



May 27, 2015

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Competition and Markets Authority
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Dear Joanna and Christiane

Retail Banking Market Investigation – Updated Issues Statement

Whilst Lloyds Banking Group (LBG) intends to respond more fully to the recent Updated Issues Statement (UIS) and the various working papers, I am writing to you now to share three initial observations which may be helpful as the CMA continues to develop its thinking and carries out analyses that will inform the working papers.

Our initial observations on the UIS relate to three important areas:

1. how best to create a robust measure of relative pricing and how to interpret the results of any empirical analysis;
2. how to measure market shares, scale and concentration; and,
3. how to consider theories of harm which seek to relate concentration to customer outcomes.

1. Measuring price

- a. The CMA's analysis is going to be much more robust (and representative) if it looks at real customer account behaviour. This is because we believe that small variations in customer behaviour can have significant differences in the overall "price paid" and revenue earned by providers. Both the distribution of customer outcomes and the way in which different competitors target and attract different customer segments are important for the CMA.
- b. For PCAs, the CMA already has the relevant account-level data and so it just needs a way of modeling relative prices. (Note that if the CMA wanted to use real midata files for such modeling, to complement the existing dataset, LBG would be able to supply these within 2 weeks.)

- c. LBG has recently been working with a firm called Runpath to consider how we can use an “analytical engine” based on the algorithm used for midata to see how thousands of real customer behaviour profiles compare. The Runpath engine is an improvement on the existing engine developed by Runpath for the GoCompare midata service because it provides more accurate and complete comparisons. The illustrative analysis we have seen to date, which is currently based only on LBG customers, is extremely interesting and can isolate:
- the existing “price” of the customer’s PCA with the existing provider (which could be cross-checked against the work on revenue distributions);
 - the potential financial benefits to the customer from switching to different providers with and without any switching incentive and over one year or longer periods;
 - the range of providers that are most likely to appeal to different types of account behaviour;
 - the proportion of times that each provider is cheapest or more expensive for customers of different types; and
 - how all of these results can be segmented by looking at different customer characteristics, such as monthly credit turnover or O/D usage.
- d. We would suggest that the CMA talks to Runpath independently about how it may apply the same empirical techniques to the PCA market as a whole because it will help improve the CMA’s understanding of the PCA market. We have attached a couple of illustrative charts to demonstrate the type of analysis that is possible; and Runpath will be able to explain in greater detail to the CMA how its analytical engine is configured (e.g. what data points it takes into account and what the results show).
- e. For BCA pricing we have not yet been able to complete the same type of analysis, but we have asked Runpath to build a similar analytical engine for BCA tariff customers as part of our midata II 'Proof of Concept'. We intend to apply this version of the analytical engine to our data with a view to testing it (in particular, the extent to which the engine can be applied to SME customers with bespoke arrangements). At this stage we would recommend that the CMA also consider talking to Runpath about the SME market.

2. Measuring market shares and concentration

- a. We have discussed previously with the CMA how differences in customer behaviour make the robust measurement of market shares difficult in current account markets. In the past, both PCA and BCA market shares have tended to be calculated on a volume basis (i.e. the number of accounts) rather than a value basis (i.e. revenue from those accounts or, perhaps as a simpler proxy, the share of balances on these accounts). For BCAs, this may be approximated through turnover segmentation.
- b. Such volume approaches to calculating market share have significant problems and are a result of data limitations within the industry. Providers would typically cut the data in different ways, or focus on different customer segments, as an attempt to overcome such problems. However, the CMA is in a unique position to properly measure market shares, by value, for all providers, in both the SME and PCA markets, and we urge it to take this opportunity to make the analysis more robust. There are a number of ways of creating value market shares, from a full revenue-based approach to using proxies like account balances, and it may be useful for the CMA to look at the relationship between a variety of value-based methods and the existing volume-based method.

- c. We have also noted that in the UIS the CMA's measures of PCA market shares are very different from those estimated during Phase 1. In Phase 1, the definition used by the CMA was accounts that receive at least £500 per month. In Phase 2, the definition used by the CMA is accounts that receive at least £500 per month on average over a year. The change to this broader definition (whereby an account that receives one deposit of £6,000 or more in a year and has no other transactions is classified as a main account) appears to have had a significant impact on providers' market shares:
- In its PCA Market Study update (July 2014) the CMA reports LBG's share of funded accounts, including TSB, at 25% in 2013.
 - In the UIS, the CMA puts LBG's share of main accounts, excluding TSB, at 25% in 2013.

We do not understand why this difference exists but we anticipate that it is largely due to the different way the CMA has applied credit turnover thresholds. This is obviously something the CMA can confirm.

- d. Concentration and scale can obviously be measured in different ways, but most methods start with market shares. Once the CMA obtains robust market shares, based on value, we believe it will also have the most robust measures of concentration that have been collected in these UK markets.

