancellor of the Exchequer, 11 September 2013, see footnote 2 above, in particular p. 6-8.

a sufficient share of "active" customers (who might otherwise switch away if the offering to them was not kept competitive). Moreover, the OFT identified the need for a sufficiently large and developed base in the provision of PCAs from which to grow into other retail banking products.

25. As the OFT observed, there is an important trade off involved in assessing the optimal scale for an effective competitor, since a "sub-scale" bank is not able to compete, while a "super-scale" bank is not incentivised to compete. The OFT observed that the optimal market share for an effective competitor appeared to lie in the range of 5% to 14%.[9]

26. This requirement for scale reflects the need for effective challengers to be able to offset the significant costs of customer acquisition. TSB believes that the market currently demonstrates asymmetries in the ability of incumbents and new entrants to offset these costs and therefore compete for new or switching customers. These asymmetries are visible in the direct costs of customer acquisition and retention, but also in the high fixed costs associated with operating a retail bank in the UK, including the significant regulatory, IT, and other "back office" costs, where incumbents typically enjoy significant economies of scale.

27. TSB therefore believes that the CMA should consider during the market investigation the possibility that competition in the retail banking market may be most effectively facilitated by ensuring that there are a sufficient number of challenger banks with the scale to offer meaningful competition. While TSB has not sought to identify a minimum market share that such challengers should have, TSB believes that the range identified by the OFT would constitute a useful starting point for the CMA's analysis.

Combined effect of these problems

28. In summary, TSB believes that competition is hindered by two factors. First, customer inertia results in low levels of switching given reported levels of customer satisfaction, as noted in the Issues Statement. Second, and partly as a result of the first problem, incumbent banks enjoy scale and incumbency advantages which act as barriers to entry and expansion. This results in most customer "flow" being acquired by a small group of incumbent banks. The combined result of these factors is that new entrants and smaller competitors cannot grow to the size they would need to reach in order to provide effective competition to incumbent banks.

29. Therefore, addressing one of these factors in isolation, without also addressing the other, is not only unlikely to have a positive impact on the market; it is in fact likely to exacerbate the current problem and lead to still worse outcomes from consumers. Simply increasing switching, without also addressing the structural barriers which prevent new entrants and smaller competitors from competing effectively with incumbents for PCA customers, is likely further to increase the strength of established incumbents, and would at best allow for incremental evolution in the market, rather than genuine disruption from new providers resulting in improved consumer outcomes.

9 OFT, PCA Market Study, 2008, para. 3.6.

30. As explained below, TSB believes that, were the CMA to investigate the theories of harm set out in the Issues Statement, it would have the opportunity to consider thoroughly the key competition problems outlined above. TSB therefore supports the approach outlined in the Issues Statement.

Comments on issues set out in the Issues Statement

31. TSB has described above the key competition problems that it believes the CMA should investigate. For completeness, in this section TSB sets out its views by reference to the issues raised in the Issues Statement.

Market definition

Product market definition

32. Retail banks typically provide a range of banking services to their customers alongside PCAs. In particular, customers will often purchase other products from the bank where they hold their PCA. Customers may therefore, over time, purchase a bundle of services from their bank (e.g. a PCA, a mortgage, a savings account and insurance). The PCA acts as an introduction to the bank for the future provision of other services over time, and the ability to grow in these additional products is determined in part by the bank's position in the PCA market.[10] Therefore, strong PCA market share often leads to the development of a large book of business in other product categories in addition to PCAs, which in turn helps to shape these providers' approach to, and ability to compete in, the PCA market.

33. The CMA will therefore need to consider the interaction between PCAs and other services. However, in TSB's view, the important competitive dynamic that drives competition in a range of banking services is competition in the provision of PCAs.

34. Similar issues arise in SME banking, where a current account again can act as an introduction to the bank for the future provision of other services.

Geographic market

35. TSB operates throughout Great Britain. TSB suggests that the CMA should consider the extent to which competition operates at a local level. TSB's experience is that competition in both PCAs and SME banking is significantly affected by the presence of a local branch. For example, customers who live in close proximity to a TSB branch are relatively more likely to open a TSB current account than customers who live further away from a branch. Competition therefore has a clear local dimension.

36. TSB notes that, whatever the exact definition of the geographic market, the same barriers to competition exist throughout Great Britain and within any narrowly defined geographic market, since products, propositions and marketing activity tend to be deployed across Great Britain. However, the propensity of a consumer in a given geographic area to

10 OFT, Letter to the Chancellor of the Exchequer, 11 September 2013, see footnote 2 above, p. 7.

purchase a current account with a given bank is strongly correlated with the presence of a branch of that bank in close proximity to the consumer's home or business, and geographic market definition may therefore be relevant for the design of any remedies which the CMA may consider.

