Retail banking market investigation

TSB case study

21 May 2015

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the updated issues statement and the other working papers which accompany it. These papers do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in September 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to comment on this paper should send their comments to retailbanking@cma.gsi.gov.uk **by midday on Thursday 11 June 2015**.

The Competition and Markets Authority has excluded from this published version of the working paper information which the Inquiry Group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂].

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Case studies

In previous investigations we have found that case studies on market entry and expansion can provide powerful insights into the practical difficulties that firms may face trying to enter and/or expand into particular markets. Such studies have contributed to the identification of possible adverse effects on competition (AECs) and where appropriate have helped us to develop remedies designed to remove or lower barriers to entry or expansion.

We have undertaken six case studies looking at examples of entry and expansion in the provision of personal current accounts (PCAs) and retail banking services to small and medium-sized enterprises (SMEs). We have in addition obtained information on a number of prospective new entrants in the process of seeking bank authorisation. The value of each case study lies in its ability to provide a detailed understanding of the way particular types of event unfold. They are therefore written as factual accounts of events.

We are publishing each case study as a separate working paper and each case study will inform our assessment of barriers to entry and expansion. We are also publishing separate working papers pulling together the evidence from the case studies and from other sources on potential barriers to entry and expansion. The first such working paper – Barriers to entry and expansion: regulation, IT systems and payments systems – will be published shortly and a further working paper on branches will be published in due course. Our updated issues statement published on 21 May 2015 sets out our current general thinking on barriers to entry and expansion.

Executive summary

1. The TSB Banking Group plc (TSB) business comprises assets divested from Lloyds Banking Group (LBG) as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS.

2. Because it entered through divestiture rather than organic growth, TSB possessed assets from the outset that other entrants did not. However, it faced some of the same potential barriers to expansion as other banks, in particular customer acquisition, and lacked the advantages of some other entrants, such as a purpose built, modern core banking platform.

3. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of market flow[1] and added over 200,000 PCAs to its stock. However, TSB put it to us that its performance in 2014 did not necessarily equate to it having a meaningful and lasting impact on the competitive dynamics of the sector in the future as:

   (a) rising costs resulting from the terms of its arrangements with LBG, in particular regarding the cost of the shared IT platform and the ongoing reduction of other, temporary profitability enhancements put in place following the recommendations of the Office of Fair Trading (OFT) in September 2013 could constrain the amount it could afford to invest in customer acquisition in subsequent years; and

   (b) PCA customers that TSB acquires from other banks may take several years to become profitable.

4. Subsequent to these submissions TSB reached an agreement on an offer from Banco de Sabadell to buy all of the shares in TSB Banking Group plc. Should the transaction complete it is Sabadell's intention to migrate TSB customers across to its own proprietary in-house IT platform which it anticipates would deliver £160 million a year in cost savings in the third full year following completion of the acquisition.

Introduction

5. In our Statement of Issues we set out three hypotheses, or 'theories of harm,' for investigation. Our third theory of harm was that there may be barriers to entry or expansion in the retail banking market leading to worse outcomes for

[1] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock'.

consumers. We said that our analysis will in the first instance look at a selection of case studies of past entry and expansion (successful and unsuccessful). The purpose of this paper is to examine TSB's experience of entry and expansion into retail banking, with a particular focus on its PCA products.[2]

6. The paper begins by explaining the circumstances that led to TSB's launch. It then describes its PCA strategy, how this fitted into its overall business strategy, how successful TSB has been in acquiring and retaining PCA customers and the reasons for this. Finally it considers the extent to which TSB's experience suggests the presence of barriers to entry or expansion in the retail banking market.

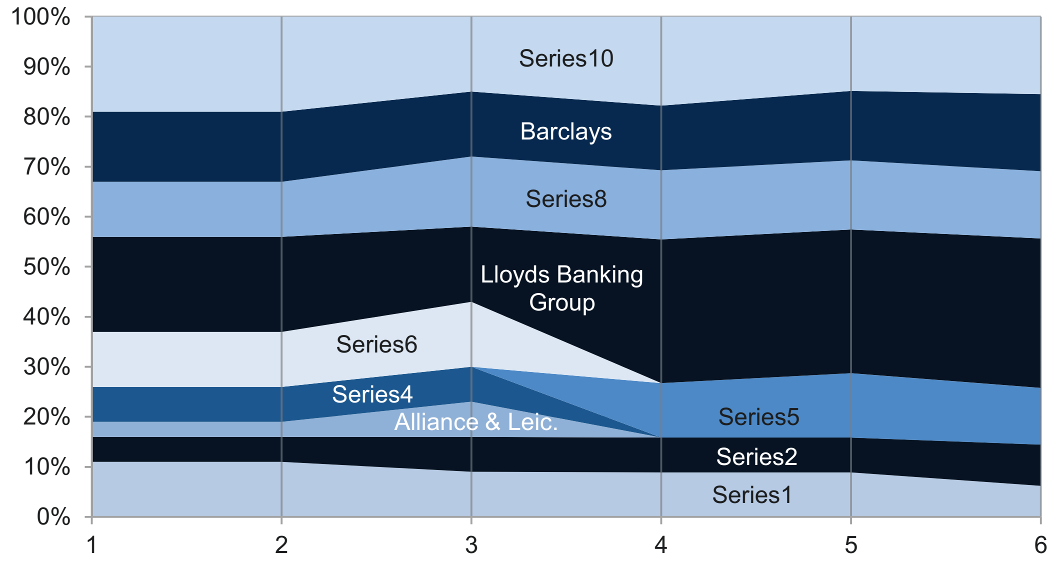
Background

The Lloyds TSB divestiture

7. The TSB business comprises assets divested from LBG as part of a restructuring plan approved by the European Commission following aid granted by the UK government in January 2009 upon the merger between Lloyds TSB and HBOS. The merger's effect on concentration in the retail banking market, and the combined entity's relative share, can be seen in the chart below.

