LLOYDS BANKING GROUP PLC

RESPONSE TO ISSUES STATEMENT

1. SUMMARY

1.1 The Competition and Markets Authority's (CMA's) Issues Statement identifies three hypotheses for investigation, and lists a number of sector characteristics that it believes inform these hypotheses. In this response, we (LBG) offer our views on these hypotheses and characteristics in order to assist the CMA as it develops its thinking.

1.2 We also discuss the important issue of how the CMA should define an appropriate "well-functioning market", as the relevant counterfactual when investigating these markets. We all agree that this concept needs to be realistic and feasible and we think the CMA therefore needs to identify factors which are "intrinsic" to these markets, and which should therefore be part of a well-functioning market (rather than assumed away in the counterfactual).

1.3 As we said in our letter of 11th November 2014, we think that there are a number of market-wide improvements that can and should be made to increase customer engagement and to improve outcomes for business and personal current account customers. We do not support the status quo. This reflects our desire to achieve real change in the reference markets.

1.4 We do, however, have detailed comments on each hypothesis and the key sector characteristics. We also think a robust and detailed analysis of these hypotheses and evidence will lead to conclusions that will, in many cases, look quite different from some "established views". It is, of course, for the CMA to decide on these points, but we hope it will investigate the following propositions:

- Many of the "features" often claimed as inhibiting or distorting competition may actually be intrinsic to these markets, and not fundamentally alterable. If this is correct, and the counterfactual appropriately reflects these intrinsic features, then competition in these markets will be appropriately assessed and will often be more intense than generally perceived, even if focused around dimensions that regulators don't always recognise. A realistic and feasible well-functioning market might, in many ways, look quite similar to what we observe today.

- While current price structures raise certain distributional issues, it is unclear whether better pricing structures are sustainable in a well-functioning market. Where there are concerns, for example in relation to overdraft charging, it is likely that the role of technology and increased customer engagement can largely address these concerns.

- On this basis, we think the evidence is likely to demonstrate that the major issue to resolve is customer engagement. This appears to be the root cause of many of the points relating to customer outcomes, and potential barriers to entry and expansion. Other points are being addressed in detail by other regulatory processes.

- It is not clear, given the seven existing national providers, that increasing the number of providers would change any of the intrinsic features of the market, increase customer engagement or the intensity and nature of competition. Customer outcomes can and should be improved, but any perceived causal link to the number of providers and market shares is not supported.

1.5 As we note, it is for the CMA to assess the evidence and to consider whether these propositions are true. We hope the CMA explains the basis for the key questions set out in our letter of 11th November 2014. The answers to these questions could fundamentally change the face of UK banking, particularly if the CMA can facilitate better coordination of regulatory intervention and find rapid ways to deliver more customer engagement.

2. INTRODUCTION

2.1 We consider that the hypotheses and characteristics set out in the Issues Statement broadly cover the main issues that are relevant for the CMA's investigation. We welcome the focus on the issues covered in Hypothesis 1. We have long argued that steps can be taken to improve how customers access, assess and act on information in these markets through coordinated action by stakeholders. We developed and supported the ICB's recommendation for the Current Account Switching Service (CASS). We have tried to push forward improvements to transparency and make it easier for customers to shop around and compare accounts, but have been frustrated at the lack of engagement by other stakeholders.

2.2 We hope the CMA can take advantage of the large amount of previous work, and ongoing developments, to give itself a head-start in its investigation of this hypothesis and focus on how it can resolve some of the issues that arise in connection with it. Hypothesis 1 is concerned with customer behaviour (specifically, customers' ability to effectively shop around, choose and switch products or suppliers). We believe that a proper investigation of this hypothesis will require behavioural analysis, in addition to any carefully designed customer surveys. We would like to see the CMA move quickly to testing and trialling to diagnose what challenges customers may face, and the changes that might be expected to have the biggest impact for customers. We have recently provided the CMA with some additional thoughts on how this might be done, which we have attached at Annex 1.

2.3 Some of the issues in Hypothesis 3 (which is concerned with regulatory, structural and conduct barriers to entry and expansion) are driven by technology, and some are the direct consequence of regulation. Many of the issues are already being resolved. Reforms to the authorisation process have already made it easier for entrants, but improvements could still be made. The Payments Systems Regulator (PSR) has set out a comprehensive work program, including two market studies, to identify and address any remaining barriers to entry in payment systems. It has a full range of powers, including divestment and price controls, to address any issues identified.

2.4 There are some other important issues in Hypothesis 3 that the CMA can usefully investigate as to whether more can be done. One area that we think is highly relevant and that may require more emphasis is the wider impact and role of regulation. For example, requirements to offer Basic Bank Accounts (BBAs) reduce incentives to enter parts of the market, reduce innovation and lead to cross-subsidisation. The CMA can helpfully consider whether there are better ways to meet the legitimate policy objectives behind BBAs in a way that would minimise effects on competition in the rest of the PCA market, and promote more innovation and competition in the provision of BBAs.

