RETAIL BANKING MARKET INVESTIGATION

Summary of hearing with Lloyds Banking Group on 9 July 2015

Introduction

1. At the start of the hearing Lloyds Banking Group (LBG) showed a short video[1] that showed a working prototype it had developed called midata II, building on the existing midata initiative to make it simple and easy for customers to compare current accounts. This used a standard industry wide API to allow personal and business customers to simply and seamlessly use their current account transaction data without any redactions to get personalised comparisons of different current accounts cost, service and other features. LBG explained that this was a much better customer experience than the current service as it did not involve any need to download transactions and worked quickly and seamlessly on tablets and desktop devices.

2. LBG said it had been through significant changes since 2011. These included the financial crisis (and the material impact this had on LBG), the commitment to divest TSB and, more recently, to face the challenges of a changing and dynamic retail banking market. Its 2011 strategy contained four pillars to take the group forward, reshape, strengthen, simplify and invest. LBG had largely delivered on that strategy. TSB was also launched as a significant new competitor.

3. LBG noted that the reduction in its cost base had helped it to compete more effectively by letting it invest in better products and services for customers. It also allowed LBG to continue to invest significantly in innovation, primarily through digital. It was critical that LBG made these changes, as in its view retail banking had never been more competitive.

4. LBG stated that there had been significant new entry and greater competition from existing providers, including Santander and Nationwide. LBG said that it was also preparing for disruptive entry from new technology entrants with new business models and much lower costs.

5. LBG commented that the relatively low level of switching and customer engagement, in business and personal current accounts, were long-standing

[1] See the video at https://vimeo.com/131805868.

issues – but there had been improvements. It said that faster, hassle-free switching had helped, but there was more to do to increase awareness and improve confidence in the switching service (CASS) for customers in both SME and retail markets.

6. LBG stated that the biggest change in retail banking had been through technology. Over 60% of adults in the UK now had a smartphone. Six million of LBG's customers currently accessed banking services through LBG's mobile apps, and the number continued to rise rapidly. LBG explained that smartphone adoption and digital usage would become universal very quickly. Over the next two to three years LBG said that it expected 93% of adults who used a mobile phone to own a smartphone. Price comparison websites had transformed competition in many retail markets, and they could have the same impact in current accounts.

7. LBG said that barriers to entry in this market were lower now than ever before. There had been unprecedented new entry, with more to come. Changes to the regulatory regime had made it easier to gain banking licences and access payment systems. LBG did not believe that large banks enjoyed significant advantages from scale. It stated that there were some economies of scale from a bigger customer base, but there were also significant diseconomies. LBG explained that its biggest challenge over the next three years would be re-engineering all of its systems and processes so it could digitise them. This would lower costs going forward and allow LBG to be quicker in launching new products and changing prices in response to competition. However, as LBG learnt from creating TSB, re-structuring banks was very costly and disruptive for customers and did not solve many legacy IT problems.

Profitability and financial performance

8. LBG explained that it had used its four pillars strategy to simplify its business and reduce its fixed and common costs. LBG first shrunk the number of layers in the bank. It removed three layers of middle management, compressing the organisation. A larger number of spans of control with fewer layers allowed LBG to be more responsive with lower costs. Secondly, it implemented Cost Management Units (CMUs), in which the owner of each CMU interlocked with the business units supporting them in delivering through lower costs and increasing expertise across the business units. Thirdly, LBG was digitising its processes end-to-end to provide a better customer service, lowering errors as well as costs. The fourth was to sponsor and foster digital developments, which by definition was a lower cost and more convenient channel compared to branches.

9. LBG said that it was difficult to allocate investments without an unambiguous view of profitability at the most granular level, but given that LBG had huge demands for investments from regulatory requirements, 'run the bank' and a growth point of view, it had a restricted pool of funds. Therefore, its main concern was how to allocate the restricted pool of money between these dimensions when regulatory change requirements were mandatory. LBG explained that it allocated money centrally to try to compare divisions and requests in a centralised way so that there was competition between business units for the funds. Given that there were fewer funds available to invest than the demands for investment, LBG commented that it became relatively easy to allocate funds by prioritisation driven particularly by strategic imperatives.

10. Strategically, LBG explained that it believed that digital was the future and it was growing at double digits. LBG stated that it had invested £750 million in digital in the past four years. LBG considered it could not lose out on this growth in digital banking and stated that it would invest a further £1 billion in digital in the next three years. It stated that others would invest in digital and if LBG did not, it would lose customers.

