Non-Confidential Version

LLOYDS BANKING GROUP PLC

CMA RETAIL BANKING MARKET INVESTIGATION

Submission prior to Provisional Findings

4 SEPTEMBER 2015

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1. INTRODUCTION AND EXECUTIVE SUMMARY

1.1 The CMA's investigation is approaching the half way stage, and the CMA will shortly publish its Provisional Findings. The CMA has published several working papers since the Updated Issues Statement ("**UIS**"), and has held private hearings with the main parties, including Lloyds Banking Group ("**LBG**"). Some of these hearings have been summarised and published. But LBG remains uncertain as to how the CMA is interpreting some of the evidence that has been published.

1.2 As explained previously to the CMA, LBG's concerns stem from its experience of previous inquiries into the reference markets that failed to identify correctly the key economics of these markets. This has created and perpetuated views that were not supported by the evidence. LBG's objective during this inquiry has been to encourage and support the CMA in getting to the real economics (supported by the facts) so that valuable and lasting improvements that drive more effective competition and better customer outcomes can be achieved.

1.3 This paper summarises briefly LBG's interpretation of what the evidence to date shows. LBG set out the important issues that are true, issues that appear to be untrue, and issues that are still uncertain. The paper ends with some implications and suggestions for the CMA's process going forwards.

Things known to be true from the evidence

1.4 There are several important areas where multiple pieces of evidence point so strongly in the same direction that the CMA can reach conclusions with confidence in its Provisional Findings. LBG lists the most important ones below, together with some brief comments.

(a) **Customer behaviour is diverse within and across current account providers, which is important for understanding the economics.** This has important implications for how the CMA interprets much of the evidence, and LBG has been encouraged to see the CMA beginning to move away from measuring the market by simple averages. The diversity of customer behaviour impacts on how the CMA should assess customer engagement and switching, pricing, entry and expansion strategies, and market shares. To understand the competitive process, and where potential improvements can be made, the CMA needs to focus on where the "pockets of value" lie.

(b) **For many customers the gains from switching will be low.** Whilst the CMA's pricing analysis is currently incomplete, it is already clear that many customers pay little for current account services and generate little revenue for providers, based on evidence from customers, transactions and financial information. Many low income customers currently hold, and are only eligible for, basic bank accounts ("**BBAs**"), where there are few available gains from switching and the new minimum standards will guarantee them a free account with the same service and access as other current accounts.

Some customers who search will conclude that staying with their current product, or current provider with a different product, is the best choice for them, because there are no significant gains from switching to another provider. These are important facts when assessing the current and likely future extent of customer engagement and switching.

(c) **Quality of service is important for customers and competition.** The CMA has recognised that any analysis of pricing, switching, and competitive and financial performance must include an understanding of quality of service. What is less clear (see below) is how the CMA will do this.

(d) **Customer satisfaction is high**. Whilst this may be a surprising fact for many, it is clear from the many different pieces of evidence that the vast majority of current account customers, in both reference markets, are happy with their provider and with the services provided. LBG has previously spoken to the CMA about the importance it places on service through a range of metrics including NPS and complaints data, and the success it has had in continuously seeking to improve service across this range of measures.

(e) **A digital revolution is taking place**. Evidence from customers; transaction patterns; existing providers' strategies and investment plans; actual and prospective new entrants' business plans; and international comparisons, all clearly demonstrate that digital banking is having significant impacts on customer behaviour and competition.

(f) **Innovation in the UK is high**. It is difficult to create robust metrics of innovation across different countries, and innovations happen at different speeds in different parts of the reference markets. However, it is clear from the evidence to date that the UK is one of the global leaders in retail banking innovation and at the very least is as good as other leading countries. As the CMA noted in its UIS, "*some of the larger banks are innovating at least as much as smaller banks/new entrants*", and LBG demonstrated at the LBG site visits a range of innovations launched (and planned) in both reference markets, including new products, cashback offers, switcher offers, and mobile apps.

(g) **Barriers to entry are significantly lower than they were several years ago**. The evidence from recent and prospective entrants, together with the sheer number of new entrants, all point to markets where new competitors with the right propositions and offers can successfully enter.

(h) **Barriers to expansion have also fallen significantly and recent entrants appear confident about growing in the most valuable segments of the market**. The evidence on barriers to expansion is less conclusive at this stage than the evidence on entry barriers, not least because the CMA has yet to publish all of its thinking (see below). Importantly, any such barriers appear to be falling. It is critical that the CMA assesses barriers to expansion in the context of the expansion plans of recent entrants: their evidence makes clear that they have each targeted specific (and valuable) segments of the market, and that this is having a more significant impact on competition than would be suggested by their market shares as measured by the volume of accounts. Any barriers to expansion that do remain stem from a lack of customer engagement in specific areas of the markets.

(i) **CASS is a great service that works, but has yet to achieve its full potential**. All the evidence demonstrates that CASS is doing what it was intended to do, and is working well for the customers who use it. However, it is clear that the marketing and communications around this innovation could be significantly improved, and that simple and valuable extensions to the service can be implemented.

(j) **Market shares, concentration and customer choice are no worse in the reference markets than in many other competitive markets**. LBG remains concerned about the CMA measuring market shares by volume rather than value. If measured by value, LBG thinks that concentration would be much lower and movements in market shares very different. Even on a volume basis, it is clear that

LBG's relative size (and concentration more generally) is no higher than in many other competitive markets. This simple fact has important implications for how the CMA interprets Theory of Harm 2 and why it cannot be sufficient to rely on generic economic theories to support this theory of harm.

(k) **LBG is under clear competitive pressure from a wide range of competitors**. The CMA has seen many pieces of evidence that demonstrate how LBG has to respond continuously to competitive threats, develop new propositions, and upgrade its capabilities.

(l) **Differentiation between current account providers exists and providers are not "all the same".** The idea that current account providers are all the same has been a myth perpetuated by previous inquiries and commentaries (as well as being supported by some new entrants without evidence) as a way of explaining why customer engagement is not greater. This is despite the fact that most customers see providers and their offers as being different, and that any objective analysis of banking services and products (including pricing models) shows clear differences.

(m) **There is no empirically robust link between customer outcomes and concentration or scale.** Although the pricing analysis remains incomplete, it is clear that there is no relationship between customer outcomes and provider scale. This is not a surprise to LBG because any such relationship would be inconsistent with many other facts: that LBG, as one of the largest competitors, has some of the most attractive propositions; that LBG is one of the biggest winners in switching; and that customer research fails to suggest larger providers are in any ways worse than smaller providers for customers.

(n) **There is no evidence to suggest that current account providers are making excess profits.** The measurement of economic profit in these markets is difficult and the CMA has rightly decided not to pursue a detailed economic profitability analysis. There is enough other relevant evidence on financial performance that although often hard to interpret (and LBG has not had access to it all), does not support a finding of excess profitability.

Important areas that remain uncertain

1.5 Set out below are some of the issues that remain uncertain:

(a) **Why customer engagement in specific parts of the reference markets is not greater.** Whilst many customers will have little to gain from switching providers, initial results from Runpath analysis suggest that some customers could make reasonable savings from switching. Previous inquiries have often failed to get to the bottom of why customer engagement is not higher (and, as a result, have often recommended remedies that proved to be ineffective). Recent customer research and behavioural analyses have shed some light on specific customer segments (such as those with overdrafts); whilst some customers have less access to the digital revolution, the CMA will need to do more to understand whether specific customer segments could be more engaged. As previously stated, while the issues are broadly the same across the reference markets, there is more work to do in the SME market, particularly at the smaller end to increase engagement.

(b) **How quality of service should be measured and how it varies across competitors.** Like other providers, LBG has its own views on relative quality of service (which is why it is confident that no relationship exists between quality and provider scale), but the CMA has yet to explain how this important piece of evidence is to be assessed.

(c) **How the digital revolution will evolve.** The speed of the digital revolution is clear and is likely to accelerate. Although exactly how it will evolve is uncertain, this trend is likely to have positive impacts for customers, and the CMA has an opportunity to influence the direction of travel. The competitive uncertainty is not in itself a problem (it is a common feature of competitive markets) but it does have implications for how the CMA views competition in the future, and how it may think about potential remedies.

(d) **The future role of branches.** It is clear that the role of branches is changing in retail banking generally and more quickly in current accounts, and it is almost certain that significantly less branch capacity will be required in the future (see above), but no provider knows exactly how this will evolve. It is clear from the evidence that many providers have different views and are preparing different plans. This uncertainty will drive the competitive process and differentiation so is not a problem but, like the digital revolution, it has implications for how the CMA views competition in the future, as well as potential remedies.

(e) **How the CMA intends to assess the links between concentration and market outcomes (Theory of Harm 2).** Any finding of a link between concentration and outcomes can only be based on the facts and robust analysis of evidence drawn from the reference markets, and cannot be substituted by theory or academic literature unrelated to the facts and competitive conditions in the reference markets today. Without having seen any empirical working papers on this issue, LBG is uncertain what (if any) evidence the CMA has analysed and what conclusions it may seek to draw from such evidence. To date the CMA has suggested two mechanisms that can theoretically connect concentration with market outcomes. The first relies explicitly on the assumption that providers cannot discriminate between active and inactive customers. This assumption is clearly wrong – the evidence is to the contrary (e.g. switching offers, periods of free banking periods, negotiated prices). LBG would be surprised, therefore, if the CMA continued to advance this as a concern in Provisional Findings. The second "mechanism" appears not to be a mechanism at all. The CMA appears to be relying on a theoretical relationship between concentration and competitive outcomes. However, the evidence that has been presented so far demonstrates that no such relationship exists. LBG cannot see how an adverse provisional finding on this issue could be made or justified.

Implications for the CMA and the Provisional Findings

1.6 In LBG's opening letter of 11 November 2014 at the start of the investigation,[1] LBG set out what it considered to be the important issues to be addressed, and posed eight questions. LBG considers that the evidence presented to date has started to answer many of these questions, but some questions remain live issues.

1.7 LBG recognises that it has not seen all of the evidence available to the CMA and that the CMA will need to form its own views on the theories of harm. However, LBG finds it difficult to believe that any of the facts listed above will be overturned by new evidence, not least because the points listed above are currently evidenced in multiple ways.

1.8 LBG believes that the implications of these evidential facts and uncertainties are as follows:

(a) Whatever the CMA concludes on the three theories of harm will need to be consistent with the facts already established (or the CMA will need to present substantial new evidence to overturn those facts).

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[1] Letter to the CMA from António Horta Osório, CEO of LBG, 11 November 2014.

(b) It would help all parties if the CMA could explain what happens to market shares when assessed by value rather than volume. This is critical to the assessment of each theory of harm and, more generally, to the CMA's understanding of why competition is evolving as it is.

(c) The Runpath pricing analysis needs to properly capture the diversity of customer behaviour, and to explore the different pockets of value and potential switching gains for different customers, so that the CMA can move beyond using customer profiles and averages which are not representative of real outcomes. This will also enable the CMA to identify the specific customer groups and behaviours where improvements to customer engagement could make the biggest impacts.

(d) The CMA should explore whether any remaining concerns about barriers to expansion, in the most valuable areas of the markets, are primarily driven by low customer engagement.

1.9 Any remedies that the CMA may seek to implement to enhance customer engagement will need to be designed carefully, and will require trials. The trials should be targeted at specific customer groups where they are likely to have the most impact. For example, trials could usefully be targeted at the smaller end of the SME market, where LBG believes there is greater scope for customer engagement to be improved.

1.10 LBG is encouraged that the CMA has recently written to providers exploring their willingness to participate in trials. LBG will work with the CMA to trial potential remedies that would improve engagement and make it easier for customers to shop around and switch in both reference markets. LBG is already running a series of trials and has demonstrated to the CMA how better comparison tools could look. Based on LBG's experience of running trials with the FCA in other retail banking products, LBG hopes that the CMA will take up its suggestions on how to engage with customer groups as well as providers in the design and coordination of trials.

1.11 LBG would not want any trials to be compromised by the CMA's inquiry timetable. LBG genuinely wants to deliver lasting and enduring change to the reference markets to deliver even better customer outcomes. If more time is needed to deliver robust trials and remedies commanding wide support, LBG would support an extension to the inquiry timetable. LBG looks forward to engaging further with the CMA in the investigation, including the period in which additional evidence would be generated from the proposed trials and is made available for comment.

2. SECTOR CHARACTERISTICS

2.1 The retail banking sector in the UK has been transformed in recent years due to competition, innovation and regulatory intervention:

(a) Today a customer can receive a text alert that she has gone into her unplanned overdraft limit while on the bus to work, log in to the mobile app of her savings provider and transfer funds using Faster Payments from any provider to top up her account before she reaches the next stop. All providers offer grace periods so as long as she does this by the end of the day she won't be charged. Most providers also offer buffers, so she won't be charged for small overdrafts. She can then earn cashback rewards by using her contactless card when she visits a convenience store whilst walking to her workplace. She can shop around, earn a significant reward to change her account and choose from a range of accounts offering very attractive interest on credit balances. If she has found a better PCA for herself, she can apply online during her break and seven days later could have a new provider without any further hassle and a guarantee against missed payments.

(b) Similarly, a director of an SME can, on the train on his way to a meeting with his accountant, make online comparison of the banking rates which would be applicable under each of LBG's BCA tariff schemes[2] and look up an indicative cost of an LBG loan at a selected interest rate.[3] At the meeting with this accountant, he can, on his tablet, bring up details of this BCA balance and transaction history, while his accountant uses LBG's Finance Selector tool[4] to consider the details of alternative finance options on his laptop. They may also wish to consider alternative BCAs by visiting the Business Banking Insight website,[5] to glean other SMEs' views of alternative BCAs. The director can then pay his accountant's fees, swiftly and securely, on his way home via his mobile.