2.5 The CMA should investigate whether branches are a barrier to entry in either reference market. But as we said in our letter of 11th November 2014, if the CMA identifies a competition concern on the basis of robust evidence, then we would be willing to explore the feasibility of industry-wide agency service arrangements for the servicing of personal and/or business current accounts.

2.6 We do not believe that the evidence supports Hypothesis 2 (concentration leading to worse outcomes for customers). If any outstanding issues in Hypotheses 1 and 3 are resolved, then we do not believe Hypothesis 2 is relevant.

2.7 We have not provided new empirical evidence at this point as the CMA will already hold relevant existing evidence collected as part of recent studies, and will be collecting additional evidence as its investigation unfolds. The CMA has stated that the evidence it has reviewed to date was gathered as part of the previous CMA competition reviews and those of its predecessors. This is relevant evidence, but we trust that the CMA will not accept the existing interpretation of this evidence without taking a fresh and objective look.

2.8 In the remainder of this document, we first provide comments on the CMA's approach to defining an appropriate counterfactual (Section 3). Section 4 discusses each of the CMA's hypotheses in turn, commenting on the issues and how we believe relevant evidence can be gathered. Section 5 sets out our comments on the sector characteristics identified by the CMA, and Section 6 concludes by summarising the eight areas we believe will be important for the CMA to consider as a priority in this investigation.

3. DEFINING AN APPROPRIATE COUNTERFACTUAL

3.1 The CMA states that it will assess the effectiveness of competition against the benchmark of a 'well-functioning' market. We agree this is the right approach, and that it is important that this benchmark is realistic and feasible, and not based on an idealised market, which the CMA recognises. However, the CMA has described its benchmark as being *"the absence of **any** features giving rise to AECs that we [the CMA] identify"*. We are concerned that it may not be possible or feasible for some features, relating, for example, to certain customer characteristics and preferences to be absent.

3.2 It is helpful to think of the appropriate benchmark as a counterfactual state of the market, which is a realistic description of how competition could feasibly be most effective. To identify a realistic counterfactual, we believe that market features need to be identified as either intrinsic or variable.

3.3 Variable features are those that can be influenced by firms (either unilaterally or multilaterally), or by regulators. For example, a variable feature may be the regulatory requirement to provide BBAs, or the length of time it takes to switch provider. In a realistic counterfactual, variable features may be absent or different and can, in principle, be changed.[1] The intrinsic features will remain.[2]

3.4 Evidence on whether features are intrinsic or variable could come from a variety of sources including behavioural research and differences between new and established competitors. Such evidence would identify whether the same features

---

[1] Whether any remedies should ultimately be adopted will still depend on the feasibility, effectiveness, proportionality and potential unintended consequences of doing so.

[2] For example, at this stage, we suggest that intrinsic features would include customer preferences for PCA and BCA products to bundle together core services e.g. deposit holding, payment, overdraft and transfer services, the fact that products are "longer term", not transactional products, that customers exhibit different transactional behaviours, and that existing providers operate with legacy infrastructure.

arise in all circumstances, which may suggest they are intrinsic, or whether the features vary in different circumstances.

3.5 For example, if charging structures are complex, is this an intrinsic or a variable feature of the market? This could be explored by analysing the following questions:

- Do entrants to the market use simpler pricing structures than existing providers and if not, why not?
- Have simpler or significantly different pricing structures been used in the past, and were these successful?
- Are there simpler pricing structures that could be used (for example, based on transaction types), and would the resulting pricing distribution be better than the current distribution?

3.6 A realistic counterfactual can then be used to analyse the hypotheses for investigation.

3.7 Comparisons with other markets can also provide helpful context when considering whether any features are of sufficient concern. For example, does the CMA consider that PCA and BCA pricing structures are more or less complex than pricing in other markets such as supermarkets, telephony/broadband/television bundles and transport? Do customers have the ability to understand this level of complexity and/or engage effectively in these markets?[3] Moreover, where complexity is observed, is this driven by product innovation which delivers important benefits to customers by tailoring product features more closely to specific customer requirements?

4. HYPOTHESES FOR INVESTIGATION

4.1 We welcome the clarification in the Issues Statement that a theory of harm is solely a hypothesis to be tested, with no prejudgement of an adverse effect on competition.[4]

---

[3] Further thoughts on this point are set out in Annex 1.