11. LBG stated that profitability at a product or segment level was very difficult to estimate. LBG explained that it had a centralised approach to fixed and common costs. SME revenue was driven from two sources: customer balances that they held with LBG, and fees that customers paid. LBG noted that its main costs were fixed costs such as its IT infrastructure and branch network, and then its variable costs to support customers in terms of delivering or distributing that product. LBG also faced impairment costs. LBG also noted that profitability could, and did, vary quite significantly over time both at a customer level and at a product level.

12. At the highest level, LBG stated that it had segmented between Retail Business Banking business unit clients (typically the smaller turnover and smaller borrowing customers with more simple and straightforward needs) and the larger turnover and bigger borrowing businesses in its SME Banking business unit. LBG explained that there was a difference in revenues and costs across those two segments at a business level, which was largely driven by the volume of activity that clients were undertaking. Typically, smaller turnover customers would generate a lower level of income, but would have less complex needs and lower borrowing, so LBG would therefore have lower capital and liquidity costs against them. That was one of the reasons that in its strategy documents, LBG changed its operating models because [✂].

13. In terms of cash profit, LBG explained that the SME business would be more profitable than Retail Business Banking. If it was looked at through a return on

risk weighted assets lens, rather than through a cash profit lens, the tables turned a little bit because typically the clients served in the SME business would have more complex needs, more debt, and therefore LBG would have more capital and liquidity costs against them. Retail Business Banking customers would have a higher proportion of deposit-led customer relationships with lower lending (due to segmentation). LBG explained that it was therefore difficult to identify one of the business units as being more profitable.

14. LBG explained that there was huge churn in the SME market. Three million start-ups had opened in the last few years. The turnover of the market every five years was due to the pace of business cessations in the UK. If LBG wanted to continue to compete, it believed it was incredibly important to be successful in the start-up market. LBG commented that it needed to replace [✂] of its active customers every single year through start-ups and switchers to maintain market share, across the SME market.

15. With regard to PCAs, LBG said that there were three key categories from an income perspective: the margin that LBG made on balances, the income from transaction fees, and income from overdrafts. There were lots of common costs. LBG stated that it was working hard to make sure that every customer could contribute towards those common costs. LBG needed to open 1.7 million accounts every year to try to maintain market share and therefore continue to cover its common costs.

16. LBG stated that every year there was a lot of activity in the student marketplace. There was a focus for two months of the year as students joined university. It was noted that providers innovated through the course of the year by developing their offers and as that competitive tension worked through the market, this resulted in highly competitive propositions. For example, lots of student accounts offered interest free overdrafts for students for the duration of their university course. LBG did not think about acquiring student customers solely for the duration of their degree course; it was a longer-term opportunity for LBG.

17. LBG stated that its main strategic driver was market share. Strategically, LBG, as a retail and SME bank, should aim to provide easy to understand products with easy access. Costs should be kept as low as possible in order for the intermediation of deposits and loans to be as cost efficient as possible.

18. However, LBG considered that there was a danger of cutting costs in the short term to the detriment of the long term. LBG had therefore made a commitment that a third of its simplification costs would be reinvested in the business in order to improve service for its customers. Simplification savings

had enabled LBG to reinvest double in discretionary investment over the last four years, compared with the previous period. With this type of approach, market shares were key. If market share were to shrink, profits could increase in the short term but at the expense of longer-term profits.

19. LBG noted that its market share of basic bank accounts (BBAs) was significantly higher than that of other banks, and providing BBAs involved significant cost to LBG, even though these accounts generated very small revenues. Not all banks were required to provide BBAs.

20. LBG stated that it supported the provision of BBAs and it considered that everyone should have access to a bank account. LBG was committed to providing one in four BBAs at the moment. LBG explained that HMT's approach to BBAs had meant that over the last couple of years some of their marginal contribution to its fixed costs had been eroded. LBG stated that at the beginning of next year, it would make further changes following requests from HMT to improve the terms on which BBAs were provided. This would mean that any marginal contribution to fix costs would move close to zero.

21. LBG said that it did look at customer profiles and wrote to BBA customers to explain their options of moving to a full service account if they were eligible. However, the conversion rate from BBAs to LBG's other bank account ranges was less than 5%.

22. LBG noted that its Retail division had changed its approach to KPIs and measures within the branch network. All output based targets had been removed with branch staff and management focused on service and quality both for personal as well as Retail Business Banking customers.