2.2 These examples may not be how all customers behave, as different customers have different needs, behaviours and attitudes in both SME banking and PCAs. However, most of this was impossible even five years ago (with most mobile banking innovations younger still) and more customers are becoming aware of these changes and taking advantage of them.

2.3 The competitive landscape today is characterised by strong competition from technology-enabled entrants and other disruptive new players which benefit from low barriers to entry, and which target particular customer groups and their differing needs. The established providers are also making significant investments in technology and new products in order to maintain their competitiveness.

2.4 The remainder of this section reviews the following key sector characteristics:

(a) the rapid growth of digital innovation and its impact on competition; and

(b) the diversity of customer needs, product types and provider strategies.

The rapid growth of digital innovation and its impact on competition

The significant rise in digital usage and innovation

2.5 Digital usage and innovation in the market is ever-increasing, driven by competition and technological/regulatory change. High customer service expectations are driven by their

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2 See the Lloyds Bank Tariff Calculator, for example.

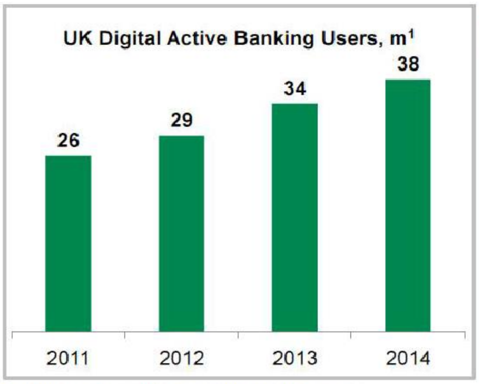
3 See the Lloyds Bank Loan Business loan calculator, for example.

4 See the Lloyds Bank Finance Selector tool, for example.

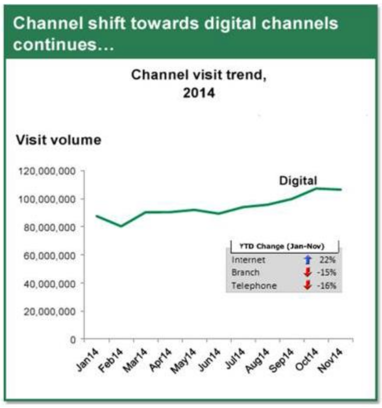
5 See www.businessbankinginsight.co.uk.

experience of other digital and retail providers and their apps and by extremely rapid advances in device capability, access speed and data volumes:

(a) **the number of digital banking users has been consistently increasing** over the last five years with the digital banking customer base in the UK reaching c.38 million in 2014. Fewer customers are using branches and telephone banking to service their current account;



1. Ebenchmarkers: 98% representative of UK market



(b) **UK internet banking use is projected to rise significantly** by the end of the decade from 53% of UK account holders in 2014 to 66% by 2020 – an increase of 7.5 million internet banking users,[6] affecting all age groups; and

(c) **demand for mobile banking is particularly high**: Digital growth is being increasingly driven by mobile banking, which has experienced particularly significant uptake since 2011:

(i) it originally took LBG four and a half years to achieve 1 million internet banking users from launch, whereas it only took three months to achieve 1 million mobile banking users;

(ii) since the launch of LBG's SME mobile app in launch in March 2014, LBG already has over 100,000 mobile banking business users;

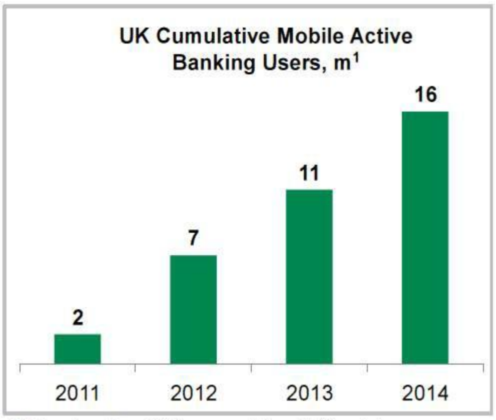
(iii) the CAGR growth in mobile banking adoption between 2012 and 2014 was 73%;

(iv) as at June 2014, 14.7 million banking apps had been downloaded and £1.7 billion was being transferred weekly via mobile;

(v) there was a 62% increase in mobile e-commerce between 2013 and 2014; and

6 *Future trends in UK banking: analysis and projections*, Centre for Economics and Business Research report for Fiserv, February 2015.

(vi) UK mobile banking is projected to rise from 17.8 million users in 2014 to 32.6 million in 2020.[7]



1. Ebenchmarkers: 98% representative of UK market

2.6 Digital banking and technological innovation is transforming expectations of banking services and fundamentally changing customer behaviour by allowing greater control and engagement. This has increased the dimensions and intensity of competition both amongst traditional providers, and between traditional providers and non-traditional providers:

(a) the *GfK NOP PCA banking survey report* indicates that two in three (66%) consumers use internet banking and most are frequent users (at least once a week).[8] 37% of consumers use mobile banking and a third of these users access mobile banking services every day. The *Phase 2 BDRC Survey* found that: (i) 95% of SMEs use internet banking and 41% use a mobile banking app on a tablet or mobile; and (ii) 37% of SMEs use internet banking at least once a day and 79% of SMEs use internet banking at least once a week or more;[9]

(b) studies have shown the link between greater digital use and positive outcomes for customers. For example, digitally active 18-to-35-year-old customers are approximately 5% less likely to go into an unplanned overdraft.[10] The FCA has identified that signing up to text alerts or mobile banking apps reduces the amount of unarranged overdraft charges incurred by 5% to 8%, and signing up to both services has an additional effect, resulting in a total reduction of 24%;[11]

(c) a key element of LBG's digital strategy is to use technology to deliver new and innovative money management and educational tools (as outlined in Figure 3.4 in Section 3 below). It is expected that 50-70% of simple customer needs (PCAs, overdrafts, credit cards, savings and loan products) will be met by LBG through the digital channel by 2017 (up from 40% in 2014); and

(d) digital and mobile technologies create opportunities to increase personal and SME engagement and switching still further. For example, as explained in more detail in Section 3 below, LBG has highlighted to the CMA potential improvements to the midata programme, and has worked with comparison specialists to develop

7 *Future trends in UK banking: analysis and projections*, Centre for Economics and Business Research report for Fiserv, February 2015.

8 *GfK NOP PCA banking survey report*, 21 May 2015, paragraphs 27 and 78.

9 *Phase 2 BDRC Survey*, Questions 12(b) and 12(c).

10 AlixPartners, *Mobile Financial Tracking Study*, March 2014.

11 FCA, Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour, 11 March 2015.

prototypes that demonstrate what a good service might look like. Ultimately, rolling out an improved midata programme will require the support of the whole industry and the CMA can help to support this and build more momentum around the project.[12]

Innovative new providers are disrupting the sector

2.7 The competitive landscape is fundamentally different in a digital world with strong competition from technology-enabled entrants and other disruptive new players that benefit from lower barriers to entry. New providers offer propositions and distribution networks focused on a range of customer segments. As acknowledged by the CMA, "*advances in technology that have led to an increased take-up of digital banking are enabling different banks to adopt … different strategies towards branches.*"[13] For example:

(a) **Atom and Starling (online and mobile banking propositions) will launch this year** amidst what is described by Atom's Chairman, who was also chairman of Metro (a branch based new entrant at launch), as a "seismic shift" to mobile banking. Atom's investors point to the fact that it is not been plagued by outdated IT infrastructure or legacy issues and has been "designed for digital";[14]

(b) **digital banking development has also facilitated the entry and expansion of new entrants**. These entrants serve customers over a relatively wide geographic area with a relatively limited branch network which has been augmented by digital capabilities. For example, Tesco has been enhancing its digital capability while choosing not to offer branch account opening/servicing, even though they have a nationwide network of stores;

(c) **the CMA recognises the potential benefits to new entrants of utilising innovative IT** (including off-the-shelf modular pay-per-use IT platforms designed for start-up providers) compared to the burden of legacy systems. In the Metro Bank case study, for example, the CMA states "*Metro seems to have overcome many of the scale advantages enjoyed by the large banks by deploying an integrated IT solution. It has taken the application on a hosted pay-per-use basis minimising the level of upfront IT investment needed and rendering IT as a variable cost. Since Metro has focused on growing organically, it has not been burdened by legacy IT systems, and its IT system appears to be a key competitive advantage;*"[15] and

(d) **entry by specialist payment technologies** from global companies such as PayPal, Apple and, soon, Samsung[16] and are expected to play a significant role in the near future. In this connection, according to a YouGov survey of more than 2,000 people, "*digital-payment services such as PayPal and WePay are more likely to disrupt the banking market than new lenders such as Metro Bank or Virgin Money ... Almost a quarter of respondents said that they would be "likely" to bank with an alternative digital-payment service instead of a large bank within two years … [while] only 13% said that they would consider moving to a new bank*".[17]

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12 LBG, *Response to the Updated Issues Statement*, 11 June 2015, para 3.5(a).

13 CMA, *Updated Issues Statement*, paragraph 128.

14 LBG, *Response to the PCA Market Questionnaire*, paragraph 5.2(b).

15 CMA, *Metro Bank case study* Working Paper, 21 May 2015, paragraph 57.

16 See BBC article, "Samsung Pay: What is it and how does it compare to Apple Pay?", 19 August 2015. Samsung Pay is currently available in South Korea. But it will expand to the US on 28 September 2015, and the firm has indicated that the UK, Spain and China will be next to get the facility sometime in the near-future.

17 FT article, "Paypal poses bigger threat to UK lenders than 'challenger' banks", 7 December 2014.

2.8 In summary, developments in digital banking and technological innovation have both materially changed customer behaviour: in particular, improving levels of customer engagement. Moreover, barriers to entry and expansion have been reduced, driven by technological change and customer adoption.

Diversity of customer needs, product types and provider strategies

2.9 As explained in LBG's response to the UIS, there is a wide diversity of customer needs and behaviours as well as providers and provider strategies in relation to both SME banking and PCAs. For example:

(a) **in relation to the diversity of PCA customers' needs and behaviours**. At the end of 2014 LBG had [Confidential] PCAs, of which [82%] were active and [50-60%] were main accounts.[18] Amongst all these PCAs, there is significant diversity in customer account usage in terms of, for example, the following:

(i) size and duration of credit and overdraft balances and overdraft usage. For example:

(A) LBG data shows that, over a period of six months in 2013, [around 70%] of Lloyds and Halifax PCA customers[19] had 'never' used an overdraft, [15-20%] 'always' used their overdraft, [7.5-12.5%] were 'occasional' overdraft users and [0-5%] were 'regular' overdraft users; and

(B) Figure 2.1 below illustrates the different balances of LBG PCA customers that switched to and from LBG PCA accounts in Q1 2015. It shows that 55% to 60% of switchers had balances of under £1000, between 30% and 35% of switchers had balances between £1000 and £5000, and 10% to 15% of switchers had balances of over £5000;

Figure 2.1: Balance Band for Switchers In/Out of LBG (Q1 2015)
[Confidential]

(ii) volume and type of transactions. Figure 2.2 below illustrates the variation between different LBG PCA accounts in terms of the number of transactions that are processed each month; and

Figure 2.2: Transactions per month, all LBG PCA accounts (H2 2014)

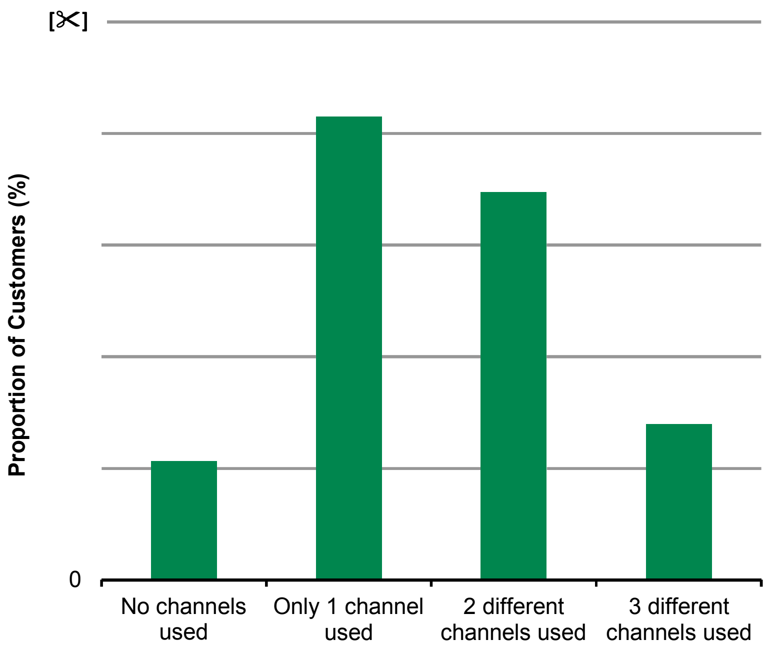
Number of transactions per month	**0**	**1-30**	**31-60**	**60+**
Share of accounts	**[20-30%]**	**[40-50%]**	**[20-30%]**	**[0-10%]**
Share of transactions	**0%**	**[20-30%]**	**[30-40%]**	**[30-40%]**

(iii) channel usage. Customers use different channels and in different combinations, as shown in Figure 2.3;

Figure 2.3: Proportion of LBG customers by different channels used, based on transactional data for Q4 2014

[18] See LBG, *Response to the PCA MQ Aggregate Data Request*, sheet A.1, variables A.3-A4. "Main account" based on CMA's definition of accounts with an average monthly incoming payment of more than £500.

[19] Excludes the following PCAs: Graduate, Students, Cash Accounts, U19s, Club & Societies.