[4] "*A theory of harm does not imply any prejudgement of an AEC; it is solely a hypothesis to be tested. Our investigation is at a very early stage, and the purpose of identifying these hypotheses is to present some early thinking on these issues for comment, to help frame our investigation*." Issues Statement, paragraph 24.

4.2 At first sight the evidence might potentially support some of the hypotheses identified in the Issues Statement, and we believe there are a number of key regulatory, information and behavioural factors that are relevant to consider. Customer engagement solutions are evolving, but we are keen to see a leading role played by the CMA to coordinate action between industry participants, consumer organisations and regulators in order to address some of these issues. This would accelerate progress, enhance customer engagement and provide regulatory clarity, thereby delivering benefits to both customers and providers.

4.3 In very broad terms we believe that there is merit in using Hypothesis 1 to explore issues relating to customer engagement, although we disagree with the conclusion that providers compete weakly. We do not see Hypotheses 2 and 3 as raising significant issues which are distinct from Hypothesis 1.

4.4 Competition to retain existing customers (as well as to attract new customers) can take various forms, and the absence of significant switching between providers does not necessarily point to a lack of competition. For example, so far over 500,000 of our own customers have chosen to switch from an existing Lloyds account to our Club Lloyds account which offers better interest, a £100 free overdraft and a range of other benefits. As this account was introduced in response to rival offers this shows many more customers are engaged and benefitting from competition than those who have simply switched provider.

Hypothesis 1: Impediments to customers…resulting in weak incentives for banks to compete

4.5 Hypothesis 1 is split into three parts that relate to customers' ability to access and assess information relating to the reference products, as well as to act (i.e. make an active decision in relation to that information). As well as the ability to access, assess and act, an additional factor to consider is whether customers have the willingness or incentive to undertake these activities. For the majority of customers PCAs are not a significant household cost (even when factoring in all costs including any foregone credit interest) and the potential financial gains from switching are low relative to other markets.

4.6 Both ability and willingness are needed to access, assess and act, and this suggests that investigation of motivation as well as ability will necessarily form part of the analysis. One hypothesis for a customer not switching might relate to an inability to access, assess or act on information, but an equally valid hypothesis is that ability exists, but motivation does not. Disentangling these effects will require well designed behavioural investigation.

4.7 More generally, given the behavioural issues at play, we strongly suggest that the best way to explore what works best in practice is to test different options, including through trials and other research.

4.8 Technical solutions are beginning to emerge to enhance the way customers engage with PCAs and BCAs (e.g. developments in existing price comparison engines and data sharing initiatives such as Midata, as well as the growth in "mobile banking" via mobile phones). However, faster and more effective solutions to these issues will require cross-industry agreement and oversight by a regulator. This is an area where the CMA can add real value.

4.9 In the Issues Statement, the CMA has provided a more detailed breakdown of Hypothesis 1 using its 'Access, Assess, Act' framework. For ease of comparison, we have used this framework to provide structured comments below on each of the CMA's sub-hypotheses, including how relevant evidence can be gathered.

4.10 However, in addition to the access, assess and act methodology, there are other mechanisms that can achieve the same competitive outcomes without customers needing to consider detailed information in the way implied by this framework. In many markets, including PCAs, providers provide signals to customers through price promises, being 'never knowingly undersold', and through satisfaction guarantees. Innovative providers have always found ways to communicate information and give assurances to customers without the need for detailed calculations by customers themselves, and this will (and should) remain an important part of the competitive process.

Access

4.11 Customers must be able to access relevant information in order to compare offers or make informed decisions. This should, as a minimum, include awareness of the following:

- current cost of banking services and specific transactions and behaviours e.g. overdraft usage;
- knowledge of the customers' own behaviour and usage patterns, credit score and transaction profile (usage is a key feature in determining future costs);
- alternative products available;
- sources through which information can be gathered; and
- mechanisms through which any actions could be implemented e.g. switching or increasing overdraft limits.

4.12 Customer awareness can be explored through carefully designed questions in customer surveys, which can be compared to real customer data (held by providers) to identify areas where lack of awareness may be particularly acute. Any assessment should include service and quality factors, as well as price.

4.13 Customers will incur some search costs in gathering the information outlined above, which raises alternative hypotheses: do SME customers (for example) borrow more frequently from their own bank because they value the relationship and the reduced search costs associated with that relationship, or do providers create barriers to search?

Assess

4.14 The sub-hypothesis relating to assessment of information suggests that, as the CMA puts it, potential “cognitive limitations and behavioural biases” affect the ability of customers to interpret pricing and product information.[5] This can be tested by exploring the willingness and ability of customers to compare the information available to them. [6]

4.15 Importantly, a hypothesis which the CMA intends to explore is whether existing products and pricing structures exploit customer biases. An important part of the testing outlined above, therefore, will be to assess the extent to which customers have the *ability*, and the *willingness* to compare products. While providers can make it easy for customers to compare, they have little influence over customers’ fundamental willingness to do so.