23. LBG explained that it had a multi-channel approach. LBG was seeing counter transactions decrease by about [✂] a year for small business customers, and [✂] of small business customers did not use branches at all, trading entirely online and on mobile with LBG.

24. LBG noted that only about a quarter of SMEs, [✂] currently but now falling, said that the branch was their main channel. A lot of the contact and service on business products was through relationship managers, who were based centrally in larger centres or increasingly online. Customers with high cash handling requirements tended to use branches because that was better for management of cash. For others, the ability to transact cash was no longer important because their cash receipts had declined as they were operating online or contactless.

25. LBG stated that SME lending as a market was an area in which it wished to grow. LBG believed it was [✂] in this market and that it was a strong strategic

fit with its aim of being the best bank for customers and supporting the economy. In this sector, the average client holding and income per client was higher, and therefore LBG had a particular focus on growth in its SME businesses.

26. LBG stated that its targeted geographic areas in which it believed that it was under-represented, such as the [✄]. Tactical investments were made, whether that was in additional relationship managers, or investment in business development managers in order to attack those areas. This was true both for SME and small business customers, so that LBG could target certain segments and certain geographies such as [✄]. The business banking market was incredibly diverse, ranging from very small start-ups and microbusinesses to some quite large, established businesses across multiple sectors.

27. LBG submitted that it did not believe there were any SME segments that it found particularly difficult to get to or service. However, it stated that the financing needs of some sectors were more challenging than others; for example, [✄] companies requiring debt financing were more difficult for LBG to lend to responsibly as they had more 'hope value' in their business plans. LBG happily looked after their transactional banking requirements and also tried to use its networks and contacts to help introduce them to other providers of finance, which might be high-risk debt finance or equity finance, whether that was through angel finance or other investors. LBG explained that it tried to compete in all product markets for its clients, but there were some things in relation to which banks were not necessarily the best providers.

28. LBG said the product types that SMEs required had not really changed over time. When a business was starting up, banking was not their first priority. Very often, they were leaving paid employment; they were taking a risk. Creating transactional banking was a requirement so that they could pay their expenses and bank their takings. Businesses then hit a point where they required financing (typically) to grow or expand, which was the challenging stage of the growth cycle of a business. The market was now more liquid in providers of risk capital because there were options through various platforms and business angels seeking to invest risk capital.

29. LBG said that four years ago, it split SME banking from the commercial division, making the head of SMEs part of the Group Executive Committee, as LBG gave SME banking more focus. As a result of this focus, LBG had managed to grow its share of SME loans in a shrinking market.

30. For smaller SMEs, LBG was weaker and was losing customers. LBG considered that to grow its share of small SMEs it needed to focus on providing a better service, meeting the specific needs of smaller SMEs.

31. LBG explained that [✄] of its customers who had a business current account also had a personal current account. Even though a customer may have a PCA with the bank, they might also have other PCAs with other banks, and therefore LBG did not know if they were a main banker or not. LBG had to compete extremely hard to win SME customers.

32. LBG said that SMEs increasingly used a formation company to get advice on which bank to bank with. Barclays, in particular, had been very successful in using such intermediaries.

Innovation

33. LBG said that it faced significant competition from big and small banks (which had increased in number) and non-industry entrants. Innovation was driven both by LBG's own desire to stay in the game or try to be ahead in certain areas, or, as a response to others (in the UK and overseas). For instance, Santander launched its 1-2-3 account, and after 12 months, LBG had lost £ [✄] million of current account balances. In an effort to respond and retain customers, LBG launched the Club Lloyds Account. LBG was the first to launch spending rewards in the UK after seeing developments internationally. With new entrants such as Apple, Google and PayPal, LBG's aim was to increase its investment in digital to be a fast follower. LBG said that there were so many potential innovations that it was difficult to assess which one of them was going to be a potential breakthrough.

34. LBG said that trends outside financial services were driving a lot of thinking in financial services. Customers' experiences of, for example, Amazon and Facebook were driving customers' expectations in relation to their PCAs and BCAs. Customers now used Skype and expected the bank to be able to provide these services, and LBG stated that it was now developing remote capabilities. Another example provided by LBG was PayPal; customers were receiving benefits from its use, so LBG invested in Paym.

35. LBG said that there had never been so many banking licences granted as in the last 30 years. Such new entrants had new systems and were able to devise lower cost models than LBG, given LBG's costly legacy systems. These banks may be smaller, but they were growing in number and taking a larger market share.