Source: Based on LBG transaction data submitted to CMA Tranche 3.
Based on a sample of 23k customers. Transactions in Q4 2014

(b) **LBG's one million BCA customers' needs and behaviours are even more diverse.** The relevant BCA customers range from microbusinesses to medium-sized enterprises, with vastly different transactional banking, financing and more general financial services needs. By way of illustration:

(i) c. 10% of LBG's BCA customers have general business loans; [20-30%] have deposit accounts; [40-50%] of SME customers are registered to use Internet Banking; and c. 30% are clubs, charities and societies who need a strong basic offer to meet specific transactional needs with multi-channel accessibility; and

(ii) whereas the average credit balance per LBG BCA customer is c. [Confidential] in 2014,[20] [around two-thirds] of customers have a credit balance of less than one quarter of this the average, and [c. 5%] have more than [Confidential]; and

(c) **in relation to the diversity of provider strategies**, new entrants have adopted a range of business models and strategies, in many cases explicitly choosing to avoid the costs incurred by "traditional" providers which seek to offer a universal multi-channel service. These strategies include:[21]

(i) targeting more valuable customers, whether on a demographic or geographic basis (e.g. Santander, Tesco, Metro, Atom);

(ii) offering a simpler product range to increase speed to market and allow flexibility to adapt to regulatory change and customer preferences (e.g. the Post Office);

(iii) focusing on online and mobile channels rather than incurring the costs associated with branch or telephony-based service and using the Post Office

[20] This excludes accounts in debit or with no credit balances (such as dormant accounts).

[21] As outlined in LBG, *Response to working papers on "Barriers to entry and expansion: capital requirements, IT and*

payment systems'' and "Summary of entry and expansion in retail banking", 28 July 2015, paragraph 2.3.

network to provide services such as paying in cheques (e.g. Atom and Starling);

(iv) linking financial services products to their wider brands and retail reward schemes (e.g. Tesco and Marks and Spencer Bank); and

(v) differentiating their service proposition, for example by seeking to offer more personalised service or access to branches (e.g. TSB, Post Office).

2.10 LBG has emphasised the concentration of income, and the complex distribution of customer account usage across multiple dimensions. For example, the size and duration of credit balances, size and duration of overdraft balances, volume and type of transactions (e.g. debit card and direct debit), and volume of foreign debit card usage. This distribution is not normal and much of the income derived by providers comes from customer usage in the tails of the distribution. (See paragraph 3.28 *et seq*. by way of illustration).

2.11 This has important implications for assessing competition, pricing and profitability that have not been understood or explored properly in previous inquiries into these markets. There is also significant diversity in customers' credit history, channel usage, attitudes to technology, risk aversion and life stage, amongst other dimensions. This means that it is generally misleading to look at averages, representative profiles or volume metrics across all customer segments. LBG would suggest that each Theory of Harm should be considered and tested across customer segments and actual patterns of customers' account usage in all relevant dimensions that drive providers' income and costs. For example:

Figure 2.4: Key questions relating to value and customer segments

For Theory of Harm 1	For Theory of Harm 2	For Theory of Harm 3
• Is engagement (accessing, assessing and acting) an issue for all customer segments? • What are the key parameters of competition for each customer segment? • How can customer engagement be most effectively and efficiently increased for each customer segment? • How do potential gains from switching vary across customer segments and patterns of use? • To what extent do customers gain from switching compared to choosing better suited products or negotiating?	• How does concentration vary by market segment? • How does concentration vary by value (rather than volume) market shares? • Does customer satisfaction differ by income and channel usage, and how does this relate to market share in that segment? • How do existing customers react to new products and service improvements from their providers that are launched to attract new customers and respond to competition? • How much does this lead to the benefits of competition (new products, pricing changes and/or service improvements) spreading beyond those customers that actively switch provider?	• Do entrants want to achieve national scale and reach or are they focussed on the most profitable segments of the market? • To what extent are there barriers to entry and expansion in each market segment? • Are products outside the markets defined by the CMA closer substitutes to PCAs, BCAs and SME loans in certain customer segments than others?

2.12 In the case of market shares, volume metrics (such as footfall or number of customers) are rarely used in retail markets. This is because the mix of customers and usage will be the primary driver of value. The metric used for market shares is therefore usually how much customers spend with different retailers. In banking, value metrics are not readily available, which is why they are not generally used, but the CMA is uniquely placed to correct this and look at value shares using the data it has collected.

2.13 LBG does not believe this has ever been done in any of the banking inquiries. In meetings the CMA have suggested that using value rather than volume shares is either empirically difficult and/or does not make a significant difference to the market shares calculated on a volume basis. Although LBG does not have the data that the CMA now holds, value shares remain important and, based on LBG's knowledge and understanding of its own volume versus value distributions, this remains an important area for the CMA to explore. LBG has set out how the CMA can tackle the first problem and make simple adjustments to the data it holds to calculate value shares. Figure 2.5 below sets out an illustrative example to show why LBG thinks the CMA should do this.

2.14 This example shows that when looking at value, conclusions about levels of concentration, rates of expansion and the market share of entrants and smaller providers may be very different. LBG has provided the CMA with evidence about the distribution of income and revenue amongst its customers. This shows that income and revenue are highly concentrated in relatively small numbers of customers. Given current account pricing and revenue drivers, LBG believes that this concentration would be a market wide feature i.e. across all 69 million active current accounts income and revenue will be highly concentrated in a relatively small number of accounts. LBG has also provided evidence that typically, customers who sit within the segment where most of the revenue/income is made typically have higher incomes, balances, use overdrafts and transact more frequently. Many providers apply eligibility requirements that are designed to attract these high income customers.

2.15 The following is illustrative but demonstrates the potential importance of this effect (the CMA could perform this analysis using real data subject to appropriate normalisations as set out in LBG's letter). First Direct and Santander 123 are two products that target the highest income customers. Assuming that these products have successfully attracted customers from the top 20% of the income/revenue distribution, market shares by value could be as high as 5% and 20% compared with volume based market shares of 1.5% and 6%. This would have significant implications for concentration, barriers to entry and expansion and whether new entrants want or need to achieve national scale or reach to have a significant impact on competition, customer outcomes and existing providers revenue and pricing.

Figure 2.5: Illustration of value vs volume shares for First Direct and Santander 123

Total market			Source/Calculation
Total PCA revenues	£8.1bn	A	2013 OFT Phase 1 , Annex A, para 3.
Total number of active accounts	69.0m	B	2014 CMA UIS, Annex 1, Table 1.

Top 20%			
Proportion of value generated by top 20% of accounts	[60-70%]	C	Estimate based on LBG data
Value generated by top 20% of accounts	c.£5.5bn	D	C x A
Total number of active accounts in top 20%	13.8m	E	20% of B

First Direct			

Market share of First Direct by volume	**1.5%**	F	GfK FRS
Number of First Direct accounts	1.0m	G	F x B
Value generated by First Direct assuming in top 20%	c. £0.5bn	H	G/E x D
Market share of First Direct by value	**5%**	I	H/A

Santander 123			
Number of 123 World customers	4.1m	J	Santander 2015 H1 Results Presentation
Market share of 123 by volume	**6%**	K	J/B
Value generated by Santander 123 assuming in top 20%	[c. £1.5bn]	L	J/E x D
Market share of 123 by value	**20%**	M	L/A

2.16 The following sections examine each of the CMA's Theories of Harm in turn.

3. THEORY OF HARM 1 – IMPEDIMENTS TO CUSTOMERS' ABILITY TO SHOP AROUND

3.1 LBG's first question in its Initial Letter of 11 November 2014[22] asked how customer engagement and the ability to switch could be enhanced quickly and sustainably. LBG asked the question in this way because it is clear, in light of a number of investigations of these markets, that customer engagement can be enhanced. This is of critical importance to this market investigation because, as LBG has previously explained, if any concerns relating to customer engagement can be resolved, then any residual issues in respect of customer outcomes relating to Theory of Harm 2 and Theory of Harm 3 fall away, as explained below.

3.2 The CMA now has an extensive bank of information[23] on the reference markets, competing products, how providers service their customers, and customers' views. Reviewing this information as a whole, LBG considers that the key considerations in relation to the CMA's Theory of Harm 1 are as follows:

(a) **customer engagement is increasing**, with the majority of customers satisfied with the services they receive from PCA and SME banking providers. Paragraph 3.4 below sets out some key facts that illustrate this trend;

(b) **satisfaction is high**, and in combination with low prices and constantly evolving service and products is a powerful explanation for low consideration and low levels of switching;

(c) **prices are relatively low**, in particular compared with other household purchases, and more providers are offering attractive credit interest rates, cashback and other rewards;

(d) **products are continually improving.** LBG continually needs to improve and develop its products to retain existing customers, to acquire new customers, and to achieve its overarching objective of being the "Best Bank" for customers;

(e) **engagement can be further enhanced.** Despite increased levels of customer engagement and satisfaction, consistent with LBG's previous submissions,[24] the CMA's work to date suggests that customer engagement could be further enhanced, in particular in relation to smaller SMEs. LBG believes that the combination of current market developments and properly trialled and tested initiatives aimed at increasing customer engagement will continue to deliver world leading transparency and ease of switching to the sector. This is why LBG has engaged with the CMA to offer suggestions as to how engagement can be further enhanced by:

(i) identifying a number of market developments that are already in train;

(ii) sharing with the CMA details of the numerous initiatives LBG is currently trialing in order to enhance customer engagement; and

(iii) sharing with the CMA best practice for rolling out such trials across the sector to ensure a comprehensive view of all segments and customers.

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22 Letter to the CMA from António Horta Osório, CEO of LBG, 11 November 2014.

23 This comprises information from Phase I, Market Questionnaire Responses, numerous other information requests and the CMA's own Working Papers and parties' responses to those working papers, for example.

24 See letter to the CMA from António Horta Osório, LBG CEO, 11 November 2014 and LBG's responses to the Issues Statement and Updated Issues Statement.

In this connection, LBG very much welcomes the CMA's announcement of 28 August[25] that it is considering the testing of potential remedies and welcomes the opportunity to contribute to this process; and

(f) **the CMA should be cautious in interpreting current evidence** about the extent of any impediments to customers' ability to shop around. LBG has a number of methodological observations in this regard.

3.3 Each of the above key considerations considered in turn below.

Customer engagement is already increasing

3.4 The evidence shows that levels of customer engagement are steadily improving:

(a) **switching has increased:** In the past 12 months, there have been 1.1 million switches through CASS. This represents a 4% increase compared to the same period one year earlier. The total number of switches now stands at over 2 million since CASS was launched in September 2013.[26] These CASS figures underestimate overall rates of switching between providers, which include manual and gradual switching. In relation to SME banking in particular, BCA switching rates have increased to 4%, compared to 3% at the point of previous enquiries;

(b) **internal switching rates have increased:**

(i) since the launch of Club Lloyds PCA, over [0.5-1 million] Lloyds customers have actively switched to this account internally[27] and now get rewards, attractive credit interest rates and a £100 interest and fee-free overdraft; and

(ii) in relation to SME banking, LBG has also seen a material shift to its BCA Monthly Price Plan: as at June 2015, c. [Confidential] customers have taken up a Monthly Price since its launch in July 2011;

(c) **multi-banking has increased:**

(i) the average number of brand relationships across all personal banking products is 2.26, with 56% of customers holding more than one relationship (including PCAs, savings, mortgages, loans, credit cards and investments);

(ii) regarding PCAs, there has been an increase in the proportion of customers that have more than one PCA relationship from 14% to 21% over the past ten years;[28] and

(iii) the proportion of SME customers that multi-bank has [Confidential];[29]

(d) **the use of digital banking has also materially increased** for both PCA and SME banking customers, as outlined in paragraphs 2.1 *et seq.* above; and

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25 CMA, *Investigation update*, 28 August 2015.

26 *Current Account Switch Service Dashboard Issue 7: 1 April 2015 – 30 June 2015*.

27 LBG, *Response to the PCA Market Questionnaire*, 23 January 2015, question 39.

28 LBG, *Response to the PCA Market Questionnaire*, 23 January 2015, question 35, citing *GfK NOP Financial Research Survey (FRS)*.

29 [Confidential]

(e) **churn been consistently high:**

(i) the number of new SME start-ups has varied between 450,000 and 550,000 over the last seven years. These represent a large proportion of SME BCA sector, all of which are making active decisions about their choice of BCA provider over and above those who switch; and

(ii) with regard to PCAs, churn is equally important: LBG needs to open at least 1.7 million accounts every year to continue to maintain its market position and to cover its common costs.

Customer satisfaction is high

3.5 Customer satisfaction in the reference markets is high and explains the low observed switching rates in the reference markets.

3.6 High customer satisfaction in relation to the PCA sector is illustrated by the following:

(a) the CMA-commissioned *GfK NOP PCA banking survey report* provides that the overwhelming majority of customers report that they are satisfied with their PCA provider. 91% of all respondents mentioned that they were either "fairly satisfied" or "very satisfied" (only c.4% rating their experience as dissatisfied);[30]

Figure 3.1: Satisfaction with main PCA supplier - overall (2014)

Source: *GfK NOP PCA banking survey report*, page 32.

(b) in a British Bankers' Association/YouGov survey in June 2014, only 14% of PCA respondents had a negative view of their provider and 60% said they did not want to switch providers because they were happy with their bank account. The British Bankers' Association suggests that this helps to explain why the increase in switching due to CASS (14%) is not higher; and

(c) LBG's NPS improved from 55 to 59 between 2013-2014.

3.7 High customer satisfaction in relation to SME banking sector is illustrated by the following:

(a) [Confidential]

(b) [Confidential][32 33]

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30 *GfK NOP PCA banking survey report*, 21 May 2015, page 32.