[2] TSB told us that the main focus of its business strategy was the consumer sector and growth of the business current account (BCA) business was not seen as a strategic priority. It said that the profile of its SME customers was weighted towards the smaller end of the segment with sole traders representing 40% of its business customers and clubs and charities almost 30%. Reflecting this it said that its share of the business lending market was less than 1%. (Response to SME questionnaire, Q5).

Figure 1: Market shares for the largest PCA providers, 2007 to 2012, Great Britain



Source: OFT, State Aid Divestments by LBG and RBSG, Economic Advice, paragraph 49.

8. Lloyds TSB and HBOS, already large banking institutions, merged amid serious concerns that HBOS would collapse without some form of external support. In the event, this merger proved insufficient and the enlarged banking group required an injection of £20.6 billion[3] in taxpayer funds. This intervention gave rise to EU concerns as regards state aid and its impact on competition.[4]

9. In its analysis the European Commission noted that the combined entity had a large market share of PCAs (20 to 30%[5]) and that in Scotland it was even larger (40 to 50%). It said that Lloyds TSB's share of the PCA and mortgage markets had been strongly reinforced by the acquisition of HBOS, which had had a share of 10 to 20% and 20 to 30% of these markets respectively.[6] In addition, the Commission noted that not only had the acquisition allowed LBG to increase its market share, particularly in PCAs, it had also allowed it to 'eliminate a challenger in particular on certain segments of the market which were already concentrated and featured low switching rates among

[3] State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 178.
[4] TSB submitted that these concerns were limited to addressing the distortions to competition brought about by the UK government's support for LBG and that it was not the European Commission's intention to create a scale challenger which would provide a disruptive competitive presence in the market. We do not agree entirely with TSB's analysis since we consider that the European Commission did take account of the fact that LBG had eliminated a 'challenger bank' and that the objective of the divestiture was to recreate 'a viable business in the future that can compete in the retail banking business in the UK' (ibid paragraph 185).
[5] The non-confidential, version of the European Commission's analysis used ranges to indicate market shares.
[6] State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 179.

customers.[7] Consequently, measures are necessary in order to remedy this distortion of competition which had been created by the aid'.[8]

10. To address the Commission's concerns LBG was required to create and divest a ring-fenced business entity (code-named 'Verde') with assets of between £51 billion and £70 billion.

11. Verde was to consist of:[9]

(a) the TSB brand;

(b) the banking licence of Lloyds TSB Scotland;

(c) the Intelligent Finance business and brand;[10]

(d) the branches, including the banking business associated with all customers and all branch employees, of Lloyds TSB Scotland;

(e) the Cheltenham and Gloucester (C&G) branches and branch employees, all C&G savings accounts and those C&G mortgages associated with branch-based customers;

(f) supplementary branches and their branch business, selected by LBG, which:

(i) numbered at least 600;

(ii) together with the other branches and their business comprised at least a 4.6%[11] share of the PCA market;

(iii) resulted in the average retail income per retail customer being not less than the average retail income of LBG;

(iv) had a 'reach' of at least 43%;[12]

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[7] ibid, paragraph 181. A footnote makes clear this refers to the PCA market.
[8] ibid, paragraph 181. It concluded that absent the state aid, the merger would not have taken place and that, consequently, measures were necessary in order to remedy this distortion of competition created by the aid as well as the moral hazard created. See paragraph 182).
[9] As set out in European Commission, 2009, State Aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group. Further detail on the package was contained in the Term Sheet setting out the commitments of the UK authorities (paragraph 97, ibid).
[10] An online and telephone bank offering current account, mortgage and savings accounts.
[11] The EU originally envisaged a divesture package equivalent to a 10% market share but this was opposed by HM Treasury, which argued that on the basis of previous OFT investigations, a 5% share would be a sufficient opening base for a challenger and that a 10% share could reduce the incentive of the new entity to acquire new customers aggressively. (HM Treasury, *Effective Challengers in UK Retail Banking*, 8 September 2009.)
[12] 'Reach' was defined as the proportion of the GB population that lived within 2 miles of a branch.

(v) resulted in the average gross ground floor space of all branches in the divested business being at least 220m^2.

12. LBG, in pursuit of a trade sale, committed to approaching potentially interested and suitable[13] buyers by 30 November 2011 and to completing the divestiture by 30 November 2013. If the disposal through a trade sale had not been completed by that date, the government said it would appoint a divestiture trustee to oversee the sale at no minimum price. LBG was also permitted to dispose of the business through an initial public offering (IPO).

Responses to the proposed divestiture

13. The Independent Commission on Banking (ICB)[14] expressed concerns over the size and nature of the Verde package. Its report concluded that a substantial enhancement of the proposed LBG divestiture provided the best opportunity to improve the structure of the PCA market and was the most cost-effective way available to ensure the emergence of a strong new challenger. It said this should be effected by ensuring that the entity resulting from the divestiture had a strong funding position and sufficient scale.[15]

14. On the former, it said that a strong challenger required a sound funding position, both in terms of the amount of wholesale funding it needed to raise, and the price at which it could access such funds. With a weak funding position relative to its peers a bank would be unable to be a strong challenger because:

(a) it would have an incentive to shed loans in order to reduce its reliance on wholesale markets, rather than competing hard to lend; and

(b) its cost of funding would be higher, making its customer offerings more expensive generally.

15. The ICB said that to be considered as having a stronger funding position, Verde's loan-to-deposit ratio should be better than its, then, 200% and comparable with particular banks it listed in its report, which varied between 98 and 148%.[16]

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[13] The buyer was to have no more than 14% of the PCA market after acquiring the divestiture, for example. See State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 190.
[14] For the background to the establishment of the ICB or 'Vickers' Commission see GOV.UK.
[15] *Independent Commission on Banking. Final Report* (2011), paragraph 8.13.
[16] ibid, Table 8.2, p209.