4.16 Disentangling willingness and ability will need to be targeted at the customer segments where the CMA has concerns, as any identified issues and their associated solutions are very likely to differ on a customer segment by segment basis. For example, if the CMA is interested in overdraft usage, research should focus on overdraft users to understand the specific barriers these customers face, and trials and potential remedies should be tested specifically on overdraft users. Similarly, the level of engagement may vary between different sizes of SMEs. Solutions are unlikely to be one size fits all.

4.17 One option to explore both customers' willingness and ability to engage is through laboratory testing. For example, an experiment could be set up which provides

---

[5] Issues paper, Hypothesis 1b.

[6] For further detail, please see Annex 1.

customers with a cash prize if they correctly identify the best value product, given a set of behaviours. If customers are in fact able to identify the best value product, this would support a hypothesis that customers (or particular customer segments) do have sufficient information and the ability to act, but lack the motivation to search for alternative products. If, on the other hand, customers do not do well at this task, it might suggest the information is incomplete, or that the task is too difficult.

4.18 There are multiple sub-hypotheses to be tested in the category of "assess", particularly as regards the question of whether PCA, BCA and SME business lending products are complex, namely:

- How is complexity measured and against what objective scale or comparison?
- How does it compare with products that customers experience in other sectors?

4.19 Further, products such as the Club Lloyds PCA[7] and Halifax Rewards[8] have recently been launched with the explicit intention to improve customer outcomes. These launches have been successful, and we have seen strong take-up. As a result, simple cross-market comparisons may have become more difficult to some extent, but in our view this is clearly evidence of the competitive process delivering benefits to customers through the introduction of new products and greater product and provider differentiation, rather than an indication that customers are worse off in some way.

---

7 Club Lloyds is a new current account proposition that offers customers with two active direct debits a tiered credit interest on their balances up to 4% (capped at £5,000), a £100 interest and fee-free overdraft, exclusive access to improved offers on other products – currently savings and mortgages and a choice of non-banking benefits (either six cinema tickets, membership of the gourmet society or a magazine subscription). It also includes Everyday Offers that rewards customers with up to 15% cash back on debit and credit card purchases and 'It's on Us' a monthly competition where debit or credit card spend of up to £500 is refunded to the customer. The account is free as long as customers pay in £1,500 or more per month, otherwise a £5 monthly fee applies. Club Lloyds can be taken as a standalone account or added to one of our AVA products. See http://www.lloydsbank.com/current-accounts/club-lloyds2.asp. It also makes available 'Everyday Offers', which is a similar scheme.

8 This account pays a £5 monthly reward to all customers who fund their account with £750 and pay out two direct debits during the month, and includes Cashback Extras which rewards customers with up to 15% cash back on purchases with retailers. See http://www.halifax.co.uk/bankaccounts/current-accounts/reward-current-account/.

Act

4.20 This sub-hypothesis centres on the ability of customers to shop around and switch. In our view, this appears to place undue weight on switching providers as a single measure of success. Switching providers is one of a range of options available to customers.

4.21 Switching between products offered by the same provider is also an important measure of engagement and activity. Customers cannot automatically be migrated from one product to another (as products have different eligibility criteria), hence switching between products demonstrates an active behaviour on the part of customers. This form of switching is consistent with the competitive process and benefits customers, particularly where a key rationale for product innovation is to retain internal switchers that might otherwise become external switchers. This is an important behaviour that needs measuring and understanding to progress Hypothesis 1.

4.22 If the greatest gains for customers relate to switching products or changing behaviour, measuring the extent of provider switching will underestimate the degree of engagement and competitive activity in the market. These behavioural changes should be given equal weight to switching providers: when considering their options, our existing customers will only choose to remain with us if our products are competitive.

4.23 Often, switching products, or even simply changing behaviours can generate the biggest impact for customers. For example, customers who fund their account with £750 per month can gain £5 per month by switching to a Halifax reward account from a standard account, and our overdraft customers can gain £1 per day by moving to a packaged account with bundled overdraft charges.[9] Or as the FCA has shown, mobile banking apps are reducing overdraft charges by helping customers to optimise their behaviour. [10]

4.24 For this reason, measures of the ability of customers to "act" should also include full consideration of the following:

- switching providers and brands;

---

[9] Halifax Reward customers will receive £5 per month if they fund their account by £750 each month. Halifax Ultimate Reward customers do not pay the £1 fee per day for using an overdraft up to £300.

[10] http://www.fca.org.uk/news/beesley-lecture#Overdrafts

- switching products;
- changing behaviour e.g. overdraft usage; and
- deciding existing products and behaviours remain appropriate.