31 [Confidential]

(c) for each of 2012, 2013 and 2014, the most common reason for not switching reported by SMEs eligible to use CASS was a good relationship with their existing provider (74% in 2012, 75% in 2013, 76% in 2014).[34]

3.8 High satisfaction in combination with low prices and constantly evolving service and products is a powerful explanation of behavioural outcomes in the reference markets. It is a likely explanation for low consideration and resulting levels of switching, given the small potential gains from doing so, given other priorities for households and small business budgets. For example, the *GfK NOP PCA banking survey report* states that:

> "[t]*his high level of satisfaction is a major reason for not switching – nearly two-thirds of those who had not looked around or switched in the last 3 years gave satisfaction with their current provider as the reason*".[35]

3.9 The CMA should consider this factor as a potential driver of any evidence on engagement.

3.10 In this connection, LBG sets out below some illustrative examples of the low prices and evolving propositions in the reference markets.

Prices are low

3.11 For many customers, the cost of products is low, both in absolute terms, and as a proportion of total household and SME budgets:

(a) customers with free-if-in-credit ("**FIIC**") PCAs (including student and youth accounts) or BBAs do not pay a monthly fee or transaction fees - providers primarily earn revenues on these accounts through net credit interest, overdraft charges (in the case of non-BBA FIIC accounts) and interchange fees. This is changing as more customers choose products with a monthly fee, such as Santander 123, Club Lloyds and Tesco Bank;

(b) [55-65]% of PCA customers included in the LBG transaction data submitted to the CMA generate pre-impairment income of less than £5 per month (excluding the value/cost of funds);

(c) [55-65]% of LBG's BCA customers generate pre-impairment income of less than £10 per month (excluding the value/cost of funds); and

(d) numerous providers offer SMEs an introductory free-banking period. LBG offers free day-to-day business banking for 18 months for start-ups and 6 months for switchers. Approximately [Confidential] of LBG's BCA customers (c. [40-50]%) benefit from some form of free banking.[36]

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32 [Confidential]

33 [Confidential]

34 The Payments Council, "The Current Account Switch Service – One Year On", September 2014.

35 *GfK NOP PCA banking survey report*, 21 May 2015, paragraph 18, page 2.

36 As at January 2015. See LBG's response to Question 22 of the *SME Market Questionnaire*, 23 January 2015.

Products are continually improving

3.12 As explained in LBG's responses to the CMA's Market Questionnaires, LBG competes with a wide range of PCA and SME banking providers and providers of substitute products. It continually needs to improve its products to retain existing customers, to acquire new customers, and to achieve its overarching objective of being the "Best Bank" for customers. The nature of the reference markets requires all providers to act in a competitive fashion. Examples of recent product enhancements, innovations and initiatives were provided to the CMA in LBG's responses to the CMA Market Questionnaires,[37] illustrative examples of which are set out below in Figure 3.3, with further detail provided at Annex 1. This is in addition to the digital innovations outlined in Section 2 above and the engagement-enhancing initiatives outlined in Figure 3.4 below.

Figure 3.3: Illustrative LBG PCA and SME banking product innovations, with further detail provided at Annex 1.

PCA	SME
• **Halifax Reward:** £5 monthly reward to certain customers. • **Cashback Extras/Everyday Offers:** Cash back reward initiative. • **Club Lloyds:** A new current account proposition with tiered credit interest, a fee and interest free overdraft, rewards and exclusive access to improved offers. • **It's on us:** A number of customers are selected at random to have one of their debit or credit card transactions reimbursed in full, up to the value of £500. • **Initiatives to help meet the needs of the social banking segment.** • **Making international payment simpler.** • **Improving travel money exchange rates.**	• **Monthly price plan:** SME customers can choose from a range of fixed monthly fees. • **Fee free switching for BCAs:** Six months of free banking and waiving lending arrangement and security fees. • **Free banking offer for BCAs:** Free day-to-day business banking for 18 months for start-ups and 6 months for switchers. • **Participation in the Funding for Lending Scheme** • **Waived arrangement fee offers:** For new and existing business customers signing up for new term loans. • **Loan discounts.** • **Simplified lending fixed rate loan product.** • **Cobweb:** An information resource to help business owners develop their own business.

Engagement can be further enhanced

3.13 Despite improved levels of customer engagement and satisfaction, consistent with LBG's previous submissions,[38] the CMA's work to date suggests that customer engagement could be further enhanced, in particular in relation to smaller SMEs. This is why LBG has shared with the CMA the engagement-enhancing initiatives it has already developed, and has offered suggestions as to how engagement can be further enhanced by supporting existing market developments and a better understanding of customer behaviour through trialling. As the FCA has shown, enforcing information remedies such as annual statements is only useful when they have been preceded by trials to demonstrate efficacy.

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37 See, in particular, LBG's response to Question 16 of the *PCA Market Questionnaire* and Question 22 of the *SME Market Questionnaire*.

38 See Letter to the CMA from António Horta Osório, CEO of LBG, 11 November 2014, as well as LBG's *Response to the Issues Statement* and *Response to the Updated Issues Statement*.

LBG existing initiatives aimed at enhancing engagement

3.14 LBG continually seeks to improve its PCA and SME propositions and introduce product enhancements on a regular basis.[39] Many of these propositions are aimed at increasing customer engagement by providing money management tools, increasing transparency, and promoting switching. These initiatives have been detailed in a number of LBG's previous submissions.[40] However, for ease of reference LBG lists below some of its key initiatives, with further detail provided at Annex 2.

Figure 3.4: Illustrative LBG initiatives aimed at enhancing engagement, with further detail provided at Annex 2

PCA	SME BANKING
MONEY MANAGEMENT TOOLS	
• **Mobile banking Push Alerts** • **Free Mobile App:** Enables customers to review their transactions to avoid going into unplanned overdraft • **Balance Extra:** Gives customers an early warning if upcoming payments are going to push them into overdraft. Whilst LBG believes that Atom and Starling may be developing similar services, LBG was the first to introduce this to the PCA UK market on 2 September 2015, and already has 4,000 users. LBG expects this figure to grow significantly in the near future, as c.550,000 Halifax customers are currently eligible.	• **[Confidential]** • **Improvements to the mobile app**. • **Quicker and simpler payments process** • **Improvement to digital functionality** allowing [Confidential] • **Business ToolBox** providing start-ups access to a range of tools to help start, manage and grow their businesses.
TRANSPARENCY INITIATIVES	

• **Halifax credit checker:** Provides customers online access to their credit report and score and advice on how to improve that score.
• **Enhanced overdraft transparency and customer information:** Includes:
  ○ an online overdraft calculator for Halifax customers;
  ○ highlighting other suitable forms of borrowing in annual statements; and
  ○ piloting communications to customers who are at risk of incurring unplanned fees to inform them if they may be eligible for a larger planned overdraft limit.
	• **[Confidential].**
	• **[Confidential]**
	• **Online Monthly PricePlan Calculator:** Identifies the most suitable tariff for a given customer's needs.
	• **The Tariff Calculator:** Provides detailed comparison of the LBG banking rates.
	• **The Loan Calculator:** Generates an indicative cost of a loan at a selected interest rate based on its amount and term.
	• **The Finance Selector:** Identifies products likely to match customers' specific financing needs

MEASURES WHICH PROMOTE SWITCHING	
• **Halifax:** LBG continually seeks to refine the switching proposition for Halifax. • **No exit fees on PCAs.** • **Further promotion of CASS**. • **Improvements to the application journey:** Includes enabling customers to open a joint account online. • **Photo eID&V:** Includes a project to allow customers to submit identification and verification documents online or via a smartphone. • **AVA journeys:** Allowing customers to up- or down-grade to the PCA of their choice.	• **An enhanced switching lending proposition** • **Fee-free lending for switchers** (for six months). • **No exit fees on BCAs and general purpose loans.** • **Streamlined lending application and affordability assessment** for new lending application up to £25,000. • **Further promotion of CASS** (through all RBB channels and aggregator websites).

39 For further details see LBG's response to Question 4(b) of the *PCA Market Questionnaire* and Question 5(b) of the *SME Market Questionnaire*, 23 January 2015.

40 For further details see the LBG's response to Question 4(b) of the *PCA Market Questionnaire* and 5(b) of the *SME Market Questionnaire*, 23 January 2015.

Additional market initiatives

3.15 As set out in LBG's response to the UIS,[41] there are a number of existing market initiatives which are aimed at increasing customer engagement some of which the CMA could progress and/or consult on with the FCA and other stakeholders:

(a) **midata 2 (PCAs and BCAs):** Whereas the Government's midata programme has the potential to facilitate powerful, easy to use comparison tools, its current implementation is very poor, its functionality is limited, and is only available for PCA customers. However, as demonstrated by LBG to the CMA,[42] LBG (together with Runpath) has developed an enhanced "midata 2" programme which allows comparison websites, for the first time, to offer meaningful comparison services for BCA customers, in addition to PCA customers. midata 2 will also be usable on any device – desktop, tablet, and smart-phone. Morevoer, it allows PCA and BCA customers to compare the costs and benefits of different accounts and the quality and range of services offered - a significant improvement on the current system. LBG considers that midata 2 can play a material role in enhancing both PCA and BCA customer engagement. However, rolling out midata 2 will require the support of the whole industry and the CMA could have a key role in facilitating this. In addition, it should be recognised that midata 2 will not benefit those without digital access. Alternative channels need to be investigated for this dwindling customer segment;

(b) **enhancing campaign to raise awareness of CASS (PCAs and BCAs):** LBG has consistently advocated the potential effectiveness of CASS in promoting shopping around and switching,[43] and believes that CASS continues to head in the right direction in increasing engagement. Nevertheless, LBG considers that more time is required to evaluate the full impact of CASS, particularly in relation to qualifying BCAs. In this regard, the CMA should also consider the potential impact of an increased and sustained campaign to raise customer awareness of CASS, particularly amongst smaller businesses. In this connection, CASS undertook a renewed marketing campaign in relation to qualifying BCAs and, more recently, providers are in the process of launching a multi-million pound new advertising campaign to promote CASS more widely (the campaign is expected to include adverts dedicated to the switching scheme itself, as well as greater promotion of CASS in providers' own current account adverts). The CMA should examine the evidence of the impact of CASS on different customer segments, in particular for SME customers, following these recent campaigns. LBG is discussing with the FCA how future campaigns can be enhanced and LBG is happy to share these thoughts with the CMA;

(c) **SME Prize Fund:** LBG has consistently called for further innovation in price comparison websites so that small businesses, in particular, can more easily compare competing current account offers from different providers. In this connection, LBG has been engaging with the banking industry and innovation charity NESTA to establish a prize fund to incentivise innovation by comparison websites to achieve a step change in the number of businesses that switch their provider. The Prize Fund is currently in its design phase [Confidential]. The CMA was provided with an update in relation to the prize fund on 30 July 2015. Extensive stakeholder engagement is currently underway including with new specialist and smaller providers, financial technology companies and business groups. The SME Prize Fund is expected to launch at the end of 2015;

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41 LBG, *Response to the UIS*, 11 June 2015, paragraph 3.5.

42 LBG provided two midata 2 iPad demonstrations to the CMA: on 15 July 2015 (demonstrating the PCA midata 2 initiative); and on 23 July 2015 (demonstrating the PCA and SME midata 2 initiatives).

43 See, for example, LBG, *Response to the CMA's Provisional Decision*, 17 September 2014.

(d) **increasing awareness of alternative finance (SME loans):** The UIS states that the awareness and interest in alternative finance amongst SMEs is currently low.[44] Alternative finance goes beyond recent innovations, such as peer-to-peer lending and invoice financing, and includes hire purchase and leasing (which have an aggregate value broadly equivalent to that of term loans). As set out in paragraph 6.6 below, LBG considers such products to be substitutes for SME loans. In this regard, LBG has already suggested that the CMA should investigate how to raise awareness, and the relationship between awareness and active interest, in relation to alternative finance. This might include:

(i) talking to organisations that specialise in trying to provide such information to SMEs, to understand the challenges they face and how they think improvements can be made;[45] and

(ii) considering supporting BIS' and HMT's proposals to introduce a website portal which provides details and or links to alternative finance providers and products. This may ultimately be a website to which SMEs that have been declined for finance are to be referred, with the potential to form a destination in itself for businesses seeking finance and which are looking to understand the range of options available;

(e) **improving the account opening process:** The UIS states that the account opening process can be lengthy and onerous because of anti-money laundering regulations, in particular for SMEs.[46] In this connection, before considering whether the current regulatory framework should be changed, the CMA should consider two key factors:

(i) steps are already being taken to improve the account opening process. For LBG's part, it regularly reviews and assesses the sales process and functionality across all channels to ensure that they are as efficient as possible whilst ensuring fair and transparent outcomes for customers. This includes regularly soliciting feedback from online customers regarding their experience of LBG's application processes. In this connection LBG has invested heavily over the past three years to improve the PCA and BCA application process in all channels to improve the customer experience; and

(ii) as previously suggested by LBG,[47] in particular in relation to BCAs, the CMA could undertake specific behavioural research into the relationship between account switching and perceptions of different account opening processes. Again, this is an area where the FCA may be able to support the CMA;

(f) **Business Data Initiative:** LBG is also aware of an Experian, KPMG and Santander-led proposal to enable SMEs to upload their business data into a databank which would then be accessible by SME banking services providers as a secure and low cost means solution for the exchange of SME-related information in order to assist with KYC and other customer checks. The initiative is still is at proposal stage and is not yet in the public domain; and

(g) **regulatory initiatives:** In addition to CASS, there are a number of other key regulatory initiatives already in train which are aimed at lowering barriers to entry and expansion and/or promote customer engagement. LBG submits that the CMA

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44 CMA, UIS, paragraph 44.

45 Good examples of such organisations are Bizfitech and the National Association of Commercial Finance Brokers, which operates a specialist platform to help SMEs with such issues (www.businessfinancecompared.com).