16. As regards scale, it said that to have the best possible chance of becoming a strong, effective challenger, the entity resulting from the divestment should have at least a 6% share of the PCA market.[17]

17. Evidence from the previous decade, it said, showed that small banks (below 5% PCA market share) on average had grown only slowly, with an average annual growth in market share of 0.07%. Banks with a PCA market share of between 5% and 12%, it said, grew significantly more quickly, with an average annual growth in market share of 0.34%, though it noted that given the relatively small number of challengers, this number was drawn from a small sample. Above 12%, banks begin to act as incumbents as their incentives changed with their market shares.

18. It said that with a PCA market share of 4.6% Verde was on the borderline of sub-scale banks that had failed to grow significantly in the past and was smaller than most previous challengers over the past decade, as measured by PCA market share.[18]

19. Finally, the ICB noted that this enhancement in PCA share could either be achieved by the acquisition of Verde by a bank whose existing PCA share would bring the new entity's total share to above 6% or, were Verde to be sold via an IPO, increasing the number of PCA accounts divested by LBG. The former scenario seemed possible at this time as a bank, the Co-operative Banking Group (CBG), whose acquisition of Verde would take the combined entity's share of the PCA market to 7%,[19] had emerged as a bidder.

The CBG bid

20. Following discussions between LBG, CBG and the European Commission, the European Commission indicated in September 2012 that, because of the emerging difficulty in funding the business, it would agree to a reduction in the balance sheet of the divestment business to £23 billion. This compared with the balance sheet implied by the original perimeter of £53–£71 billion, the £71 billion in the Information Memorandum and the reduction to £36 billion agreed by the European Commission in March 2012. Although under the original perimeter the business met the tests set down by the European Commission to demonstrate profitability, once LBG had entered into exclusive discussions with CBG, CBG sought further profitability enhancements through, in particular, the removal of: high loan-to-value, relatively low yielding

[17] LBG argued to the ICB that the 6% threshold was inappropriate (Competition Slides for ICB Private Hearing, 20 July 2011). Similar data was presented to the OFT in the context of its advice to the Chancellor on the Verde package (Annexes 4 and 5). See paragraph 22.
[18] ICB, paragraph 8.22.
[19] House of Commons Treasury Select Committee Report on Project Verde, paragraph 300.

mortgage assets; relatively expensive fixed rate deposits; and the Intelligent Finance online and telephone banking business – such that the Verde business's PCA market share fell by 0.3% to 4.3%. Changes to the cost of IT and systems support services from LBG were also discussed, although at this point they were not included in the amended divestment package.

21. However, in April 2013 the CBG withdrew from the process[20] and LBG proceeded to prepare for, with the approval of the European Commission, an IPO of the Verde package.[21] The Verde package, as we have seen, was originally designed to be consolidated with an existing retail bank rather than floated as a free-standing entity. It comprised a smaller share of the PCA market than the original package and fell significantly short of the 6% referenced by the ICB or the 10% originally contemplated by the European Commission. The Chancellor of the Exchequer asked the OFT for its advice on the impact of the divestment on competition in retail and SME banking and whether anything could be done to strengthen competition through enhancing the divestiture package.

The OFT's advice

22. The OFT provided its advice to the Chancellor of the Exchequer on the impact on competition of the LBG (and RBS) divestitures in September 2013.[22] Regarding the scale of the divestitures being contemplated it referred to its own work on PCAs which it said identified effective competitor banks as occupying a market share of roughly 5 to 14% and having a network of around 700 or more branches. It said that such scale enabled banks to offset certain costs and maintain their incentive to compete because of the number of marginal customers they were likely to have.

23. It made a number of recommendations:

(a) Steps should be taken to ensure that the service agreement with LBG, under which it provided TSB with an IT platform, did not allow it to influence TSB's competitive behaviour or impair its profitability.

(b) Measures to provide TSB with a higher income to enable it to invest in its legacy C&G network, possibly through a direct capital injection.

[20] For a description of the events leading up to the withdrawal of CBG see the House of Commons Treasury Select Committee report on Project Verde.
[21] See State aid SA.29834 (2014/N-2) – United Kingdom – Amendment to the restructuring plan of Lloyds Banking Group.
[22] Letter dated 11 September 2013.

(c) TSB's PCA opening market share should be increased to at least that level foreseen in the original package (4.6%) within two years of the divestment or IPO.

24. HM Treasury and LBG broadly[23] agreed the changes recommended by the OFT.[24] The European Commission indicated in May 2014 that proposals by the UK authorities to amend conditions for the divestment of LBG's UK retail business, in the context of LBG's restructuring plan, were in line with EU state aid rules.[25] On 9 June 2014, the IPO completed with the listing of an initial 38.5% of TSB's shares. TSB was now an independently managed, stand-alone 'challenger' bank,[26] with 4.5 million retail customers,[27] 8,600 staff, 631 branches, £23 billion of customer lending and deposits of £23.3 billion. A further tranche of 11.5% was sold in September 2014 such that LBG owned 50.001% of TSB.[28]

TSB's entry and expansion strategy

25. Growing its share of the PCA market was one of three strategic priorities for TSB. Its aim, as set out in the IPO Prospectus,[29] was to grow its share of PCA 'market flow'[30] to at least its share of branches, which was then around 6%, including the C&G branches which were part of the Verde package. Capturing 6% of PCA market flow would, it argued, eventually translate into a 6% share of the PCA market overall.