4.25 The hypotheses which the CMA intends to explore are that: (i) there are barriers to changing behaviour, including that there are insufficient prompts to act; (ii) there are costs associated with changing behaviour; or (iii) there are customer-perceived costs.

4.26 The best way to test these alternatives is to assess what works best with real customers. This can be done by exploring providers' customer data to test whether specific events have had an impact on observable behaviour. The FCA's recent work on annual statements and text alerts is a good example of this type of event analysis approach.

4.27 Further, within the timescales of the investigation, live trials could be set up with providers to test the impact of new types of intervention. This would diagnose any behavioural issues and test whether behaviour could be influenced e.g. through new prompts, or by providing incentives. Again, if incentives could successfully influence behaviour, this would expose whether customers have the ability to act but not the motivation, or whether there are perceived barriers to certain behaviours, such as switching.

Hypothesis 2: Concentration

4.28 Hypothesis 2 is described in the Issues Statement as follows:

- high levels of concentration may indicate that one or more providers have market power;
- providers with high market shares may have less incentive to compete vigorously; and
- where providers exert market power, outcomes for customers may be worse, either through higher prices or a reduction in quality and/or innovation.[11]

4.29 In summary, we do not believe that the evidence supports this hypothesis.

4.30 The CMA has not yet clearly articulated the mechanism whereby large providers, or high concentration in these markets, might lead to harm for customers. Clearly, if

---

11 Issues Statement, paragraphs 42 to 46.

customers have the relevant information and switch easily (Hypothesis 1) and rival providers with attractive products can supply switchers (Hypothesis 3) then a provider, no matter what its size, will lose customers if it does not provide competitive products. The CMA's stated aim is to model competitive constraints, but it is unclear what model of competition will be used to assess this.

4.31 The CMA will need to consider the evidence supporting such a hypothesis. It will need to establish that:

- measures of market power (e.g. prices, profit margins) are significant enough to lead to certain outcomes based on its theoretical model of how competition works;
- that these measures are linked to market shares or concentration levels; and
- that there is causality between these outcomes and concentration.

4.32 We think there are basic facts that demonstrate the practical difficulties in establishing this evidence:

- The reference markets are less concentrated than other markets that are known to be competitive. The largest competitors in the market are also not large by any standard that would imply significant market power. LBG, for example, will have a share of around 22% of active and funded PCA accounts after the divestment of TSB. The largest BCA provider has a share of around 23%, the largest general purpose SME business loan provider has a share of 26%,[12] and the share in overall business lending is lower still.[13] These shares are not particularly large compared with firms in other markets. For example, the largest grocery provider, Tesco, holds around 29% of the UK grocery market and the largest mobile phone operator, EE, has a market share of around 33%.[14]
- Whatever the CMA's beliefs about different aspects of the offer for customers, we do not think that the evidence will establish on a robust basis that customers

[12] CMA and FCA market study, Banking services to small and medium-sized enterprises, Figure 4.2 and Figure 4.5 (England and Wales)

[13] Market shares for business lending overall should appropriately reflect the wider SME finance environment which includes a variety of smaller and specialist providers that offer credible and attractive finance options for SMEs.

[14] Kantar Worldpanel; 12 weeks to 14 September 2014, and GSMA Intelligence, 2 December 2014 – Share of active connections.

today are worse off relative to some other scenario or benchmark. What is it that customers realistically want that they are unable to get at present, but which a more fragmented market would provide without associated customer inconvenience and costs? We strongly believe that in very many respects, customers receive a very good deal from providers.

- LBG is one of the largest providers and has some of the most competitive offerings in the market, which is at odds with this theory of harm.
  - Halifax has been one of the leading net gainers of PCA switchers since the launch of CASS.
  - LBG's share of SME lending has grown by over[Confidential] in the past two years.
  - The CMA's own analysis has shown there is no relationship between price and market share.[15]
- We believe we are also leading the market in terms of innovation[16], which we plan to demonstrate on the panel's forthcoming site visit.

4.33 To the extent that there are concerns here, they will be resolved by tackling Hypothesis 1 and improving how customers shop around between different providers. We think focusing on Hypothesis 1, and relevant aspects of Hypothesis 3, will be more productive for the CMA and the industry, as these are more likely to lead to robust conclusions and, if necessary, result in actions that could deliver clear benefits for customers and competition. If Hypotheses 1 and 3 are resolved, we do not believe Hypothesis 2 is relevant.

Hypothesis 3: Barriers to entry and expansion

4.34 Hypothesis 3 identifies a number of possible barriers to entry and expansion that the CMA expects to consider. The main issues set out relate to barriers in payments, and the role of branches.