46 CMA, UIS, paragraph 85(a).

47 See, for example, LBG, *Response to the UIS*, 11 June 2015, paragraph 3.5(e).

should assess the cumulative impact on customer engagement of all of these developments. These include:

(i) in relation to retail banking generally: changes to the authorisation process for new entrants; changes to capital requirements; establishment of the PSR; introduction of a new Payments UK Code of Conduct; and the increasing impact of technology and innovation;[48]

(ii) in relation to PCAs: enhancements to BBAs and midata 2; and

(iii) in relation to SME banking: improvements to the sharing of credit information; legislation to match SMEs who have been turned down with alternative credit providers; agreement between major providers to process most claims for a "deed of priority" or "waiver" within seven working days; agreements between major providers to provide standardised documentation; Government schemes such as Funding for Lending to mitigate the effect of the financial crisis on SMEs; and the recent review of the Lending Code.[49]

Trials - developing practical methods to improve engagement

3.16 Different customer segments are likely to require different approaches to increase engagement. As set out in further detail in paragraph 3.36 *et seq.* below, LBG considers that in order to achieve effective and proportionate results it is essential that initiatives aimed at enhancing customer engagement should be trialled first.

3.17 As the CMA is aware, LBG is trialling a number of initiatives for both SME banking and PCAs to test whether customer engagement can be enhanced quickly. LBG met with the CMA to explain the details of these trails earlier this year,[50] and has offered the CMA the opportunity to discuss how these trials are currently progressing. LBG hopes that the final results of these trials will be ready in November 2015, at which point LBG will report back to the CMA. The CMA should then be in a position to set out designs for its own trials or, at the very least, consider how LBG's trials can be rolled out in the market more widely. An outline of these trials is set out below:

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48 Including significant increases in the usage and functionality of digital banking, and the disruptive emergence of alternative payments providers such as PayPal, Amazon, Apple and Google and online only providers.

49 The aim of this review is to seek and consider views on what changes might be appropriate to ensure the Code continues to add value for subscribing firms and their customers. See http://www.lendingstandardsboard.org.uk/docs/LSBPRESSRELEASECODEREVIEWERAPPOINTEDFINAL.pdf for further details.

50 LBG presented details of its trials at meetings with the CMA on 30 March 2015 and 22 April 2015.

Figure 3.5: LBG trials

LBG TRIAL	HYPOTHESIS	TARGET CUSTOMERS
1. Availability of a planned Limit	Providing customers that go overdrawn unplanned with timely information around available planned limits will lead to a reduction in unplanned fees going forward and customers being better off in the long term.	PCA
2. Auto opt in low balance text alerts	Automatically opting customers into 'near limit' alerts will reduce accidental use of unplanned overdrafts and therefore reduce overall fees.	PCA
3. Auto opt in low balance text alerts	Customers who receive enhanced information on their overdraft usage (near limit alerts) incur less excess fees/spend less time in an excess position.	RBB/SME
4. Annual Summary Statements	Customers who receive a transparent summary of key areas of Current Account cost and value, act on the information and switch products/change behaviour internally or switch out externally. To test if variations in design of an annual statement can affect the level of engagement.	RBB/SME
5. Annual Summary Statements	Customers who receive a transparent summary of key areas of Current Account cost and value, act on the information and switch products/change behaviour internally or switch out externally. To test if variations in design of an annual statement can affect the level of engagement.	PCA
6. Complaint letter Insert	An insert outlining simplicity of switching may lead to some PCA customers to act on the information by contacting the third party advice service detailed in the insert or switching to another provider.	PCA
7. OD Eligibility checker	A simple pre-application overdraft eligibility tool. Some overdraft customers who would not normally apply will have the confidence to do so. Also those customers likely to fail the eligibility requirements can take alternative action and protect their credit history.	PCA

Methodological observations

3.18 As outlined above, LBG agrees that customer engagement can be enhanced and that there are steps that can be taken to make it easier for customers to understand and manage their account usage and charges, to compare providers, and to switch. However, the CMA should be cautious in interpreting evidence about the extent of any impediments to customers' ability to shop around.

3.19 There are six relevant considerations that should be reflected in the interpretation of analysis of Theory of Harm 1:

(a) absence of a benchmark of customer behaviour in a well-functioning market;

(b) role of high satisfaction and low price in driving behaviour;

(c) difference between value and volume metrics;

(d) lack of robustness of traditional survey metrics;

(e) interpretation of market-wide gains from switching as a metric; and

(f) importance of trialling.

Absence of a benchmark of behaviour in a well-functioning market

3.20 The CMA stated in its Statement of Issues that it will assess the effectiveness of competition against the benchmark of a "well-functioning" market.[51] LBG agrees that this is the right approach, and that it is important that this benchmark is realistic and feasible, and not based on an idealised market, which the CMA recognises.

3.21 This is important when interpreting evidence of engagement and the extent to which customers consider the gains from switching and searching, their ability to estimate these gains, and their perception of the costs and benefits of switching. The CMA should judge such evidence on the basis of a realistic benchmark, which is a feasible description of how engaged customers behave in a market. To identify a realistic counterfactual, LBG believes that market features need to be identified as either intrinsic or variable.

3.22 Variable features are those that can be influenced by firms (either unilaterally or multilaterally), or by regulators. For example, a variable feature may be the availability of information on tariffs, or the length of time it takes to switch provider. In a realistic counterfactual, variable features may be absent or different and can, in principle, be changed.[52] The intrinsic features will remain and it is not feasible to consider them to be absent or changed. (Potential intrinsic features in the reference markets may include low levels of usage and small gains from switching for many customers, the (in)ability of customers to recall spending patterns over a long period, a preference amongst some customers to purchase a selection of services from a single provider and the diversity of customer behaviour across those services.)

3.23 Evidence on whether features are intrinsic or variable could come from a variety of sources including behavioural research and differences between new and established competitors. Such evidence would identify whether the same features arise in all circumstances, which may suggest they are intrinsic, or whether the features vary in different circumstances. For example, if customer awareness and recall of product usage is low, whether this is an intrinsic or a variable feature of the market could be explored by analysing the following questions:

(a) How accurate is customer recall of spend or usage in other product markets with variable spend, such as stationary supplies, grocery shopping or mobile apps?

(b) Do customers of market entrants have better recall than customers of existing providers?

(c) Are there tools that could be used to give customers the relevant information better than recall and could they made easily available?

3.24 Based on such evidence, a realistic counterfactual can then be articulated and used to analyse the hypotheses for investigation. Without a benchmark it is not possible to conclude that customer behaviour or understanding is higher or lower than should be expected in a well-functioning market. The CMA should therefore be cautious in interpreting its evidence without such a benchmark.

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[51] CMA, *Statement of Issues*, paragraph 20.

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

Relevance of high satisfaction and low prices

3.25 For many customers, the cost/price of products is low. For example:

(a) in relation to PCAs, around [55-65%] of PCA customers included in the LBG transaction data submitted to the CMA generate pre-impairment income of less than £5 per month (excluding the value/cost of funds); and

(b) in relation to BCAs, around [55-65%] of BCA customers generate pre-impairment income of less than £10 per month (excluding the value/cost of funds).

3.26 In addition, as outlined above, the CMA also found that customer satisfaction in the reference markets is high.

3.27 In this connection, as outlined in paragraph 3.5 *et seq*. above, the combination of high satisfaction, together with continuous product enhancements and low prices is a powerful explanation of behavioural outcomes in the reference markets. The implication of these explanations is not that no action is required to enhance engagement. Rather, the focus of such action should be on ensuring that there are no impediments to the awareness of alternative product and service offerings and no impediments to engagement for those customers who prefer such an alternative. This focus should be targeted at those customers with the most to gain from switching because of, for example:

(a) their usage relative to their income and wealth; or

(b) the size of the gain relative to their income (i.e. a relatively small gain from switching may, nonetheless, be significant for certain low income customers).

Need to consider value and not volume in understanding engagement

3.28 The distribution of account usage is non-normal and highly skewed. A significant proportion of providers' income will be generated in the tails of the distribution, for example, on high credit balances or high overdraft usage from credit-worthy customers. In this connection:

(a) the highest 20% contributing[53] PCA customers provide around [60-70%] of the total PCA income; and

(b) the highest 20% contributing BCA customers provide around [80-90%] of the total BCA income.

3.29 It is important that the CMA attempts to understand customer behaviour from a value perspective, and not only by looking at volume metrics. Such volume metrics may be misleading as the behaviour of both customers and providers can be driven to a large extent by value. For example:

(a) **customer switching measured by value may be more significant than when measured by volume.** For example:

(i) as illustrated in the charts in Figure 3.6 below, in 2014 LBG lost c.32,000 net customers to [Provider A],[54] which was about the same as LBG gained from [Provider B]. However:

(A) the value of net balances lost to [Provider A] was around seven times greater than the value gained from [Provider B]; and

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53 In terms of charges, transaction fees, interest etc.

54 Based on evidence submitted in Annex 39.05 to LBG*, Response to the PCA Market Questionnaire*, 23 January 2015.

(B) the value of the average balance lost to [Provider A] was around three times greater than the average balance gained from [Provider B];

Figure 3.6: Number and value of PCA switchers lost to and gained from [Provider A] and [Provider B] (2014)

[Confidential]

(ii) in relation to BCAs, as illustrated in Figure 3.7, LBG's analysis of BCA-related CASS switching data shows that, for the period January to July 2015, [Provider C] and [Provider D], for example, between them account for 13.8% of LBG's BCA switching losses through CASS by value, even though the volume is much lower (only 7.3%). Moreover, despite their relatively small market shares by volume, [Provider C] and [Provider D] collectively accounted for 27.1% of LBG's net switching losses by value;

Figure 3.7: Number and value of BCA switchers lost to and gained from [Provider C] and [Provider D] (2015)

[**Confidential**]

(b) **customers with higher levels of activity and account usage are more likely to switch than low activity customers.** This means that rates of switching, and other activity metrics, may be higher on a value rather than volume basis. Accounts that are funded by more than £500 per month make up around [60-70%] of all active accounts, but around [80-90%] of all PCAs that switched out of LBG in 2014;[55] and

(c) **results from customer surveys will largely be driven by the large volume of customers with low account usage.** These customers will have a different experience of their product and service than higher value customers, paying less in charges (and less frequently), using products less intensively and perhaps receiving a different service level. This evidence will tend to give a perspective that may not be consistent with the higher customer segments that entrants and other providers will seek to target.

3.30 In all its analysis, the CMA should review its results based on value metrics as well as volume metrics to identify where there are material differences. The CMA is uniquely placed in this investigation to use such metrics to gain a better understanding of customer behaviour and engagement. This is in addition to looking at value metrics in the analysis of other theories of harm, such as market shares and barriers to expansion.

Lack of robustness of traditional survey metrics

3.31 Traditional market research methods often underestimate the importance of unconscious and heuristic processes that consumers use in their decision making. Considered thinking is a physiologically expensive activity, and as such, cognitive effort is rationed. Contextual influences and emotions are extremely important in the real decision making process; the context in which a decision is made is pivotal to its outcome.

3.32 In terms of overarching principles, LBG refers to the note by Frontier Economics submitted to the CMA on 26 November 2014.[56] In this note, Frontier Economics

[55] See LBG, *Response to the PCA MQ Aggregate Data Request*, sheet A.2a.

[56] Frontier Economics, "How behavioural economics can improve customer research in retail banking markets", November 2014.

suggested some approaches to minimise the problems that arise with traditional market research. These principles suggest research should:

(a) focus on the consumers who have had a particular experience and are likely to be able to recall this experience with a reasonable level of accuracy;

(b) avoid asking customers to explain what they have *not* done since people cannot answer these questions meaningfully;

(c) focus on recent behaviour. People can more reliably report what they have done in the recent past. Their post-rationalisations about why they have acted in a particular way or what they will do in the future are generally inaccurate; and

(d) investigate how people behave in relation to their banking (in particular their level of engagement with it) before asking them explicitly about it. This could include looking at banking behavioural data in the first instance.

3.33 The CMA should consider the validity of evidence based on customer surveys that do not adhere to these principles. LBG set out detailed comments on how it interprets such evidence in its response to the *GfK NOP PCA banking survey report* in relation to PCA banking[57] and sets out its views in connection with the CMA's *Research Works SME qualitative research report* in Annex 3 to this submission.

Interpretation of market-wide gains from switching as a metric

3.34 The CMA has proposed that it will estimate the market-wide gains from switching based on its transaction-level pricing analysis. LBG understands that this will be used as a measure of the potential customer benefits of increased engagement. Whilst LBG agrees that there will be customer benefits from increased engagement, simply summing up individual gains across the sample and grossing up for the proportion of all PCAs represented in the sample is highly misleading:[58]

(a) **there is no evidence that PCA providers earn excessive profits through the cycle[59] and providers' income from PCAs is currently at an historical low.** Higher switching levels are likely to lead providers to respond by changing their PCA propositions, including switching incentives, tariffs, eligibility criteria and quality. The CMA's proposed analysis cannot capture these dynamic responses, and therefore the CMA will not be able to estimate market-wide gains from switching in the way it proposes; and

(b) **the CMA's proposed approach would also ignore differences in the quality of the PCAs**, such as channel access (multichannel or remote only), opening hours, and differences in digital services.

3.35 The CMA should therefore limit the inference it draws from these results to individual customers' gains from switching products and providers. Exploring the distribution of such gains is instructive, and can offer the CMA valuable insights in relation to its theories of harm. Calculating an aggregate potential switching saving across the market is wholly inappropriate and would lead to severely misleading conclusions. LBG is concerned that it will not see the output of this important analysis in advance of the CMA's provisional findings.

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57 See LBG, *Response to GfK PCA Investigation Report*, 9 June 2015.