26. The Prospectus noted that the main driver of TSB's growth, along with its re-entry into the mortgage intermediary channel, was its share of PCA flow and associated cross-sales of savings accounts and unsecured lending products to these PCA customers. It said that not only was PCA growth an important enabler of medium-term profit growth it was also a critical enabler of long-term value as PCAs provided a key source of low-risk, low-cost liabilities. In addition, the relatively high level of transactions associated with current accounts provided an opportunity to develop the customer relationship and

[23] TSB's share of the PCA market was not enhanced to a level closer to 6%, a move which had been strongly opposed by LBG. However, the annual charge for IT platform support was cut by 10% and a monitoring trustee was installed to maintain oversight of the arrangements with LBG. TSB's profitability was enhanced by the transfer of a £200 million mortgage bond and the provision of a £40 million customer acquisition fund.
[24] See news story, 'Office of Fair Trading reports to government on Lloyds and RBS divestments'.
[25] See European Commission press release: State aid: Commission approves amendments to restructuring plan of UK bank Lloyds Banking Group.
[26] Albeit having a continuing link with LBG via the shared IT platform.
[27] Plus 110,000 'micro' SME customers.
[28] In March 2015 LBG agreed to sell 9.99% of its remaining shareholding to Banco de Sabadell, and entered into an irrevocable undertaking in respect of the remaining 40.01%.
[29] P90.
[30] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.' Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.

over time meet more of their other banking needs. PCAs, therefore, were both a ‘gateway’ product, enabling cross-sales of other products, and a low-cost and low-risk source of funding.

27. TSB’s Customer Plan for the PCA market set out its strategy in more detail. It said that while the PCA market was reaching maturity, with around 70 million accounts being held, consumers opened some 5.7 million new accounts each year and these consumers were its target. TSB estimated that switchers (2 million) represented the largest single segment within this group.[31]

28. The plan noted that customers increasingly expected to be rewarded for their loyalty and that just over 11% of current account holders had accounts that paid interest on their credit balances, up from 8% in 2013. It said that one-off incentives such as cashback had been successful but that long-term rewards, such as credit interest, were also becoming more popular.[32] Spend incentives, it said, were becoming more prevalent but their value to individuals was not always clear.

29. TSB stressed the importance of the branch network in executing its plan and we consider its reasoning and the evidence underlying it in the next section of the paper.

The TSB branch network

30. The size and composition of the branch network inherited by TSB, which, as was noted earlier, accounted for about 6% of all retail bank branches in the UK, is shown in the table below. It comprised a total of 631 branches, 164 of which were formerly branded Cheltenham and Gloucester, 185 of which were formerly operated by TSB Scotland and 282 former Lloyds TSB branches in England and Wales.[33]

Table 1: TSB’s branch network

Heritage	*Number of branches*	
	(freehold)	*(leasehold)*
Cheltenham & Gloucester	13	151
Lloyds TSB (Scotland)	80	105
Lloyds TSB (England and Wales)	67	215
Total	**160**	**471**

Source: TSB.

[31] These comprised both customers using the current account switch service (CASS) and those switching without using CASS.
[32] The TSB Classic Plus account would offer 5% interest on balances up to £2,000 but, unlike Santander’s 1-2-3 account, for example, not cashback on payments.
[33] TSB has no branches in Northern Ireland.

31. The importance of the branch network in generating PCA sales and the existence of a relationship between its share of branches and its share of the PCA market is a recurring theme in TSB's policy documents.[34] An example of its analysis of this relationship is shown in the table below which suggests an association between TSB's share of branches and its share of flow[35] by country or region. As can be seen, TSB's share of flow was highest in Scotland ([✂]%), where it had its highest share of branches ([✂]%) but lower, and roughly in proportion to its share of branches, elsewhere.[36]

Table 2: PCA and branch share

CACI region	*TSB share of flow*	*TSB share of branches (w/0 C&G)*	*TSB share of total branches* %
Scotland	[✂]	[✂]	[✂]
West Midlands	[✂]	[✂]	[✂]
Northern	[✂]	[✂]	[✂]
North West	[✂]	[✂]	[✂]
Yorks & Humber	[✂]	[✂]	[✂]
East Midlands	[✂]	[✂]	[✂]
East Anglia	[✂]	[✂]	[✂]
Greater London	[✂]	[✂]	[✂]
Wales	[✂]	[✂]	[✂]
South West	[✂]	[✂]	[✂]
South East	[✂]	[✂]	[✂]
Northern Ireland	[✂]	[✂]	[✂]

Source: TSB.

32. The underlying reasoning here was that as the majority of new PCAs were sold/opened in TSB branches and as [✂]% of switchers to TSB came through a branch, the higher share of branches TSB had the more likely it was to win the locally available PCA business. Whilst online and mobile were growing in usage, the branch remained the most important channel for opening new accounts and servicing customers.

33. Further, as was shown in TSB's consumer research, branch location was an important consideration for consumers who were planning to switch bank accounts. While consumers (other than Lloyds customers) who had decided to switch from their current provider did so mainly (44%) because of bad service, the main reason they gave for switching to TSB (51%) was 'convenient branches'. 60% of switchers from Lloyds cited convenient branches as the reason for switching to TSB.

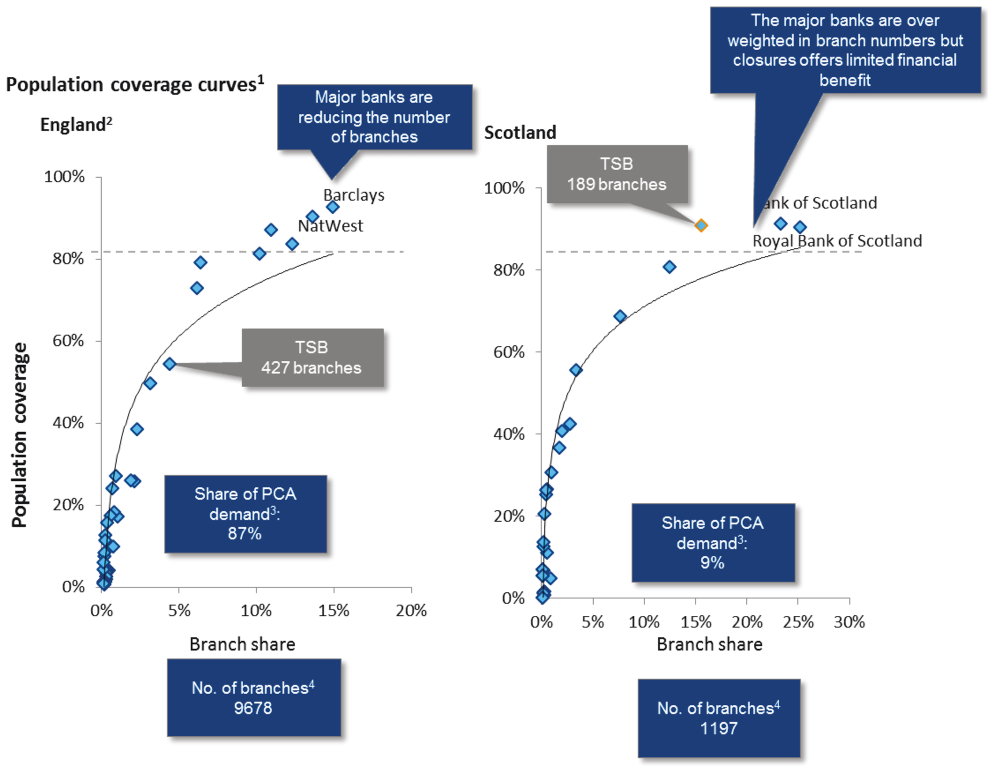
[34] Other banks also told us there was a correlation between PCA share and share of branches. See, for example, Nationwide's response to the issues statement, paragraph 2.2(iii).
[35] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock.' Share of flow thus refers to the share of new account business a firm wins, typically each month. Estimates of the size of flow are provided by organisations such as CACI.
[36] The association between total TSB branches and its share of flow is slightly less evident in the South West, for example, where a higher proportion of branches were originally C&G and C&G did not provide PCAs.