36. LBG stated that Big Data opened up great opportunities for many players in the market. LBG explained that the data that LBG had today was probably less relevant than the behavioural data that the Big Data companies were scraping from social media about customers. LBG's concern was that the data required to help the big data solution was sitting outside the bank with credit reference agencies, social media, supermarket spend patterns, etc.

37. LBG said that whilst had lots of data, it had not yet been able to use it as effectively as it would like to target its products.

Competition

38. LBG submitted that there was significant competition between players for relationship managers. For LBG, having good career structures that allowed people to come into its commercial bank, develop themselves professionally and become relationship managers (RMs) was a core part of its strategy. In the last 18 months [✂]. LBG's strategy and values were appealing factors for incoming relationship managers. LBG explained that [✂] had been recruiting a lot of RMs on the basis of attractive reward packages.

39. LBG said that the relationship between the RM and business in the SME market was very important, but not defining. LBG knew that a change in RM for a client was an identifiable root cause of a dip in client satisfaction. In 2014, LBG needed to change the RM of a majority of its SME customers as part of its restructuring of the SME business. Only [✂] of customers complained, reflecting the investment made by LBG in managing the transition.

40. For SME customers, LBG said switching accounts was a complex decision. It submitted that research showed that customers wanted banks to know the customer and the business in order to help the provision of banking products. About [✂] of LBG's new SME Banking clients came from existing clients referring on the basis of having had a good experience. [✂] would come largely through introductions from intermediaries, whether that was from solicitors, accountants, brokers, or other professionals. [✂] was made up of various things such as transfers from LBG's Retail Business Banking business unit due to customer growth.

41. LBG said that it had seen a market trend towards higher thresholds at which RMs were deployed on a local face-to-face basis. Lending decisions used to be quite a manual process made by an individual who had long experience and was there to talk to customers. Increasingly, that was being enabled by automated credit systems and credit information on a more systematic basis. LBG submitted that there was greater use of other channels than the

traditional face-to-face meeting. In addition, the banks had moved towards more efficient centralised approaches to deploying RMs. With the larger SMEs the banks must deploy a local RM approach, but as they were larger businesses, it was easier for banks to have a more regional approach than with a smaller SME.

42. LBG explained that if a client of LBG got finance from a competitor, there was a high risk that the client might move their main banking relationship to that competitor. LBG in turn was also always trying to compete for this new business just like other banks. LBG stated that its strategy was to be relevant to the client every day. LBG would try to identify client needs and engage the client in conversation on a relevant basis.

43. LBG explained that RMs' experience was that clients tended to make their decisions about choosing banking providers, whether for a loan, or for their main banking relationship at a time that was suitable to them. The challenge for the bank was to hold the right conversation with the client at the right point in their trading cycle.

44. LBG stated that smaller SMEs were not offered RMs because customer needs were relatively simple and straightforward, and were quite similar to the needs of a personal customer. What customers were looking for was excellent service that was delivered reliably with simple, straightforward products and services. In the small business market, LBG stated that it was also competing against alternative finance providers. That market had tripled in the last few years and was becoming increasingly relevant for small businesses. The average loan or ticket size was in the £10,000 to £20,000 range and could be provided by supermarket finance, other forms of retail finance or traditional bank-led business finance.

45. LBG said it had an informed choice sales process to provide clients with the correct product. The client decided what type of product they wanted but, from a conduct perspective, it was important to demonstrate that the client had been informed of other financing solutions. This was done by asking a set of structured questions which would inform the client as to whether, for example, a loan may be a better option than a credit card or overdraft. LBG stated that this was the case for SME and smaller business clients.

46. LBG found that it was not just price that clients were looking for in comparison with other financial providers, but also flexibility. There were some clients where price was the be-all and end-all. For some clients it was the element of safety and just wanting to have the security of knowing they had a credit line in place, because that was helpful to them in their overall financial planning.

47. LBG said that when the SME market was declining, LBG managed to increase its market share by remaining open for longer-term lending, at a time when it was expensive to do so. LBG retained an appetite for good clients who could demonstrate serviceability such as in property. LBG was also very active in its use of government schemes like the Enterprise Finance Guarantee.

48. LBG indicated that when clients were looking for finance there may be a footprint left on their credit score, but that did not make a material difference to the credit decision. LBG explained that it was able to differentiate between adverse credit information such as county court judgments, and information which merely reflected that the SME had been shopping around.