58 CMA, *Invitation to comment on PCA pricing analysis using transactions data*, 26 June 2015, paragraph 16.

59 This is also the case for SME banking.

Importance of trialling

3.36 Human behaviour is complicated and difficult to predict. Whilst sensible estimates can be made about how a large number of people may respond to a significant event (for example, what happens to national savings when there is an economy-wide increase in savings rates), more detailed and nuanced behaviours are very difficult to predict (for example, how different customers respond to annual summaries of charges). In this connection, as consistently raised by LBG in previous submissions,[60] LBG considers that testing and trialling propositions or different scenarios in the field is the most robust way to predict customer behaviour and that more resources should be spent in this connection to find and test real improvements for customers, rather than on creating abstract theories of customer behaviour or creating (inappropriate and possibly misleading) comparisons to other markets.

3.37 As the CMA reaches its provisional findings it may find that remedies are required in relation to Theory of Harm 1. LBG considers that it is important that the development of any remedies should be taken forward using trials to identify what works. LBG is concerned that the outcome of any investigation may be a set of remedies that are selected on the basis of guesswork or customer surveys and which will ultimately not be effective, as has been the case in previous investigations. Previous regulatory interventions have often been disappointing because they were not planned and trialled correctly; for example, the FCA has recently found that annual summaries for PCAs mandated by the OFT had no effect on increasing customer engagement.[61] LBG therefore very much welcomes the CMA's announcement of 28 August[62] that it is considering the testing of potential remedies and welcomes the opportunity to contribute to this process.

3.38 In this connection, the FCA's programme of trials in cash savings and credit cards is a good model for how the development of remedies can be taken forward. LBG believes that the trials it is unilaterally conducting (set out in the paragraphs above) can help the CMA in the development of any potential remedies. However, this programme should ultimately be taken forward on an industry-wide basis with the support of the CMA so as to have the best chance of delivering changes that benefit customers.

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60 See, for example, LBG, *Response to the UIS*, 11 June 2015, paragraphs 3.1-3.2.

61 FCA, *Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour*, 11 March 2015.

62 CMA, *Investigation update*, 28 August 2015.

4. THEORY OF HARM 3 – BARRIERS TO ENTRY AND EXPANSION

4.1 The UIS noted that the CMA was "*still gathering information and undertaking analysis of potential barriers to entry and expansion…* [and] *continuing to liaise with the PRA and PSR respectively*",[63] and did not set out the CMA's views or evidence on potential barriers in any detail. In its subsequent *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, the CMA identified a number of potential barriers on which it had yet to provide initial findings, namely:

(a) **regulatory barriers:** authorisation, and anti-money laundering requirements;

(b) **natural or intrinsic barriers:** access to funding, and full-service provision;

(c) **strategic advantages of larger providers:** access to distribution channels (intermediaries and vertical arrangements), activities that increase the cost of switching, and proprietary information; and

(d) **"first mover" advantages:** brand/reputation.[64]

4.2 The CMA explained that work was ongoing in these areas and that it would report on them before or at provisional findings. However, despite LBG's request in its response to that Working Paper,[65] the CMA is yet to provide further detail on its analysis and views on these areas. LBG is therefore unable to comment meaningfully on these areas in this submission, and reserves the right to do so when the CMA's analysis is published. Moreover, as the CMA has not gathered robust evidence and data on these points, put back any evidence to parties, or disclosed and consulted on its framework of analysis, LBG does not consider that the CMA will be able to identify a provisional AEC on any of these points to the applicable legal standard in its provisional findings.

Barriers to entry

4.3 The evidence before the CMA clearly shows that the reference markets have experienced significant and unprecedented levels of new entry in recent years from a range of sources,[66] including:

(a) organic entry (e.g. Metro);

(b) expansion and/or diversification from neighbouring financial services markets (e.g. Virgin Money, Post Office, Tesco and M&S);

(c) divestment (e.g. TSB);

(d) new investment from international firms, including via acquisitions of existing providers and/or assets (e.g. Santander's acquisitions of Abbey National, Bradford & Bingley and Alliance & Leicester); and

(e) entry by specialist service providers offering a number of substitute products to PCAs, BCAs and general purpose business loans (e.g. Aldermore, Shawbrook, Paragon for SME banking, and Apple, Google, PayPal and payday lenders for PCAs).

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63 CMA, UIS, paragraph 158.

64 CMA, *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, Table 1.

65 LBG, *Response to Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems Working Paper*, 28 July 2015, paragraph 1.4.

66 CMA, *Summary of entry and expansion in retail banking* Working Paper, 14 July 2015.

4.4 This trend is accelerating, with the CMA noting "*a sharp increase in the number of firms seeking authorisation to provide banking services*",[67] including imminent entry from Atom (PCAs, BCAs and SME lending), Starling and Fidor (PCAs), CivilisedBank (BCAs and SME lending) and OakNorth (SME lending). Williams & Glyn will also be launched in 2016, offering PCAs, BCAs and SME lending.

4.5 The significant recent entry and the number of prospective entrants to both reference markets clearly show that there are no material barriers to entry. Regulatory changes and technological advances have facilitated such entry and have allowed entrants to develop differentiated and flexible business models, as clearly evidenced by the CMA's Case Studies. The scope and diversity of actual entry in both markets shows this can be done at any scale and distribution model.

Barriers to expansion

4.6 In relation to barriers to expansion, the UIS correctly recognises that "*the existence of barriers to entry and expansion does not necessarily give rise to an adverse effect on competition*".[68] LBG does not believe that there are significant barriers to expansion, and considers that market conditions enable providers of all sizes to implement their respective business plans and contribute to effective competition. Moreover, any analysis of potential barriers to expansion for newer or smaller providers should also take into account the IT, regulatory and other advantages such providers enjoy over more established providers.

4.7 In considering whether barriers to expansion exist, the CMA should recognise that attracting new customers requires providers to be innovative, differentiated and offer better products and service and/or better prices than competitors. Expansion in any market is never automatic, particularly in circumstances where customers are highly satisfied with their existing provider and where there are already established providers that are constantly innovating and developing new products and services themselves (see Section 3 above). The question for the CMA is whether there are barriers that would prevent a truly differentiated provider offering a superior product from acquiring customers quickly. LBG considers that there are not, as evidenced by:

(a) the experience of building societies (some of which demutualised in the 1990s) including Halifax, Abbey, Alliance & Leicester and Nationwide, which grew from a combined volume-based market share in the PCA market of 19.4% in 2001 to 27.9% in 2008 – an increase of 43%;

(b) Metro, which has grown its number of accounts from 8,912 in 2010 to 447,000 in 2014 and plans to double its number of BCAs in 2015;

(c) TSB, which, following its divestment from LBG, announced in October 2014 that it was attracting one in 10 new UK bank account customers.[69] It has also claimed an 8.4% share of all people switching or opening a new bank account in 2014, with 500,000 new accounts opened;[70]

(d) Santander's growth in the PCA sector - Santander has recently reported that: its deposits grew by £3.1bn in Q2 (£4.5bn in 6 months to June), all driven by 123 PCA balance growth; and PCA balances grew by £3.1bn in Q2 2015 continuing the steady inflows of previous periods. Santander now estimates that its PCA balances

67 CMA, *Prospective Entrants case study* Working Paper, 5 June 2015, paragraph 1.

68 CMA, UIS, paragraph 112.

69 BBC News, "Standalone TSB picks up customers", 24 October 2014.

70 BBC News, "TSB hails 2014 as 'pivotal year' as it grows accounts", 25 February 2015.

total £47.4bn (up 35% from last year),[71] which account for an estimated 20.5% of market PCA balances; and

(e) Santander's growth in SME banking – Abbey National and Alliance & Leicester had between them c.3-5% of the BCA sector when the former acquired the latter in 2008,[72] Santander now has c.10%.

4.8 The extent of and speed of expansion[74] should also be compared to a realistic counterfactual, having regard to legitimate prudential regulations aimed at ensuring the sustainability of providers' business models. The CMA should not assume that recent entrants and smaller providers are attempting to replicate the business models and scale of the largest providers by providing a universal, national, multi-channel service. LBG's understanding of these competitors is that they have diverse strategies focused on targeting the most valuable customer segments while avoiding the legacy costs and complexity of the largest providers, as explained at paragraph 2.9(c) above.

4.9 It is also critical to assess expansion on a value basis and based on each provider's rate of growth, in order to evaluate the current and future impact of such expansion on other providers. It is clear that competition for the most valuable customers can significantly affect the overall profitability of providers' activities in the reference markets. For example:

(a) in any given year LBG's most valuable 10% of PCA accounts generate around [40-50]% of value (pre-impairment);

(b) the average revenue from LBG's PCA customers in London is [10-20]% higher than customers in non-metropolitan areas, reflecting higher customer incomes in London; and

(c) Handelsbanken has systematically expanded its operations into the SME Banking market by identifying and actively targeting lower risk and niche sectors and competing on price in these distinct segments. In the period January to July 2015, Handelsbanken, which has market share of approximately 1% of BCA accounts by volume, has achieved a net gain of [Confidential]% of the value of all BCA switching from LBG through CASS.[73] See, in addition, Figure 3.7 above, which illustrates that the average balance of BCA customers switching from LBG to Handelsbanken is c. [Confidential] times greater than those BCA customers switching from Handelsbanken to LBG.

4.10 On a value basis, it is clear that many entrants and smaller providers have expanded successfully. For example:

(a) Santander has recently reported that it now estimates that its PCA balances total £47.4bn (up 35% from last year)[74] and account for an estimated 20.5% of market PCA balances;

(b) Metro's customer numbers increased by 63% to 447,000 in 2014;[75]

(c) Handelsbanken's operating profits rose 47% to £180.5m in 2Q 2015;[76]

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71 *Santander UK Group Holdings plc – Half Yearly Financial Report 2015*.

72 See paragraph 1.5 and Table 4.3 of the OFT's *Review of the undertakings given by banks following the 2002 Competition Commission report*, 17 August 2007, which states that HBOS, Alliance & Leicester and Abbey National had a market share of c.9% collectively in 2005. LBG has estimated Alliance & Leicester and Abbey National's 2008 market shares based on its knowledge of HBOS's market share in 2005 (c.4-5%).

73 Year to date, as at July 2015. Based on LBG analysis of CASS switching figures as at July 2015.

74 *Santander UK Group Holdings plc – Half Yearly Financial Report 2015*.

75 Daily Telegraph, "'Metro Bank plots further expansion after loans double", 21 January 2015.

(d) Aldermore announced that its return on equity for 2014 had increased to 15.1% (from 11.6% in 2013).[77] Even more recently, it announced that it more than doubled profit in the first half of 2015, exceeding expectations with a underlying pre-tax profit of £44 million as it issued more mortgages and loans to SMEs;[78]

(e) Shawbrook's return on tangible equity was 29.6% at the end of 2014;[79]

(f) TSB's pre-tax profit increased by 2.3% to £133.7 million in 2014, at the same time as it increased the number of new accounts it opened by 500,000;[80] and

(g) a KPMG report found that among a group defined as "smaller challengers", the average return on equity in 2014 was 18.2%, compared with 2.1% among the "larger challengers" and 2.8% among the largest five providers.[81]

4.11 Moreover, the response of incumbent providers to competition in the most valuable customer segments results in benefits for customers in all segments. For example, many of the LBG initiatives outlined in Figures 3.3 and 3.4 (such as improvements to mobile apps, shopper rewards and streamlined application processes) were triggered either as a result of identifying a nascent consumer requirement or as a result of competitor actions, but in both cases as a result of intense pressure for LBG to remain a competitive provider.

4.12 It is therefore critical that the CMA understands what these competitors are trying to achieve by share of value and corroborate any views expressed against internal strategy documents to gauge their success. If entrants are not meeting their plans, then the CMA will need to understand if this is due to problems with execution of their strategies or a lack of a better/differentiated product. A failure to expand is not necessarily evidence of barriers to expansion.

4.13 However, as explained in Section 3 above, it is possible to improve customer engagement across the market, which would increase the competitive threat faced by all providers.

Regulatory barriers

4.14 As the CMA has identified in its *Regulatory framework applicable to the retail banking industry in the UK* Working Paper, providers of the reference products face extensive regulation, administered by a number of regulators. Providers (including LBG) who are also active in other markets are subject to further regulation. The regulatory framework has a number of important objectives other than competition, including financial stability, prudential regulation and conduct.

4.15 LBG agrees with the CMA that "*understanding the regulatory framework applicable to the industry is particularly important to the CMA's consideration of barriers to entry to the retail banking market, and of the feasibility of potential remedies.*"[82] In doing so, the CMA should take a prospective view of the impact of recently implemented regulations and regulatory developments in the pipeline.

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76 Daily Telegraph,"Challenger banks Handelsbanken and Secure Trust report surge in profits as consumer confidence grows", 21 July 2015.

77 See *Aldermore Group PLC Annual report and accounts 2014 - Highlights*.

78 City AM, "Profits double at Aldermore as lending grows", 28 August 2015.

79 See *Shawbrook Annual Report and Accounts 2014*, page 3.

80 BBC News, "TSB hails 2014 as 'pivotal year' as it grows accounts", 25 February 2015.

81 KPMG report, "The game changers: challenger banking results, May 2015", page 3.

82 CMA, *Regulatory Framework applicable to the retail banking industry in the UK* Working Paper, 1 May 2015, paragraph 2.

4.16 In this connection, HM Treasury recently recognised that various recent UK government initiatives represent "*the most significant, sustained programme to deliver lower barriers to entry and exit, level the playing field, and increase consumer engagement in banking for many years and, at the very least, since the mid-1980s*".[83]

4.17 However, a lack of regulatory coordination and uncertainty regarding future regulatory requirements may in fact act as a barrier to entry and certainly acts as a burden, imposing direct and opportunity costs on entrants and incumbents alike, and disincentivising investments, as the CMA has identified.[84] The role of regulation, beneficial or otherwise, must be considered in any assessment of a "well-functioning" market.