34. TSB's analysis indicated that the same factors operated as regards traffic the other way: TSB customers (ie those originally transferred to Verde from LBG) switching back to Lloyds. It found that overall just [✂]% of TSB customers who also had an account at Lloyds had switched (back) to Lloyds. However, where a customer's accounts were split between Lloyds and TSB, and the nearest TSB branch was more than 10 miles away and where the customer used a local branch on average once a month, the rate of switching back to Lloyds was ten times higher, over [✂]%.

35. TSB's analysis suggested, however, that the relationship between a bank's share of branches and the proportion of the population that the branch sales channel could address (its 'reach') was not linear: above a certain point the increase in reach achieved by an increase in share of branches began to diminish.

36. In Scotland, for example, TSB said that increasing its reach would require a disproportionate increase in its share of branches. Conversely, a reduction in its share of branches would result in a less than commensurate fall in population coverage. In England, increasing reach would be less costly in terms of growing share of branches. The charts below show TSB's and its competitors' branch market shares in England and Scotland together with the reach of their branches.

Figure 2: Branch share, population coverage and PCA share



Source: TSB.

37. An internal TSB presentation assessed the potential for branch expansion in London and the South East, where it said switching rates were higher and where there were several catchment areas currently unserved by TSB branches. The presentation stated that it would be necessary to open new branches in some areas as ‘powering up’ the legacy C&G branches would not on its own be sufficient to address the business potential identified. Nonetheless, because of the size of the catchment areas concerned, a comparatively large increase in reach could be accomplished by a relatively limited expansion of the network in Greater London, as illustrated below.

Figure 3: Branch expansion in Greater London

[✂]

Source: TSB.

38. Having considered TSB’s strategy we now examine the extent to which it was successful in increasing its share of the PCA market.

TSB’s strategy implementation and results

Results overall

39. Between October 2013 and October 2014 TSB achieved a share of flow of around 8%, representing a net gain of around [✂] PCAs, growing its account base by [✂]%. However, because the annual flow represents such a small proportion of the overall PCA stock, this translated into an increase in its share of the PCA market of 0.3%: from 4.0% to 4.3%.

40. These net figures conceal quite large inflows and outflows, with total gains of around [✂] and losses of just under [✂] in the period between October 2013 and October 2014. Early on, TSB suffered losses arising from the departure of customers it had acquired from Lloyds, later on gaining new customers for its interest-bearing PCA. We show the overall pattern of gains and losses in Figure 4.

Figure 4: PCA accounts opened and closed, 2013 to 2014

[✂]

Source: TSB.

41. We next looked at data on the origin and destination of customers who switched either to or away from TSB in 2014, where this was known, and these are shown in full in the table below and for the largest movements in or out in the chart following it (Figure 5).

Table 3: Switchers in and out of TSB, 2014

	Switched in	*Switched out*	*Net*
Lloyds Bank plc	[✂]	[✂]	[✂]
Halifax	[✂]	[✂]	[✂]
Santander	[✂]	[✂]	[✂]
HSBC Bank	[✂]	[✂]	[✂]
Nationwide Building Society	[✂]	[✂]	[✂]
Nat West Bank plc	[✂]	[✂]	[✂]
Bank of Scotland plc	[✂]	[✂]	[✂]
Barclays Bank plc	[✂]	[✂]	[✂]
Royal Bank of Scotland	[✂]	[✂]	[✂]
Co-operative Bank	[✂]	[✂]	[✂]
Clydesdale	[✂]	[✂]	[✂]
Metro Bank	[✂]	[✂]	[✂]
Yorkshire Bank	[✂]	[✂]	[✂]
Tesco Bank	[✂]	[✂]	[✂]
Cumberland Building Society	[✂]	[✂]	[✂]
Handelsbanken	[✂]	[✂]	[✂]
Secure Trust	[✂]	[✂]	[✂]
Bank of Ireland	[✂]	[✂]	[✂]
Lloyds International	[✂]	[✂]	[✂]
NBL T/A Danske Bank	[✂]	[✂]	[✂]
Ulster Bank Limited	[✂]	[✂]	[✂]
Isle of Man Bank Ltd	[✂]	[✂]	[✂]
Reliance Bank	[✂]	[✂]	[✂]
First Trust Bank	[✂]	[✂]	[✂]
C Hoare & Co	[✂]	[✂]	[✂]
RBS One Account	[✂]	[✂]	[✂]
Coutts	[✂]	[✂]	[✂]
Lloyds Private Bank	[✂]	[✂]	[✂]
Adam & Company	[✂]	[✂]	[✂]
Virgin Money plc	[✂]	[✂]	[✂]
JP Morgan Europe Ltd	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

Source: TSB.