4.35 The issues that relate to access to payment systems overlap significantly, if not completely, with the forthcoming work of the PSR. The PSR has set out a comprehensive work programme and will commence two market studies into access

---

15 Paragraph 2.30, Personal current accounts: Market study update, CMA (2014).

16 For further details, please see our latest Strategic update: http://www.lloydsbankinggroup.com/globalassets/documents/investors/2014/2014oct28_lbg_strategic_update_booklet_.pdf

and ownership of payment systems by April 2015. It is unclear what additional work the CMA will need to undertake that would fall outside the scope of the PSR programme, and avoiding duplication is important to minimise burdens on the sector. Our remaining comments largely relate to the role of branches as a possible barrier to entry and expansion.

4.36 We observe that entry is taking place by a range of competitors, including some with large-scale, professional infrastructures and strong brands. It does not appear that barriers to entry are causing problems for entrants.

4.37 As noted by the FCA, there has been significant progress in reducing or removing many of the regulatory barriers to entry.[17] However, the effect of these reduced barriers on the market has not yet been fully realised, with many potential entrants only now at the business planning stage. We expect to see these enter in the foreseeable future as the full impact of the regulatory changes develops.

4.38 To the extent that there may be any barriers to expansion, this may largely relate to Hypothesis 1 and enhancing customers' ability to shop around and switch to new or currently smaller providers. The rate of switching will affect how quickly a provider can expand (assuming that its offer is sufficiently attractive and competitive), although we note that recent new entrants have been successful in developing propositions that have attracted new customers, particularly in specific segments. We therefore believe that tackling Hypothesis 1 will largely resolve any issues that might exist in relation to barriers to expansion.

4.39 To assess whether there are any barriers to expansion, it is critical to understand how large each provider wants to be (or indeed needs to be) in order to contribute to effective competition. The CMA and its predecessors appear to assume that every competitor needs or wants to be large and national in scope to compete effectively. We do not agree and have seen no evidence to support such an assumption. For example, Handelsbanken is not a mass-market player and does not seek to be, and Metro has focused on specific geographic regions.

4.40 Many entrants and smaller players are targeting specific segments and providing a competitive constraint in the market. Similarly, in the UK Grocery market providers such as Aldi, Lidl and Waitrose (which target a particular segment of the market) are exerting a strong competitive constraint on larger providers.

---

17 http://www.fca.org.uk/your-fca/documents/barriers-to-entry-one-year-on

4.41 The relevant question in relation to barriers to expansion is how, and the extent to which, smaller providers wish to expand beyond their current shares i.e. whether they have business models that assume or require that they achieve large scale (and an associated large branch network), and whether any provider has experienced problems expanding within the segments of the markets it is targeting. We would expect that evidence on these points will be available from the relevant strategy documents of these providers.

5. SECTOR CHARACTERISTICS

5.1 Here we briefly respond to some of the key points made in paragraph 19 of the Issues Statement. Before considering these points, we comment on two key methodological issues that we feel are helpful to draw to the CMA's attention at this stage.

Methodological points

Active and funded accounts

5.2 Ensuring that the sector is characterised using appropriate value-based metrics is important in order to be able to distinguish between outcomes which can reasonably be expected in a well-functioning market, and those which provide evidence of an AEC. A number of metrics exist and have been debated in discussions over market shares: a robust market share definition will be particularly important for the CMA when considering Hypothesis 2.

5.3 We believe the CMA is right to distinguish between open and active accounts. However, a further step is required in order to identify those accounts which yield any material value. The appropriate measure is one which is consistent with the reality of where providers earn revenue i.e. active, funded accounts. For example, we had 22 million open PCAs at the start of 2013 but only around 10 million active accounts (funded by at least £500 per month).

5.4 Moving from a funded to an unfunded basis shifts our own market share downwards by 6% in PCAs.[18] This is a significant difference, and one which will have bearing on the CMA's interpretation of evidence in relation to Hypothesis 2.

---

[18] CMA, PCA Market Study Update, Figure 2.2 and Figure 2.3.

Averaging metrics across providers

5.5 In previous investigations, comparisons have been made across a range of metrics to investigate the relationship between these metrics and the size of provider. On a number of occasions, scores across providers, particularly across the so called 'big four' providers have been averaged.

5.6 In our view, any assessment should be based on the offers available to customers in the relevant market, and not on averages across providers. Averaging can obscure significant differences in offers across providers. Across a range of metrics, we are very different when compared to the rest of the 'big four'.

Sector characteristics

5.7 Our main observation is that although we agree with a number of the factual statements, in several instances they are consistent with alternative and equally plausible interpretations.