4.18 Moreover, the *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper refers only to "*regulatory burdens that impose costs proportionately on all firms and those that hit new entrants harder than larger banks*" and to the possibility that regulation may hinder expansion "*by systematically favouring incumbent banks*."[85] The CMA's analysis of regulation will be fundamentally incomplete if it fails to consider whether certain regulations have a disproportionate burden on larger providers. As LBG has explained since the outset of the investigation, a good illustration of this is BBAs.

4.19 BBAs form part of the government's financial inclusion agenda, which LBG supports. These are loss-making accounts, but importantly they have a much wider impact on the market beyond the balance sheets of the individual providers who offer them: they drive an inevitable cross-subsidy between customer groups, and their mandated provision also "crowds out" the emergence of higher functionality accounts (potentially with monthly fee charging structures) aimed at BBA customers (such as Secure Trust and Thinkmoney). Accordingly, any entrant that wished to target the basic end of the market cannot charge an economic price because the providers which have committed to provide BBAs are being forced to price below cost.

4.20 HM Treasury's requirement that providers extend the functionality of these accounts and, for certain groups of customers, remove any fee income will exacerbate these concerns. The CMA's investigation is yet to engage with BBAs, and must now consider whether the legitimate policy objectives which underpin BBAs can be achieved with less distortion to competition, and better promote innovation in the provision of BBAs so that customers in this segment of the sector can continue to benefit from developments and innovation in the wider current account market.

Authorisation

4.21 The CMA has found that the authorisation process for new providers is proportionate and efficient and no longer acts as a barrier to entry, consistent with recent reports by the ICB, FSA and Bank of England, and the evidence the CMA has received from recent and prospective entrants.[86] LBG agrees with these conclusions.

Capital Requirements

4.22 LBG does not consider that capital requirements are a significant barrier to entry or expansion. However, the CMA should not merely rely on a review of the overall regulatory framework or on the assertions of individual providers (who will have very limited understanding of the capital requirements imposed on other providers), but should

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83 See paragraph 1.4 of HM Treasury, *Banking for the 21st Century: driving competition and choice*, March 2015.

84 CMA, UIS, paragraph 124.

85 Paragraphs 2(b) and 9.

86 CMA, UIS, paragraph 119; and *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraphs 11-12.

engage with the PRA on this topic, in order to obtain an understanding of how this framework is applied in practice to each provider in the reference markets. LBG notes that further regulatory reforms are being considered in this area and would support measures that could help ensure equitable treatment for all lenders whilst ensuring that prudential regulation remains effective.

4.23 LBG does not agree with the CMA's assertion that "*a key implication of this difference in regulatory treatment is that smaller and newer banks wishing to compete in these markets are likely to have lower profitability (all other things being equal), impacting on their ability to expand their lending, grow their business and attract new investment*".[87] This is because:

(a) the CMA has not attempted to assess profitability in the reference markets;

(b) larger providers do not necessarily use an internal ratings based approach for all of their asset classes, as the CMA has recognised.[88] As LBG explained at its main hearing and its response to the CMA Financial Questionnaire, it uses a combination of the standardised, foundation and advanced approaches;

(c) the potential benefits of operating an internal ratings based approach to risk weighting are offset by additional capital requirements applicable to larger providers. These include capital buffers for large systemically important providers (of which LBG is one) and Pillar II/Individual Capital Guidance. As explained above, the CMA should obtain relevant information from the PRA on the interaction of these effects in practice;

(d) any benefits of an internal ratings based approach are likely to be offset by the leverage ratio and the proposed review of capital risk floors;[89] and

(e) there is extensive evidence of smaller and newer providers expanding their lending, growing their businesses and attracting new investment, including:

(i) Secure Trust, which has grown from 189 staff and a balance sheet of £89 million in 2010 to 600 staff and £500 million of lending in 2014;[90]

(ii) Aldermore has reported that, in 2014, its net loans to customers increased by 42% to £4.8 billion (from £3.4 billion in 2013), and that its lending to SMEs increased by 32% to £2.2 billion (from £1.7 billion in 2013).[91] Even more recently, it announced that its lending his risen by 13% to £5.4 billion in the first half of 2015 alone, putting it on course to deliver full-year net loan growth of £1.4 billion for 2015;[92] and

(iii) OakNorth hired Adair Turner, former head of the FSA, as one of its directors in March 2015, and plans to lend £1bn over the next few years.[93]

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87 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 23.

88 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 19.

89 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraphs 45-47.

90 Telegraph article, "We don't see a lack of demand for loans from SMEs… quite the reverse", 20 October 2014.

91 See *Aldermore Group PLC Annual report and accounts 2014 - Highlights*.

92 City AM, "Profits double at Aldermore as lending grows", 28 August 2015.

93 FT article, "Lord Adair Turner joins board of digital challenger bank OakNorth", 9 March 2015.

4.24 Moreover, as the CMA has noted, there are a number of recent and prospective regulatory reforms in this area, led by the PRA in accordance with its competition objective.[94] In particular, the PRA has reduced capital requirements for new entrants, with the intention of lowering barriers to entry and expansion, including for 'Small Specialist Banks'.

Anti-money laundering requirements

4.25 In the UIS, the CMA explained that it had not received evidence to suggest that the anti-money laundering (**"AML"**) regime (in particular legal requirements to perform customer due diligence (**"CDD"**)) is a barrier to entry.[95] LBG agrees with this assessment.

4.26 The CMA stated that it would consider whether AML requirements and processes may act as a deterrent to switching and therefore potentially constitute a barrier to expansion. LBG considers that this question should be explored in the context of Theory of Harm 1. As explained above in Section 3 above, LBG supports measures to increase customer engagement, including their confidence and ability to switch. LBG has implemented a number of initiatives to make account opening easier, while satisfying its legal requirements. These are outlined in further detail in Section 3 and include:

(a) optimising the application journey for all devices;

(b) enabling customers to open a joint account online;

(c) a project to allow customers to submit identification documents online or via a smartphone with the aim of minimising referrals to a branch;

(d) allowing customers to up- or down-grade to the target PCA of their choice; and

(e) exploring the potential of sharing credit information between providers.

4.27 However, LBG recognises that multi-lateral and/or regulatory action may be required to address any disincentives to switching caused by the AML regime. For example, streamlined BCA account-opening procedures formed part of the Undertakings In Lieu proposals developed by LBG and other providers during Phase 1. LBG would encourage the CMA to explore this issue in more detail with the relevant regulatory authorities.

Natural or intrinsic barriers

IT

4.28 In respect of IT systems, LBG agrees with the CMA's findings that firms providing banking products for the first time may not face significant entry barriers in relation to IT systems.[96] New IT solutions, including pay-as-you-grow models, mean that upfront sunk costs are limited,[97] and a number of recent and prospective entrants have made use of bank-in-a-box solutions, including Atom, Metro and Civilised Bank.

4.29 Moreover, smaller providers can also use an existing provider's systems on an agency basis before migrating onto its own systems as it grows. A number of building societies successfully entered the PCA market using this method, including Halifax, Nationwide,

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94 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraphs 38-44.

95 CMA, UIS, paragraph 123.

96 CMA, UIS, paragraph 137.

97 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 57.

Alliance and Leicester and Abbey National. More recently, Tesco used RBS' systems, and M&S Bank is in a joint venture arrangement with HSBC to use its systems.[98]

4.30 It has been suggested by certain providers (e.g. Nationwide and Tesco) that expanding from other financial services markets into PCAs or BCAs may involve significant time and cost in order to build a suitable IT platform which is integrated with the provider's legacy systems.[99] Although LBG recognises that such costs may be significant, it does not consider that they constitute a competitive disadvantage or barrier to expansion. Instead, they are a smaller-scale illustration of the disadvantages faced by larger providers operating legacy IT systems:

(a) as the CMA has recognised, legacy IT systems of the established providers may place them at a competitive disadvantage.[100] This has also been recognised by:

(i) Temenos, which has found that providers using modern IT systems enjoy a 28% higher return on equity and a 6.5% lower cost to income ratio compared to larger providers using legacy software.[101] The Temenos Metro Bank case study states that "*Metro Bank - as Commerce Bank did as well - is neutralising many of the scale advantages enjoyed by large banks by operating a highly efficient IT platform* […] *Not only can Metro Bank operate at a significantly lower IT cost base and so achieve minimum efficient scale sooner, but its IT infrastructure facilitates its superior customer service* […]";[102] and

(ii) ACI, which has found that legacy systems leave little room for scalability or agility;[103]

(b) newer and smaller providers have recognised that their IT systems are a source of competitive advantage:

(i) the CMA's Metro Bank case study states "*Metro seems to have overcome many of the scale advantages enjoyed by the large banks by deploying an integrated IT solution. […] it has not been burdened by legacy IT systems, and its IT system appears to be a key competitive advantage;*"[104]

(ii) Phillip Monks, chief executive of Aldermore, said Aldermore's ability to leverage its digital operating model had helped lower the cost-to-income ratio, which was 60% as at November 2014. Aldermore is aiming to lower costs to 40% of income by the end of 2017. Mr Monks stated, "*we don't have any legacy systems so we don't have to spend vast amounts to maintain it and we don't have spaghetti-like technology systems*";[105] and

98 Deloitte study, *The impact of innovation in the UK retail banking market*, 31 July 2015, page 63.

99 CMA, UIS, paragraph 137.

100 CMA, UIS, paragraph 138.

101 Cited in *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 55.

102 Temenos Metro Bank case study: 'Breaking the Mould but Breaking the Malaise', page 1.

103 Cited in *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 74.

104 CMA, *Metro Bank case study* Working Paper, 21 May 2015, paragraph 57.

105 FT article, "Aldermore increases lending as it cuts into big banks' lead", 10 November 2014.

(iii) Software as a Service (SaaS) solutions circumvent the need for firms to periodically update their systems, as repair, maintenance and system updates can be run centrally;[106]

(c) large established providers are required to incur significant costs in maintaining and upgrading their existing legacy systems in order to address rapidly evolving customer and regulatory requirements. These costs are greater than for newer IT systems, as larger providers tend to operate a hybrid of old and new systems, locally customising existing systems and integrating 'add-ons'. Deutsche Bank has predicted a material increase in IT spend by large providers over the next ten years, as their core systems are old and rely on too many applications patched too many times to cope with rising transaction volumes, regulatory change and digital channel changes.[107] For example, LBG has incurred, and continues to incur, very significant IT costs in relation to:

(i) **the integration of Lloyds and HBOS IT systems**. Following the Lloyds/HBOS merger, LBG decided to bring HBOS customer data onto the pre-existing Lloyds platform. This process took three years at a cost of c.£2 billion, and involved the migration of 30 million HBOS accounts comprising 35 billion pieces of data. This integration also required internal restructuring and changes to reporting structures, as well as the harmonisation of transfer pricing policies and management accounting methods. As explained at LBG's main hearing, it also continues to experience costs and delays in relation to the integration of Lloyds and TSB, following their merger in 1995;[108]

(ii) **LBG's Simplification Programme.** LBG has invested heavily in its Simplification Programme which encompasses over 400 initiatives to improve efficiency and re-invest in customer-driven improvements. It spent £966 million on the Simplification Programme in 2014, bringing the total spent up to December 2014 to £2.4 billion;

(iii) **the divestment of TSB in accordance with State Aid commitments**, including the provision of IT services to TSB on a transitional basis. In this connection, the total cumulative cost of the TSB divestment project has been c.£2 billion to the end of 2014 and it is anticipated to cost a further c.£500 million by the time TSB has exited all of the transitional services provided by LBG; and

(iv) **investment in LBG's Digital division.** As outlined to the CMA at its 8 January 2015 site visit, LBG has invested £750 million between 2011 and 2014 on the creation of a fit-for-purpose digital platform for PCA and BCA customers to provide scalable infrastructure connected to the legacy back-end system. It will invest £1 billion in digital from 2015 to 2017, not just at the customer interface but also in re-engineering customer journeys and bank processes.

4.31 It has been asserted (e.g. by TSB) that adopting off-the-shelf software solutions may restrict smaller providers' ability to customise and differentiate its products or to expand

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106 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 61.

107 Cited in *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 76.

108 Hearing transcript, page 129.

beyond a particular scale.[109] LBG does not consider that such assertions are supported by the evidence as:

(a) the time and cost for larger providers to introduce and adapt their products and services is significant, due to their legacy IT systems;

(b) smaller providers' strategies do not require them to target all products and customer segments, and therefore allow them to have a less complex product range than larger providers (who will typically also have off-sale legacy products); and

(c) Metro has told the CMA that it should be possible to achieve scale and avoid "legacy" IT issues.[110]

Branches

4.32 The CMA concludes in the *Barriers to entry and expansion: branches* Working Paper that "*the key issue is whether banks can achieve sufficient scale to compete effectively in retail banking without a branch network*".[111] Overall, the available evidence indicates that providers can compete effectively with relatively small branch networks, and the CMA will need to clearly define where it believes the threshold is. Alternatives to branches already exist, and as digital trends continue, the importance of branches will continue to be eroded. In LBG's view, the evidence shows that branches do not act as a barrier to entry or expansion, and that existing trends point towards branches becoming even less significant in the very near future.

4.33 LBG sets out below its key observations in this regard, with further detail provided in its response to the *Barriers to entry and expansion: branches* Working Paper.[112]

The scale required must be defined

4.34 If the CMA wishes to conclude that branches constitute a barrier to entry or expansion, and that branch networks of scale are required to compete effectively, the CMA must: define what scale is required and why; provide evidential support for this threshold; and take account for differences in the volume and value of accounts. It must also treat survey responses on the role of branches with due caution, as explained at paragraph 3.31 *et seq* above.