42. As can be seen, TSB made its biggest net losses to two LBG banking brands (Lloyds and Halifax)[37] and Santander, all three of which offered PCAs incorporating rewards, for example interest on balances and/or cash on signing up. Halifax and Santander were also major sources of PCA customers for TSB but its largest net source of PCA customers was Barclays, which did not offer an interest-bearing PCA. TSB was also a net gainer from the two other major banks, NatWest and HSBC, neither of which offered an interest-bearing PCA.

Figure 5: TSB main PCA account gains and losses by bank, 2014

[✂]

Source: TSB.

Customer acquisition

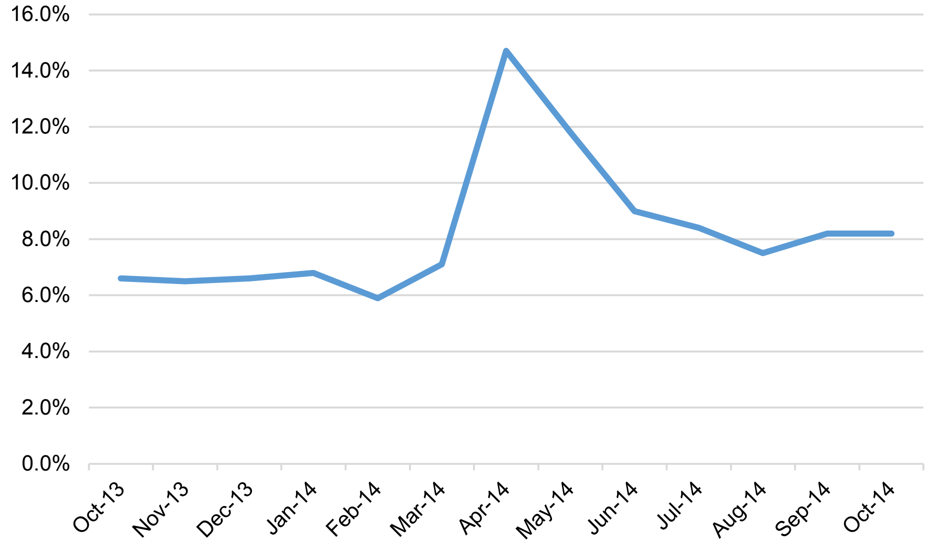
43. In April/May 2014 TSB acquired new customers in large numbers. Monthly volumes peaked at over [✂] in April, driven by the launch of the advertising

[37] Its position versus Bank of Scotland was virtually neutral.

campaign for TSB's Classic Plus product, settling at around [✂] subsequently.[38]

44. The impact of its Classic Plus campaign in April/May 2014 can also be seen in TSB's share of flow. Prior to the campaign, TSB's share of flow was, at around 6%, roughly in line with its plan (and with its share of branches). However, its share of flow more than doubled (to +14%) in April and May, then fell back to around 8%, still considerably higher than its share of the overall retail banking market: TSB was indeed 'punching above its weight.'

Figure 6: TSB share of PCA flow

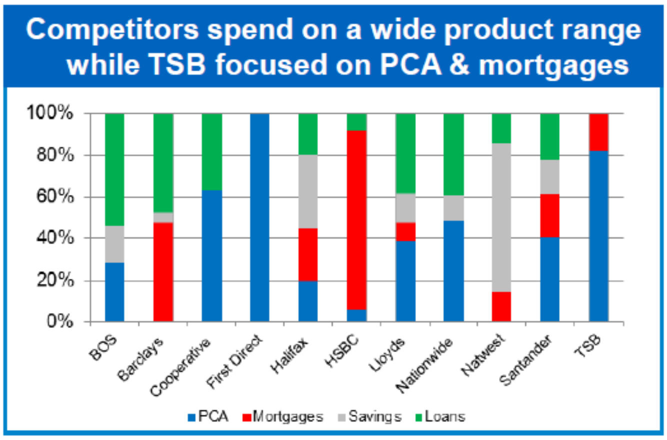


Source: TSB.

45. TSB allocated a substantial advertising budget to this campaign. Its 'share of voice'[39] (SoV) in PCA advertising specifically was very high indeed and almost the same as its much larger rivals whose total advertising expenditure was about double TSB's.[40] In the first half of 2014 TSB spent £[✂] on PCA advertising compared with Santander and Lloyds, which each spent about £8.5 million on advertising their PCAs but which spent twice as much on advertising as TSB overall.

[38] This offered customers 5% interest on balances of up to £2,000.
[39] TSB's expenditure on advertising as a proportion of the sum of its rivals'.
[40] The acceleration and then decline in weekly PCA sales volumes appears to coincide with TSB's television, press and outdoor advertising campaigns which commenced in April and ended in the last week of May.

Figure 7: TSB and competitors' advertising spend by product, January to June 2014



Source: TSB.

Figure 8: Total advertising spend of TSB and other banks, H1 2014

[✂]

Source: BEC Week 1 Update, Marketing and Communications, 5 August 2014.

Customer retention

46. In July 2014, at the same time that its new sales were stabilising, the number of non-Lloyds' switchers out of TSB increased, particularly those switching to Santander and Halifax, LBG's 'challenger bank'.[41]

Figure 9: PCA account holder switching away from TSB, May to October 2014

[✂]

Source: TSB.

47. TSB attributed this to three main factors:

(a) The end of co-servicing in Lloyds' branches in August 2014, which could have disrupted customers transferred from LBG to TSB but who habitually used a Lloyds branch.

(b) The increasing awareness of CASS.

(c) Competitor activity.

48. Research conducted by TSB among switchers to Lloyds, Santander and Halifax revealed quite different reasons for switching among the three groups of consumers. Those switching to Lloyds did so primarily[42] because of branch

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[41] LBG positions Halifax as 'The UK's number one challenger bank.'