49. LBG stated that in Holland, a couple of banks had moved towards giving benefits to customers who used standard business reporting technology, which enabled businesses to upload their credit rating on a real time basis to the bank, shortcutting some administrative processes. Standard business reporting technology may increase the portability of relevant information, which would reduce customer and provider costs in the loan application process.

Theory of harm 1: Comparability/switching

50. LBG said that the Payments Council research suggested that broadly three quarters of customers believed that they had a good relationship with their existing provider. This may be why clients were not switching. LBG provided tariff and loan calculators to encourage engagement. LBG said that it believed that the Nesta Prize Fund and midata could also encourage engagement. LBG said that it was trialling annual account reviews with customers, giving them a clear view of what fees they were paying, what services they were getting, and giving them the opportunity to look at alternatives. LBG said it had tested text alerts on overdrafts and was also suggesting that business customers be made more aware of CASS.

51. LBG said that intermediaries played a role in engagement and switching in all segments particularly in the SME market. Formation companies were becoming more prevalent in the market place. LBG said these were business focused companies that acted as a broker between the customer and the bank. In the larger SME market, comparison sites, advertising and CASS were all relevant, but intermediaries for larger companies would typically be financial advisors.

52. LBG said customers may not switch after taking advice, but they still benefited from the advice. These customers would improve their financial capability and

investment readiness. It opened the customers' minds to different forms of finance that LBG or others could provide. Customers' levels of engagement were changing faster than ever before. People may have only visited a branch once or twice a year in the past. People now on average engaged 12 times a month digitally and 20 times a month via mobile. There was an ever increasing number of new entrants, as well as players like Barclays launching new accounts. Because of this, LBG was very excited about the possibilities of midata II and the ability of customers to compare different choices.

53. LBG explained that its view of multi-banking was that it was a force for good in that it let people try before they buy. The number of people moving main bank accounts was over three million, but only one million were using the CASS service. LBG explained that there were two levels of multi banking. There was multi current account holding, ie having more than one current account with different providers, and there was multi product banking, for example having a mortgage with one provider and a current account elsewhere.

54. LBG stated that it believed the value of midata II was that it was individual to the SME; the SME could look at its business and upload all of its transaction history. It could then compare its profile with different propositions, for example a hairdresser could look at how much the account paid and compare charges to what else was available in the market. Allowing time-poor SMEs the opportunity to run their businesses wherever they were was critical. midata II provided the opportunity for customers to make comparisons between providers that were relevant to them.

55. LBG said that midata II allowed data such as a customer's phone bill to be compared to other offers. The customer would be able to see how much they spend and the cashback available on that item. This would help customers engage with the breadth of offers in the market.

56. LBG said that midata II would offer the user a good understanding of its behaviour and the ability to compare with other accounts. The customer would be able to do this with all accounts, including those with overdraft facilities or borrowing. It was possible to upload 12 months' of data with Gocompare.com, but LBG hoped to do more. LBG had provided information on overdraft switching and how customers could get confidence about whether they would be accepted elsewhere. LBG said it was launching an overdraft eligibility checker. This was a soft search that would leave no hard footprint. It would provide the opportunity for a prospective customer to see if they would be accepted at LBG. This soft search would give the customer greater confidence in being able to move to LBG without contacting the customer's current bank.

57. LBG indicated that it had increased the information provided on statements to inform the non-digital users of its overdrafts. It tried to contact customers with overdrafts through their mobile phones and had also introduced grace periods and buffers that were now up to £100. midata II worked for [✂] of people; the others that were non-digital could use the tool through trusted intermediaries because it was simple. Media must also play a role in providing such information.

58. LBG said it had invested a lot of time in developing CASS as it believed it would itself benefit significantly from customers switching. It believed that there had been a problem with the marketing of CASS and that there was not enough investment behind it. LBG said it considered that the marketing campaign should have been much more significant and needed to be continuous in order for uptake to increase.

59. CASS must be brand-agnostic as otherwise customers would become wary if there was a brand attached. CASS was not a one-year marketing campaign, and it would take a few years of reinforcement to change people's minds on the ease of switching.

60. LBG stated that [✂] of its customers would not be able to switch their existing overdraft to LBG if they applied for it today. This figure dropped to [✂] if the period was lengthened. This was expected to be a market-wide problem which the inquiry should focus on. These customers may not believe switching would help them and may feel that loyalty to their bank had given them an advantage. LBG said that the reasons for the customers not meeting overdraft eligibility criteria were diverse, for example, periods of unemployment or reduction in salary.