Regulatory oversight

5.8 Regulation has been rightly identified by the CMA as a relevant sector characteristic. The PCA and SME sectors are already highly regulated, and are becoming increasingly so as a range of regulators, legislators and executive bodies (including the European Commission, CMA, FCA, PSR, PRA, TSC and HM Treasury) have adopted wide-ranging measures across the reference markets. We are also being asked to support political interventions in areas which pre-judge the outcome of the FCA and CMA's work.

5.9 A lack of regulatory coordination and uncertainty regarding future regulatory requirements may in fact act as a barrier to entry and certainly acts as a burden, imposing direct and opportunity costs on entrants and incumbents alike, and disincentivising investments. The role of regulation, beneficial or otherwise, must be considered in any assessment of a "well-functioning" market. A good illustration of this is BBAs.

5.10 BBAs form part of the government's financial inclusion agenda, which LBG supports. These are loss-making accounts, but importantly they have a much wider impact on the market beyond the balance sheets of the individual providers who offer them: they drive an inevitable cross-subsidy between customer groups, and their mandated provision also "crowds out" the emergence of higher functionality accounts (potentially with monthly fee charging structures) aimed at BBA customers.

5.11 If there is little commercial incentive to incur the costs of enhancing the product, this has implications for the degree of engagement that can realistically be expected of BBA customers.

5.12 If HM Treasury proceeds with recent proposals to extend the functionality of these accounts and, for certain groups of customers, remove any fee income, this will exacerbate these concerns.

5.13 The CMA's investigation can helpfully consider whether the legitimate policy objectives which underpin BBAs can be achieved with less distortion to competition, and better promote innovation in the provision of BBAs.

Other comments

5.14 We have a number of comments relating to other sector characteristics:

a) FIIC is a common pricing structure, the simplicity of which customers generally find attractive. However, fee paying structures also exist e.g. packaged accounts, Santander 123 and Club Lloyds, all of which have seen considerable success since launch. Understanding appropriate cost recovery and its implications for "cross subsidies" will be important for the investigation, as will the extent to which different pricing structures are compatible with a well-functioning market.

b) "*Customers generally prefer to use a single provider to meet the majority of their banking needs*." Some customers do prefer to use a single provider to meet more than one need, and we try to meet our customers' needs across a range of different products by offering attractive and competitive products. Many customers also use multiple providers for different needs, and multiple providers for the same need, such as holding savings with different providers.

c) "*SMEs appear to value an ongoing relationship*." Relationships which develop over time (particularly with business customers) allow providers to develop insights into customer needs allowing guidance and support to be provided which delivers clear customer benefits.

d) "*Switching rates remain relatively low*." The criteria for assessing whether switching is in fact 'relatively low' are unclear, as is the appropriate counterfactual for switching rates. Does the CMA hold evidence of higher switching rates in comparably structured and regulated retail banking markets? On the other hand, we consider that customer engagement and the ability to switch to be at the heart of the matter, as the CMA also observes in Hypothesis 1. Approximately 500,000 of LBG's existing PCA customers have actively chosen to upgrade to Club Lloyds since it launched. Since 2012 Halifax has run successful switcher acquisition campaigns, offering customers £100 to switch, paid on the day of switching. This allows Halifax to maintain one of the leading positions for PCA switches. As awareness and trust in the nascent CASS increases we are expecting cross-provider activity to continue to increase.

e) *"Products and charging structures can be relatively complex."* It may be true that, as a result of competition and innovation, there is significant product differentiation in the sector, but this delivers important benefits to customers. For many larger SMEs, for example, highly differentiated (i.e. bespoke) offerings (particularly in relation to business lending) are a desirable attribute, not evidence of undue complexity. The level of product differentiation that is consistent with a well-functioning market is something which the CMA can helpfully consider.

f) *"There are significant linkages between products."* Relationships and experience over time can aid both buyers and providers in understanding likely credit risks and transaction behaviour. For example, any tendency of SME customers to use their PCA providers for their BCA and business loans reflects customer benefits arising from continuity of relationships with a banking supplier. There is no automatic advantage arising from product linkages, for example there are a significant number of alternative SME product providers and all providers aim to build deep and lasting relationships with personal and business banking customers, in particular by offering competitive products. This in turn can lead to wider product relations. A recently agreed protocol on agreeing deeds of priorities and waivers will make it easier for an SME to take secured borrowing from more than one provider at a time. Legislation requiring greater disclosure of, and wider access to, credit data will further enhance the capability of new credit providers to capture potential switchers and to provide standalone lending.

g) "*Market shares have been relatively stable*" (leaving aside disruptions resulting from the financial crisis and subsequent mergers and divestments and the entry of providers like Handelsbanken and Metro Bank). The CMA sees this as a concern, given that different levels of satisfaction have not led to changes in market shares. However:

- Continued population growth in recent decades, means the market for funded PCAs has increased significantly. Even where market shares are observed to be stable, this reflects significant competition to attract the flow of new customers.
- Similarly, there is a high rate of churn in BCAs, and significant competition over the flow of new customers. There have been around 3 million start-ups since 2008 according to Banksearch.