[42] 42% of switchers to Lloyds gave this as their trigger compared with 14% of Halifax and 4% of Santander switchers.

location, because the Lloyds branch they had been using whilst co-servicing was available was more conveniently located than the nearest TSB branch. The research indicated that references to lack of convenience increased somewhat at a distance of 4 miles from branch but increased appreciably if the relevant branch was further than 8 miles away.

49. Switchers to Halifax, which offered a £100 bonus to new account holders, cited 'financial incentives' as their main reason for switching while most switchers to Santander said they thought the Santander product was better than TSB's.[43]

50. It also appears that the offers being made by these three banks varied in their appeal to customers depending upon the size of the balances that they carried in their current account prior to switching. For accounts with average incoming payments of £500 per month, switchers to Santander held the highest average balance (£[✂]), switchers to the Halifax the lowest (£[✂]) and those switching to Lloyds a level between the two (£[✂]).

51. That said, there is some evidence that the switchers that TSB researched had one factor in common: a higher propensity to switch between other providers of services. 34% of TSB current account holders who switched to Santander and 30% of those who switched to Halifax had switched energy providers in the last 12 months, for example, which is roughly double the national average rate of switching.[44]

Barriers to entry and expansion faced by TSB

52. We now consider whether TSB's experience suggests that there are features of the retail banking market which constitute barriers to entry or expansion. We look first at TSB's results to date and then at its submission that its future growth may be constrained by falling profitability of the business. Finally we set out our tentative assessment of the evidence we have seen so far.

TSB's results to date

53. Since its launch as an independently managed bank TSB has added, net, over 200,000 PCAs, increasing its account base by 6.5% and, at its peak, was securing 14% of PCA flow. It has done so despite the quite significant loss of

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[43] The Santander account offered 5% interest on balances between £3,000 and £20,000 whereas TSB's Classic Plus offered 5% interest on balances up to £2,000. The report also noted (slide 17) the importance of Santander's 1-2-3 television advertising as a driver of switching to Santander.

[44] See CMA (July 2014), *Personal current accounts: Market study update*, p92.

customers back to LBG and in the face of competition for flow from larger rivals such as Lloyds and Santander.

54. The launch of its Classic Plus product in April/May 2014 in particular allowed TSB to grow its PCA sales, driven forward by an advertising campaign with a budget comparable to those of much larger banks.

TSB's submission on rising costs and new customer profitability

55. TSB has submitted that its progress as witnessed to date may not be sustainable in the future for two reasons:

   (a) Rising costs, as a result of its arrangements with LBG and the ongoing reduction of other temporary profitability enhancements put in place following the recommendations of the OFT in September 2013, may constrain its ability in future to invest in new customer acquisition and this will make its position as a challenger bank les effective.

   (b) The PCA customers that TSB is likely to acquire from other banks may take several years to become profitable.

56. We set out and consider both arguments below.

Rising costs

57. TSB told us that the marketing campaign which had driven its sales in 2014 had been funded in large part by the reduction in the cost of its IT services agreed by LBG for the initial years of its operations and the enhancements to profitability which were put in place following the recommendations of the OFT in September 2013.[45] It said that without that funding TSB would not have been able to invest to the same extent in attracting new customers. It said that if these profitability enhancements were excluded, TSB's underlying profitability would be significantly reduced: in the nine months to October 2014, if reductions in the cost of the IT services under the transitional arrangements with LBG and the benefit of the mortgage enhancement are excluded, TSB would have [✂].

[45] The long-term service agreement, which is due to operate from 2017, is expected to increase TSB's cost base by more than £100 million a year. In addition, TSB received, with effect from February 2014, the benefit of a £3.4 billion portfolio of mortgage loans which was assigned to it by LBG. This was designed to enhance TSB's profitability by a cumulative £230 million over approximately five years. This portfolio is subject to a call option exercisable by LBG after the £230 million profit target has been achieved. (TSB Preliminary Results Announcement 2014, p7). LBG also provided TSB with an additional £40 million capital to enable future customer acquisition and develop its branch network.

58. Furthermore, it said that these profitability enhancements were temporary and would decline year-on-year. As a result of the make-up of the mortgage portfolio, the annual income was greatest in the first year and then reduced year-on-year as the portfolio ran off. This decline in mortgage income coincided with the step up in the costs of its IT services from LBG in 2017.

59. In summary, it said that TSB's credentials as a disruptive competitive force had been fundamentally affected by a period of low profitability in its early years as a result of both the changes made to the business during the attempted Verde trade sale which saw the bank's balance sheet reduced without a commensurate reduction in its cost base and an economic environment with low interest rates, contrary to expectations at the time of the bank's design. It said that these changes had introduced a drag on TSB's underlying profitability and may reduce the business's potential to be a sustained disruptive force in the market against the large incumbent banks once the benefits of the various profit enhancements had ended.

New customer profitability

60. TSB told us that, in general terms, [✄]% of a bank's customers generated around [✄]% of its income and that its analysis indicated that these customers were half as likely to switch as others. It told us that the reason for this was that these high-value customers were most likely to be overdraft users but would be less likely to switch banks because they considered, probably correctly, that a new bank might be unwilling to provide them with equivalent facilities without the depth of customer history held by their current provider. TSB customers who did decide to switch were, therefore, likely to be less profitable. It inferred that the same was true for other banks' customers.

61. It pointed out that the less valuable customers who did switch would not become profitable for some time and this would be even more marked where a cash incentive had been offered as an inducement to switch. It said that in these circumstances it could be several years before a customer acquired through switching became profitable. It illustrated this model in the figure below.

Figure 10: Customer profitability model where cash inducement is provided

[✄]

Source: TSB.

Our assessment of TSB's submission

Rising costs

62. Clearly, a lack of sufficient funds to invest in customer acquisition would handicap a potential entrant but this would not constitute a market feature unless other potential entrants were faced by the same prospect. We considered whether TSB's arguments as to the sustainability of its status as a challenger bank were specific to the Verde divestiture arrangements or whether they could have wider application.