61. LBG said that one of the practical problems with CASS was understanding how overdraft rights were transferred when switching. If a customer was moving banks, they would have to pay off their overdraft when they switched and begin with a new account, or make arrangements with their previous bank to repay any remaining outstanding debt. Currently, switching for customers with overdrafts was not as smooth as for in-credit customers.

62. LBG said its experience was that the sizeable majority of people who ended up in financial difficulties managed to repair them. Through the financial crises, of the SME clients that transferred into its business support teams, more than 70% of them were managed back to good book or refinanced out.

63. LBG said they were investing in processes to allow customers to switch easily both face to face and online. LBG said that it had demonstrated to the CMA technology that would allow customers [✂] . This technology applied to small

business customers as much as personal customers. Anti-money laundering and know-your-customer requirements prevented technology developments from providing near-instant account opening facilities. LBG said it must comply with these requirements.

64. Currently, LBG said it would not accept a customer on the basis that the customer had been AML/KYC approved at another bank as every bank set its own risk appetite and was legally responsible for checking its own customers. It said from a business perspective, more information would be required on the nature of the account, what it was going to be used for, the value of the turnover and which markets the SME was participating in.

65. LBG said it had removed all exit fees, security fees and arrangement fees from its terms and conditions to encourage switching, with the exception of cost-reflective fees on fixed rate loans.

Theory of harm 2: Concentration giving rise to market power

66. In relation to the CMA's Theory of Harm 2, LBG explained that the two mechanisms referred to in paragraphs 99*(a)* and 99*(b)* of the UIS (exploring the link between concentration or market share to customer outcomes) were not clear as drafted in the UIS. In particular, LBG explained that it was not clear to LBG how the CMA intended to measure and test any relationship between concentration and outcomes.

67. LBG stated that its pricing for all its brands was national. LBG submitted that it had a national market share of approximately [✄] of SME BCAs, but that varied slightly by region.

68. In its view, value shares must be considered as well as volume shares. LBG said it expected big differences between value shares and volume shares generally. It may not be possible to answer whether those differences would vary across regions.

69. LBG said that in terms of number of PCA accounts, it estimated that Santander had a market share of 10 to 13% (based on GfK volume data), but on value share of PCA deposits, Santander was likely to have a 20% market share (based on Bank of England balance data). Given the fact that it was one of the major drivers of revenue, LBG suspected that on a much smaller book it would be doing relatively well. There was survey data that looked into PCA and BCA concentrations, but the difficulty with the latter was, as you segmented down by size of business and then by sector and then by geography, you got to some sample sizes with a lot of statistical volatility.

70. LBG said that following the merger with HBOS, it had retained different brands that effectively competed with each other. LBG said that it felt that trying to force customers to merge them into one brand would likely lead to customers leaving. The Halifax, Lloyds Bank and Bank of Scotland brands continued to innovate and respond to the competition in the market. Halifax, Lloyds Bank and Bank of Scotland were all having to respond to competition from a range of providers, including Santander, Barclays' innovation focus, RBS and Metro's customer service focus and having to constantly think about how they might deal with those challenges.

71. LBG said that when reviewing the effects of the Lloyds/HBOS merger it was difficult to understand the counterfactual because the market was undergoing so much radical and fundamental change. How much was caused by the fact the bank was in difficulties? How much was caused by consumers moving to digital? LBG said there was just so much noise in the system that you could absolutely observe changes in behaviour and pricing, but trying to allocate them to different factors was incredibly difficult. LBG said it had dramatically reduced its cost base as a result of the merger, but on the other hand, because of some of the financial constraints, LBG could not reinvest some of the savings made.

72. LBG indicated that a merger might give you some benefit in immediate lower costs. However, the market was changing rapidly. LBG explained that legacy systems meant that changes took longer and were more expensive. A small bank probably had more advantages over a large bank in that regard. The merger had allowed LBG to simplify the business and to exit a number of lines of business that it did not want to be in, in order to become a low-risk UK commercial and retail bank.

73. LBG said that PCA pricing was complex. It said that there were six or seven different pricing structures, and therefore you needed the customer data to analyse which structure was best for an individual customer. LBG explained that it was quite possible for somebody to have what looked on the face of it, in terms of credit interest and overdraft charges, a highly competitive product. LBG said, however, that real data needed to be run through this as the charges behind this may generate significant income (for example overseas ATM fees).