- Expecting high satisfaction to lead to increasing market share does not necessarily follow. For example, reported customer satisfaction metrics for First Direct customers are typically high, but it targets a specific customer segment and has a differentiated offer compared to mass-market providers. A Halifax customer who funds their account by £750 per month and does not use an overdraft would pay on average £180 more per year for a First Direct account; the First Direct model may not be scalable and appears to be targeted at a particular segment of customers.[19]

- More generally, the link between customer satisfaction and customer behaviour needs careful analysis. Leaving aside any behavioural biases in such survey analysis, care needs to be taken in separating out, for example, whether satisfaction levels reflect product effects as opposed to more general brand perceptions or views about the banking sector.

h) "*The four largest banks…have extensive…branch networks*". Technological innovation and digital banking are eroding the significance of branches and we expect this trend to accelerate. Atom is soon to enter the PCA and business lending markets without a branch network, and Funding Circle, Tungsten and PayPal are further examples of digital-only business lending propositions.

- Many new entrants have expressed optimism about their ability to scale up (e.g. Metro Bank)[20] and others can use existing infrastructure (e.g. Post Office, Tesco and Co-op). As the CMA has previously noted, "small PCA providers can in certain circumstances compete effectively through differentiation and innovation as their incentives are not aligned with those of their larger competitors."[21]

- It is not clear that scale is in fact beneficial. Profits are concentrated in specific customer segments, and many providers target these segments. Many smaller providers have little interest in growing to

---

19 The customer would have to pay a £10 per month fee for First Direct and not receive a £5 monthly reward from Halifax.

20 Metro Bank plans to have 200 branches by 2020 and the Post Office has doubled its account-opening branch numbers to 239, PCA Update, paragraph 2.62.

21 PCA Update, paragraph 2.16.

become a mass market provider. This can be seen by interrogating these providers' business models.

i) "*New entrants require access to a number of key inputs*." While this is true, this is an area which is highly regulated, especially in the area of payments following the creation of the PSR. It is notable that a new PCA entrant Tesco, in its response to the reference decision, was not keen to change agency arrangements. We note that the PSR has announced two market studies to commence by April 2015, one of which relates specifically to access to inputs.

j) The sector is changing rapidly. There continues to be significant regulatory, technical and structural change in the market, and the impact of digital and mobile banking is already significant and will become ever more so over the next few years. This is particularly notable in the payments sector, where the disruptive emergence of alternative payments providers such as PayPal, Amazon, Apple and Google is being felt. In business lending, firms such as Funding Circle offer alternative sources of finance. In this regard, while historic analysis is undoubtedly useful, any proposed interventions must look forward and take into account these potentially disruptive changes.

5.15 More generally it should be noted that across the sector, certain behaviours and outcomes differ according to the market segment under consideration. For example, in PCAs, the transaction histories and credit scores of customers with BBAs will be different from those with other accounts.

5.16 SMEs are also very diverse, with a range of different banking needs. Some are small businesses with banking requirements that are reasonably straightforward, others are much larger businesses with complex banking needs and a sophisticated understanding of finance. Accordingly, competition for SMEs' banking takes place across a number of dimensions, with providers seeking to differentiate their propositions in terms of quality, service and price. Our strategy is to match service to the needs of the SME in question, offering smaller SMEs a straightforward, standardised, easily comparable product offering, while providing larger SMEs a more bespoke service.

6. QUESTIONS FOR FURTHER INVESTIGATION

6.1 As we explained in our letter to the CMA of 11th November 2014, we believe that there are eight areas that the CMA needs to address as a priority in this investigation, in order to get to the bottom of often conflicting evidence and assertions. These are:

1. How can customer engagement and the ability to switch be enhanced quickly and sustainably?

2. Which pricing structures recover costs appropriately and what does this imply in terms of "cross-subsidies"?
3. How should "customer satisfaction" be measured and how does it affect customer behaviour?
4. Will the CMA investigation be more effective if it focuses on smaller SMEs (such as those with a turnover below £1m)?
5. What is the impact of existing industry structure and concentration on the ability of smaller and newer providers to compete?
6. Can competition be assessed without considering explicitly both the regulatory context and wider government policies, such as Basic Bank Account provision?
7. Can trials make potential market interventions more effective and efficient?
8. What impact has digital and mobile had in the last two years and what impact is it likely to have in the near future?

6.2 We note that each of these is covered to some extent in the Issues Statement, either within hypotheses or as sector characteristics. We believe it will be important to ensure that these questions are addressed specifically throughout the investigation.