3. Links between concentration and outcomes for customers

- a. Having obtained robust measures of pricing and market shares the CMA will then be in a position to properly assess whether a relationship exists between these variables, as part of testing Theory of Harm 2 (the CMA will also be checking non-price variables, such as customer satisfaction, but we don't discuss that further at this point).
- b. The CMA is undertaking a literature review to assess existing theories and evidence on the links between concentration and customer outcomes. LBG has previously reviewed this literature and we remain uncertain about its application to the CMA's inquiry, partly for the reasons the CMA gives in the UIS, and partly because the measures of price and concentration are not robust (see the points above). However, we will comment on the results of the CMA's review when we see them.
- c. For the moment we can only provide some observations on the CMA's thinking that is set out in the UIS, which is principally at paragraph 99. The CMA sets out two "mechanisms" that could plausibly link concentration or market shares to customer outcomes (and the CMA specifically asks for views on these points at paragraph 100). We provide our preliminary observations on both mechanisms below.
- d. In paragraph 99(b), the CMA sets out a theory under the heading "difficulty in discriminating between active and inactive customers". Our interpretation of this mechanism is that it is a version of a theory that has previously been put forward by the OFT and ICB. It would be helpful if the CMA could confirm this in the relevant working paper, especially if it is going to review the relevant literature. In addition, we have the following specific observations on this mechanism:
- The CMA appears to make clear that the mechanism being discussed is "irrespective of [provider's] size" but then goes on to ask "whether banks with higher market shares may have weaker incentives to lower prices or improve quality/innovation...". This appears to be inconsistent so it would be useful if the CMA can confirm if and how it believes market share impacts on the incentives to differentiate.
 - The CMA describes the mechanism in terms of banks with higher or lower market shares but our understanding of this theory is that it is

driven by each provider's ratio of active to inactive customers, which is not the same as its overall market share. It would be useful if the CMA can clarify this point and perhaps consider how it is possible to define such ratios (as many customers who do not switch provider actively switch their product with their existing provider) and then empirically test such ratios. One example might be the balance between stock and flow shares.

- As per our understanding of this theory, the CMA states that the mechanism works where providers cannot discriminate between active/switching and inactive/non-switching customers. However, it seems clear to us that banks can and do incentivise switching customers, in both the PCA and SME markets, something that the CMA recognises at other points in the UIS. It would be useful if the CMA could explain in the relevant working paper why this fact alone does not eliminate this theoretical mechanism.
- e. In paragraph 99(a), the CMA sets out a different theory under the heading of "ability of providers with higher market share to differentiate products and exercise market power". This theory is less familiar to us and we therefore have some additional questions:
- The CMA sets out some standard ways in which providers may attempt to differentiate themselves. At times the CMA appears to distinguish between brand or service differentiation (e.g. branch networks, websites, etc), product differentiation (e.g. targeting products at customers with higher balances or different transaction needs), and banks that have multiple brands (e.g. HSBC and First Direct). It may be useful if the CMA were to explain these various forms of differentiation in more detail as we suspect that the economic impacts will be different.
 - It may help if the CMA were to give some sense of the materiality of these different types of differentiation. In previous inquiries it has often been stated (incorrectly in our view) that banks are "all the same" or that "customers don't see any difference between banks".
 - The CMA suggests that these forms of product differentiation can "give banks the ability to raise prices above marginal costs...". Again, we are not sure that this will be equally true for the various forms of differentiation.
 - For each type of differentiation the CMA is seeking to assess the degree to which the economic effects are driven by market shares. At this stage we are not sure what such a linkage looks like and it would help if the CMA could set out clearly in the relevant working paper how market share changes the incentives of providers to differentiate.
- f. We hope that the CMA's working paper on these mechanisms is able to set out the theories more completely so that we can properly consider how they can be assessed and tested. In doing so, we wondered whether these two mechanisms are mutually exclusive. It would help if the CMA could explain the degree to which this is true, or under what conditions they could both exist in the market.
- g. Finally, it is worth noting that the Runpath pricing engine, because it is based on looking at historic customer behaviour, may also (indirectly) help the CMA in looking at the concentration mechanisms and competitive dynamics more generally. It can capture, for example, the split of customers on different product types and how many of a provider's customers have actively switched to the 'best' product - based on their usage - amongst that provider's range.
- h. If this data is aggregated by provider it would then be possible to profile each provider's customers base, show how "closely" they compete with alternative providers (by customer type) and how differentiated the offers are. If it were possible to combine this type of analysis with the account-level data that

providers have given to the CMA, it may also be possible to additionally look at the impact of customer tenure, cross-product holding and a variety of other behavioural variables. We do not at this stage know how much of this is possible in practice but we think that the CMA could establish that relatively quickly.

If the CMA wants to explore the use of the Runpath enhanced analytical engine we are happy to waive any rights we have in our contract with Runpath to allow them to share this with the CMA so that the CMA can independently check and validate the calculations and/or use Runpath independently to run any data analytics.

I have tried to keep this note short and hope that the points will be clear to your respective teams. However, if you have any questions in advance of our more complete UIS response, please do not hesitate to contact us. We would also be happy to meet to discuss any of these points in more detail.

Yours sincerely

Steve Smith

Director, Retail Competition & Regulatory Strategy

Cc: Paul Jackson, Project Manager, CMA