74. LBG said that simplistic comparisons of PCAs did not necessarily show the reasons why people chose certain accounts. LBG gave an example saying that 4% in Club Lloyds and £5 per month offered by Halifax were different propositions, but both were extremely competitive in the market. It depended on a customer's balances, level of overdraft and behavioural transaction

profile – each of these could drive which one might be better for a particular customer.

75. LBG's view was that there was a compelling logic to ring-fencing because to the extent that banks were perceived to be too big to fail, then that created a funding advantage that would favour large players. LBG said that might be washed away by diseconomies of scale, but it thought ring-fencing was a proportionate response to that to create credibility and that, irrespective of your size, if you got yourself in trouble you would go bust.

Theory of harm 3: Barriers to entry and expansion

76. LBG said it had some constraints on some of its core payment systems, which limited the services it could offer to other banks. LBG said it did participate and provide indirect access for cheques and various other services to a number of banks, but was not a big player. LBG said it was [✄].

77. LBG said it would like the issue as to whether banks using the IRB approach had significant capital advantages over those using a standardised approach to be investigated further, as there were costs involved in adopting the IRB approach. Europe had introduced scalar factors that were helpful and supportive of SME lending in general. LBG said that in its experience smaller banks were competitive in pricing, and it held capital significantly above the minimum regulatory requirements. In addition, LBG said the British Business Bank had been actively providing capital and funding on a matched basis for lots of new entrants.

78. LBG said it did not agree with the argument that banks classified as systemically important or with a large back book had a significant advantage over smaller providers or new entrants due to lower cost of funds, for example. LBG said it had high mobility of customers between its products and did not have a significant proportion of off-sale PCA products. LBG said that when it launched new products (for example, Club Lloyds), they were available to all, and it saw lots of existing customers move to them. LBG said it believed its customers were savvy and would shop around to find the best products that were competitive in the market. This would result in 'internal switching'.

79. LBG said that the suggestion that by having back book deposits it would give an advantage on the front book did not actually make any economic sense, as the amount a provider was willing to spend on acquiring a new front book customer was determined by that customer's expected value, independent of any back book customers. LBG said that it was important to understand how many customers had large balances when reviewing the funding that came

from current account balances with a zero interest rate, rather than reviewing the number of customers that were, for example, on Club Lloyds. Also, new entrants did not have big books of BBAs that they had to carry. New entrants could make choices about the customers they attracted through minimum funding requirements, and thereby target the most profitable segments

80. LBG said that it did not have experience of bank-in-a-box. However, LBG said that some of the pricing models that were available were very attractive. Firstly on speed to market and, secondly, the cost per account structure meant that it was a great way of getting to profitability quickly. LBG said it allowed an entrant to continue to expand without having to worry about having to invest £50 million in setting up its initial IT infrastructure. However, there were other methods of using IT systems to enable entry – when Halifax and Nationwide entered the PCA market, they went down the agency route until they had established themselves, so this was not new. LBG said it would also question whether some of these new entrants based on bank-in-a-box platforms actually wanted to scale nationally to all locations, rather than focusing on key business and population centres.

81. LBG said it did not believe that having a network of branches was still necessary for significant customer acquisition. The role of branches in PCA acquisitions had changed very significantly over the last few years, and this was also true for SME banking ([✄] of LBG's BCA customers did not feel the need to go into a branch). LBG submitted that the more that could be eased and made simpler online, the more that would be facilitated.

82. LBG said that commentators tended to focus on the number of branches, but it was important to understand branch economics and how much of the cost of the branch network was property costs and how much was the cost of staff. LBG said it was trimming its branch network to reduce costs, but it was also significantly reducing capacity and non-property costs within the network.

83. LBG said that customers that still wished to make cash deposits who were no longer able to access an LBG branch were able to go to Post Offices. LBG said that [✄] of its face-to-face customer transactions were made at a Post Office. LBG stated that was a big proportion of its customer base who were happy to use a Post Office.

SME undertakings

84. LBG said that it welcomed the review of the undertakings. In particular, it welcomed the switching undertaking given the new CASS standards that had been introduced. Furthermore, LBG said the portable credit history undertaking was also out of date and unnecessary. LBG said it was compliant

with the bundling undertaking, and supported it. LBG stated that its customers were not obliged to have their main banking alongside their business loan or deposit.