Theories of harm

37. The CMA identifies three theories of harm, which discuss in turn below.

Theory 1: barriers to shopping around and switching

38. Although action has been taken following previous inquiries to encourage switching, TSB considers that these initiatives have so far had limited effect and problems remain. As explained above, evidence suggests that switching rates remain lower than 3% per year.

39. The Issues Statement sets out three hypotheses within this theory of harm: customers lack access to relevant information, customers lack the ability to assess information, and customers fail to act on this information. TSB agrees that the CMA should investigate the contribution of each of these three (potentially complementary) problems to the observed low switching rates. The Issues Statement suggests that the "evergreen" nature of current accounts may mean that consumers lack an effective prompt to consider switching accounts. TSB agrees that this problem merits further investigation, as it may constitute an important prior impediment to switching before the hypotheses come into effect. As mentioned above, in contrast to, say, insurance, a PCA does not run out and need to be renewed.

Theory 2: concentration

40. TSB agrees that the PCA market is concentrated with stable market shares of "stock". In TSB's opinion the barriers identified under Theory 1 and Theory 3, and those outlined earlier in this response, prevent smaller competitors from imposing significant competitive pressure on incumbent banks, and lead to a concentrated market in which the incumbents have market power. This concentration also intensifies the competition problems presented by factors outlined in Theory 1 and Theory 3, as concentration allows incumbents to exploit and further develop the economies of scale which themselves form an effective barrier to entry. In addition, incumbents have little incentive to engage in vigorous competition, reflecting the relatively small proportion of customers who are "active", and therefore little incentive to drive effective competition.

41. Moreover, TSB believes it is important to note the scale of the challenge in developing growing market share of the "stock" of all accounts as distinct from the "flow" of newly opened accounts, as explained at paragraph 18 above.

42. TSB agrees that the CMA should investigate the market structure, including concentration and stability of market shares over time, as well as market outcomes that may be revealed through examination of pricing by, and the underlying profitability of, incumbent banks.

Theory 3: barriers to entry and expansion

43. The Issues Statement sets out at paragraph 49 five potential barriers to entry and/or expansion.

44. In TSB's experience, the key barriers to entry and expansion are the impact of economies of scale and incumbency advantages (i.e. paragraphs 49(b) and (e)), as outlined above. However, TSB believes that the CMA should investigate all the issues set out at paragraph 49 of the Issues Statement. In particular, there may be some interactions between the separate issues set out there. For example, regulation (point (a)) may create significant fixed costs which then become a source of economies of scale (point (b)).

45. TSB believes it is important that any remedies which the CMA may consider not only address issues relating to barriers to customer switching but also address these barriers to entry and expansion. It is also important that remedies do not inadvertently re-enforce these barriers. For example, the CMA should avoid reforming the switching process, or facilitating comparisons, in ways that make it easier for incumbents to exploit the advantages outlined in this response, but which may fail to provide the same benefit to challenger banks, thereby exacerbating the barriers to entry and expansion that result from the incumbents' economies of scale, and creating a barrier to real innovation and disruption in the market. Interventions which may be applied symmetrically across the market may nevertheless have asymmetric effects which could, perversely, result in detriment to consumers rather than consumer welfare gains. Previous behavioural interventions, most notably CASS, have seen limited increases in switching activity, and TSB notes that the main net gainers from CASS have been incumbent brands. It is therefore not clear that such interventions have so far provided any significant incentives to the incumbents to innovate in the creation of new products or services.

The combined impact of the three theories

46. In TSB's opinion, the three theories of harm need to be seen as complementary aspects of a single competition problem.

47. Theory 1 and Theory 3 identify barriers that protect incumbents and prevent new entrants from effectively challenging incumbents. The combined effect of Theory 1 and Theory 3 is to create the market structure identified under Theory 2, in which incumbents enjoy relatively stable market shares, face limited peripheral competition from smaller players, and have little incentive to compete vigorously with each other, while the effect of Theory 2 further intensifies the effects of Theory 1 and Theory 3. This lack of effective competition, either between incumbents or from challengers, can lead to adverse outcomes for consumers. Both sets of barriers (those identified under Theory 1 and those identified under Theory 3) are important and need to be addressed. Removing one without removing the other could inadvertently re-enforce the advantages which incumbent banks enjoy.

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