63. We noted that the cost of creating or acquiring an IT platform capable of supporting a PCA could, in theory, constitute a barrier to entry or expansion but we did not consider that we had sufficient evidence to conclude that all entrants would be similarly handicapped. On the other hand, it may be that despite such a (hypothetical) barrier, new entrants could, or have been able to, identify and adopt strategies which would overcome this obstacle, for example by offering fewer service channels or by focusing on a particular market niche.[46]

Falling customer profitability

64. PCA customers switching to a new provider may be unprofitable either because they generate less value for the bank than it costs it to service them or because they leave the bank before they have become profitable. We considered what evidence was available to assess both these possibilities.

Customer value

65. TSB argued that lower-value customers were more likely to switch PCA providers and that, generally, these would be customers who did not make use of overdraft facilities.[47] Challenger banks would therefore, if this were the case, acquire relatively lower-value customers, leaving incumbents with the more profitable ones.

66. We noted that it is certainly plausible that customers with existing overdrafts might be reluctant or even unable to switch banks if they were required to repay their debt on doing so. Further, for the reasons suggested by TSB,

[46] Outsourcing may also be possible and some newer banks appear to be considering this as an option. See PRA and FCA (July 2014), *A review of requirements for firms entering into or expanding in the banking sector: one year on*, paragraphs 69–77. See also FCA (July 2014), *Considerations for firms thinking of using third party technology*.
[47] We note that PCA customers may, by holding money in their accounts, also generate value by providing a bank with a low-cost source of funds.

customers considering switching in anticipation of securing an overdraft may refrain from doing so because they realise that their creditworthiness will be unclear to their new bank. Equally, a customer may switch and then be unable to borrow (because the new bank will not have sight of their credit history) and thus fail to generate revenue for the new bank.

67. That said, we also noted that one incumbent bank had concluded the opposite and that it was its higher-value customers whom it was most in danger of losing.

68. Data from LBG on the characteristics and value[48] of customers it had lost to rivals does not tend to support TSB's argument that higher-value customers were less likely to switch than others. LBG's concern was that it was losing customers with higher credit turnover (CTO) and balances to rivals, [✄]. It illustrated the relative propensity of its customers to switch to [✄] in the matrix reproduced below.

Figure 11: Characteristics of account holders switching from LBG to Santander

[✄]

Source: LBG.

69. This suggested that switching [✄] became more likely as a customer's CTO increased and that there was also a positive association, albeit less clear, between switching propensity and the size of account balances.[49]

70. [✄]

Figure 12: Net switching behaviour of Lloyds' higher-value customers

[✄]

Source: [✄]

71. We note that propensity to switch may depend on the salience of the offer to particular customer groups.[50] The Santander 1-2-3 offer, for example, which pays relatively high rates of interest on credit balances of between £3,000 and £20,000, may have appealed in particular to LBG's higher-value customers since the segmentation used above is based on a combination of a customer's CTO (as a proxy for income); and investable deposits and home

[48] LBG's categorisation takes account both of a customer's use of its credit facilities and how much money they keep in their current account.
[49] LBG had a retention strategy which aimed to predict which of its customers might be at risk of switching and to target them with pre-emptive retention activity.
[50] Salience may be determined not just by the monetary rewards on offer but also by the quality of service provided.

value (both as a proxy for wealth). We hope that our survey of PCA customers will shed further light on this.

Customer lifetime

72. The 'lifetime value' of customers will depend partly on how much income they generate for the bank and on how long they stay with it. We considered it plausible that customers who have switched bank accounts previously may have a higher propensity to switch subsequently if, for example, a more attractive offer became available.[51] Customers switching early in their 'life' may, therefore, never become profitable and, clearly, the higher their acquisition cost[52] the more likely this would be. Again, while we cannot know what TSB's retention rates will be in the coming years, our survey research and modelling will indicate whether propensity to switch PCAs is affected by previous switching behaviour, including between banks.

TSB – preliminary assessment of barriers to entry

73. Because it entered through divestiture rather than organic growth, TSB possessed assets from the outset that other entrants did not. It owned around 6% of the UK banking branch network, had the authorisations and licences necessary to carry out a banking business and began life with a share of the PCA market of just over 4%.

74. On the other hand TSB lacked advantages enjoyed by other entrants, such as a purpose-built, modern IT platform, and it faced the same potential obstacles as all new entrants: in particular, a low propensity of consumers to switch PCAs, sometimes characterised as 'consumer inertia'.

75. In 2014, having launched a new, interest-bearing current account, TSB won a roughly 9% share of flow[53] and added over 200,000 PCAs to its stock.

76. It is not yet clear whether TSB's growth is sustainable or whether the issues that it has drawn to our attention that it claims may threaten its sustainability, in particular the cost of an IT platform, would similarly constrain other firms seeking to enter or expand in this market.

77. Finally, we note that in March 2015 TSB reached an agreement on an offer from Banco de Sabadell to buy all of the shares in TSB Banking Group plc. Should the transaction complete it is Sabadell's intention to migrate TSB

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[51] This behaviour is sometimes described as 'rate chasing'.
[52] In terms of marketing spend per customer acquired and any reward offered on joining.
[53] 'Market flow' refers to new PCA openings, ie new sales of PCAs, as opposed to existing accounts which are described as 'stock'.

customers across to its own proprietary in-house IT platform, which it anticipates would deliver £160 million a year in cost savings in the third full year following completion of Sabadell's acquisition[54] and remove TSB's dependence on the LBG platform. Such savings would help mitigate the impact of the rising costs to which TSB drew our attention.[55]

[54] Recommended Cash Offer by Banco de Sabadell, S.A. for TSB Banking Group plc Offer document, p14.
[55] For example, limitations resulting from its current branch network, the levels of switching, the scale advantage of the biggest banks (which have a larger stock of existing customers over which to spread their fixed cost base and from which to fund competition for new customer acquisition), and the time taken for new customers to become profitable.