The importance of branches in the reference markets is diminishing

4.35 Had the CMA reviewed the reference markets ten or even five years ago, it would have observed that branches played a more important role in customer acquisition, servicing, and retention. The rise of digital banking (illustrated in paragraph 2.5 *et seq.* above) means that branches play a much more limited role in all three areas today. The trends towards digital are unambiguous and are accelerating (and not restricted to the UK), so that branches will play an even more limited role over the next five years, or sooner.

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109 CMA, UIS, paragraph 138 and *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 69.

110 *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 87.

111 *Barriers to entry and expansion: branches* Working Paper, 13 August 2015, paragraph 17.

112 LBG, *Response to "Barriers to entry and expansion: branches" Working Paper*, 27 August 2015.

4.36 This is illustrated by the following:

(a) in relation to PCAs:

(i) whereas only 9% of people visited a branch once a week and 32% once a month, 15% used online banking once a day, 59% once a week and 77% at least once a month;[113] and

(i) some 53% of people said they were confident that they could do the vast majority of their banking online or over the phone;[114] and

(b) in relation to SME banking:

(i) 68% of SMEs use online banking at least once a week (compared to 27% using a branch) and 66% could get the vast majority of their business banking done online or over the phone;[115]

(ii) 70-80% of SMEs transact more than half of their business banking online;[116] and

(iii) around 20% of LBG's active RBB customers had not transacted at any branches over a 12-month period.

4.37 For new entrants and expanding providers who do see branches as an important part of their strategy, such as Metro, there is no evidence to suggest that branches act as a barrier to their expansion. In the case of Metro, it is clear that its strategy does not include a large national network; instead focusing on servicing urban areas.

Opening/closing branches is no more costly than for other retail outlets

4.38 As demand has continued to shift away from branches, providers have reacted accordingly, and many branches have closed. However, the CMA should not mistake changes in the number of branches in a network for changes to branch costs:

(a) property costs represent only around 35% of branch costs, and in the past recent years a significant proportion of LBG's total branch costs have been removed. Branch costs are not sunk costs, and can be recovered as the branch estate adjusts; and

(b) where a physical presence is important for a particular provider's strategy, there is no shortage of available retail space and there are no barriers to opening branches.

Residual importance of branches

4.39 To the extent that the CMA has any residual concerns regarding branches, LBG considers that such issues should resolve themselves as a result of steps to enhance customer engagement (see discussion in relation to Theory of Harm 1 above). LBG expects that any non-engagement concerns relating to branches would be dealt with by ongoing market developments and initiatives:

(a) **electronic identification and verification processes**: LBG notes that the data the CMA holds will show a significant proportion of accounts being opened in branch. LBG notes that this is likely to be the result of historic demand and usage

113 British Bankers' Association, *Promoting competition in the UK banking industry*, June 2014, page 23.

114 British Bankers' Association, *Promoting competition in the UK banking industry*, June 2014, page 26.

115 British Bankers' Association, *Promoting competition in the UK banking industry*, June 2014, page 5.

116 YouGov.

patterns which are changing, and some legacy infrastructure issues. Electronic identification and verification (eID&V) processes are not always possible at present, necessitating a branch visit even where applications are started in other channels. It is particularly important that this is addressed given that, of the customers that are referred to a branch, [80-90%] do not follow up on the request to complete identification and verification in branch.[117] This shows a significant latent demand for digital opening, which LBG is moving quickly to meet. Steps are already being taken to address this issue. For example:

(i) LBG's digital transformation programme includes a project to allow customers to submit identification documents online or via a smartphone with the aim of minimising customers that drop out from online PCA applications because of a referral to a branch;[118] and

(ii) other providers are also moving quickly with the same aim, and some have already achieved straight through digital processing.[119] For example, Barclays has recently announced enhancements to their online current account application process whereby customers can scan documents and submit these electronically from home, rather than needing to visit a branch.

This is already one of the key dimensions of competition, and an area where new entrants, without legacy IT systems, are very well placed to compete effectively;

(b) **developments such as cheque digitalisation and instant deposit machines ("IDMs"):** The CMA's evidence suggests that the most common reasons for PCA and BCA customers visiting a branch were to pay in money or cheques: 85% of PCA customers reported this as the most common reasons for visiting a branch; and, 84% of SME start-ups said that this was the most important reason for having access to a branch.[120] While LBG considers that cash and cheques are important for some PCA and SME customers, and thus have been a driver of branch footfall, their importance is quickly diminishing (for example, the use of cash is rapidly falling, and cash transactions now represent less than 50% of all transactions according to the Payments Council[121]). Market innovations in this connection will reduce the requirement to visit a branch in the near future:

(i) the decreasing use of cash and cheques is expected to continue and is likely to be accelerated through contactless payments[122] and new digital entrants including Apple, Google and Samsung Pay;

(ii) the industry-wide Future Clearing Model (FCM) will also introduce cheque imaging as a way of presenting cheques, negating the need for SME (and PCA) customers to visit a branch for this service;

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117 For example, in 2014, [Confidential] applicants completed an online application form on LBG's PCA websites. Of these applicants, [50-60%] could not be identified electronically and were referred to a branch to provide documentation. Only [10-20%] of those customers attended a branch to complete their application. (LBG, *Response to "PCA application process and overdrafts questionnaire*", 23 June 2015).

118 This was demonstrated at the Site Visit on 8 January 2015.

119 For example, LBG understands that Barclays has recently announced enhancements to its online current account application process whereby customers can scan documents and submit these electronically from home, rather than needing to visit a branch.

120 See the *Barriers to entry and expansion: branches* Working Paper, 13 August 2015, paragraph 40 in relation to PCAs (citing the *GfK NOP PCA banking survey report*), and paragraph 53 in relation to SMEs (citing the *Charterhouse Business Banking Survey*).

121 http://www.paymentsuk.org.uk/news-events/news/world-class-payments-take-shape-uk.

122 In this regard, payment by contactless cards can now be made for purchases up to £30, having recently increased from a maximum of £20.

(iii) while cash handling is important for some SME businesses, there are a number of cash handling options that do not involve branches or counter service;

(iv) in the past year, LBG has started to install an additional [Confidential] IDMs within branches to allow customers to make deposits quickly and easily. There are also plans to [Confidential]; and

(v) LBG also intends to install Wi-Fi into the vast majority of branches to allow staff to educate customers on the alternative channels available; and

(c) **there are also a number of alternatives available to providers who may wish to develop a physical presence without opening branches:** The role of branches in a provider's business model is a strategic choice, with "Bank in a Box" IT solutions capable of being customised to accommodate such non-branch strategies. For example, the Post Office offers counter services, and inter-bank agency agreements ("**IBAAs**") existing in the market today are alternatives already used by competing providers. For example:

(i) LBG has had a relationship with the Post Office for a number of years. The services offered via the Post Office include cash withdrawals, balance enquiries as well as cash and cheque deposits. Barclays, RBS and Santander also offer similar services via the Post Office. Moreover, Santander's SME customers do not have access to branches, and instead use Post Office facilities;

(ii) a number of new entrants have gained significant market share without any physical presence at all e.g. First Direct, Atom, Funding Circle, Tungsten, PayPal, Fidor, and Starling; and

(iii) branch sharing arrangements are used by a number of providers. Trust Bank (which otherwise is telephone and internet only) has an arrangement for paying in money via Barclays branches; First Direct customers can use HSBC branches; and Handelsbanken customers can use NatWest branches.

Access to funding

4.40 As the CMA has identified, "*our case studies and the evidence we have received to date do not suggest that potential entrants or banks wishing to expand have had significant difficulties in raising funds,*"[123] noting that this applies to providers with existing businesses outside retail banking (e.g. Tesco, Virgin Money), providers with an overseas parent (e.g. Handelsbanken) and standalone entrants (e.g. Aldermore and Shawbrook).

4.41 However, it has been suggested that new entrants and smaller providers may be constrained in their ability to expand due to a difficulties in attracting customer deposits (as a result of low switching rates), or lack of access to wholesale markets.[124] LBG does not consider that these assertions are supported by the evidence, which shows that:

(a) **entrants and smaller providers have been able rapidly to grow their deposits**:

(i) Metro's deposits have grown rapidly: CAGR of 256% between 2010 and 2014. Total deposits stood at £2.9 billion at the end of 2014, higher than the

[123] CMA, UIS, paragraph 125.

[124] CMA, UIS, paragraph 126.

Strategic Plan of £2.4 billion.[125] Metro has raised £641 million as equity capital from private investors since 2010; [126]

(ii) Shawbrook has reported that its customer deposits in 2014 have grown by 29% to £4.5 billion (from £3.5 billion in 2013), and that its growth in SME deposits has increased by 97% to £1.0 billion (from £0.5 billion in 2013);[127] and

(iii) the KPMG report also found that lending assets of entrants and smaller providers increased by 16% over the last year;[128]

(b) **larger providers have to compete strongly to attract and maintain deposits.** For example:

(i) LBG launched Club Lloyds in response to significant switching of customers with high deposits to Santander 123, and other providers have subsequently launched high interest paying PCAs. In this connection:

(A) in 2014 the average balance of a customer switching to Santander was [Confidential]. Overall, LBG lost a net of [Confidential] balances to Santander, presenting nearly [Confidential] of all balance outflows and around [Confidential] (net) customers; [129] and

(B) the 4% credit interest paid on Club Lloyds or the 3% paid on Vantage accounts cannot be characterised as a "cheap" source of funding; and

(ii) Santander has recently reported that: its H1 2015 deposit growth is significantly ahead of the market at 3.5%; its deposits grew by £3.1bn in Q2 (£4.5bn in 6 months to June), all driven by 123 PCA balance growth; and PCA balances grew by £3.1bn in Q2 2015 continuing the steady inflows of previous periods. Santander now estimates that its PCA balances total £47.4bn (up 35% from last year) [130] and account for an estimated 20.5% of market PCA balances;

(c) **entrants and smaller providers have successfully accessed wholesale markets**. For example, Aldermore Bank and Virgin Money have both issued residential mortgage-backed securities and Tesco Bank has securitised credit card receivables;[131] and

(d) **entrants and smaller providers have access to Government funding schemes**, such as Funding for Lending and the British Business Bank. In this regard, Aldermore has drawn £585 million as at 31 March 2015 and Shawbrook £240 million. In addition, the British Business Bank has provided guarantees of £125 million to Clydesdale for small business lending and £40 million to Funding Circle.[132]

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125 CMA, *Metro Bank case study* Working Paper, 21 May 2015, paragraph 26.

126 CMA, *Metro Bank case study* Working Paper, 21 May 2015, paragraph 73.

127 See *Shawbrook Annual Report and Accounts 2014*, page 3.

128 KPMG report, *The game changers: challenger banking results, May 2015*, page 3.

129 LBG, *Response to the PCA Market Questionnaire*, 23 January 2015, paragraphs 39.1 and 39.4.

130 *Santander UK Group Holdings plc – Half Yearly Financial Report 2015*.

131 For Aldermore Bank, see *Aldermore Group PLC Annual report and accounts 2014*, page 7; for Virgin Money see Virgin Money Group Annual Report and Accounts 2014, page 49; and for Tesco Bank see Tesco Personal Finance Plc Annual Report and Financial Statements for year ended 28 February 2014, page 2.

132 Bank of England and British Business Bank.

Access to payment systems

4.42 LBG notes the conclusion that the CMA has "*not received evidence of prospective entrants or larger banks having been prevented or significantly impeded from entering or expanding in the market as a result of the costs or other challenges associated with obtaining and maintaining access to payment systems*".[133] This is consistent with LBG's own experience of the retail banking sector and the trends it has observed.

4.43 Moreover, significant improvements to access to payment systems are underway:

(a) **LBG is continuing to invest in core payments infrastructure**: LBG has limited activities in providing indirect access. LBG estimates that it serves only 10% of UK agency banking customers and a significantly lower share by payment volume. LBG estimates that the revenue it receives (from fees charged) from providing Agency services is less than £5 million per annum. To put this in context, LBG typically invests well in excess of £100 million per annum in its payment systems, so Agency fees make a minimal contribution to these marginal annual investment costs, to LBG's common annual operating costs associated with these payment systems, and to LBG's historic investment in these systems.[134] Over the next three years, LBG will continue to invest in core infrastructure across its Commercial Banking division, including building on existing and new capabilities in its Global Transaction Banking (GTB) business unit. This will include enhancing the products and services LBG offers to its customers seeking indirect access to the UK payment systems. Through this investment, it is LBG's aim to serve a larger proportion of the indirect Payment Services Providers market than it does today. LBG is aware that some new entrants have suggested that indirect access is a barrier to entry and have proposed solutions such as regulated access across the range of schemes necessary to offer current accounts. The CMA should understand that, depending on specifications, LBG may not currently have the capability to offer the full range and service quality that it understands many smaller new entrants and providers want;

(b) **direct access can be both practical and feasible for smaller providers:** LBG notes that a traditional sponsor bank relationship is only one way of obtaining access to payment systems. Several smaller providers have already chosen to obtain direct access, such as Danske Bank, which shows that direct access can be both practical and feasible for providers processing lower volumes.[135] While direct access does require an investment in the technical capabilities required to connect to the payment systems and in payment scheme fees (an investment which can be avoided by obtaining indirect access from a sponsor bank[136]), LBG believes that ongoing initiatives by the payment scheme operators to facilitate direct access[137] will make it easier to obtain direct access for those that wish to;

(c) **"technical access" services:** Access to payment systems will also be facilitated by the emergence of firms offering "technical access" services to providers and commercial organisations. These firms will offer a "plug and play" service

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133 CMA, *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, paragraph 132

134 LBG notes that there is a wider population of payment service providers which do not operate under agency banking relationships, and may obtain indirect access from a wider range of providers than the four which currently provide indirect access services to agency banks (Barclays, HSBC, RBS and LBG).

135 CMA, *Barriers to entry and expansion: capital requirements, IT and payment systems* Working Paper, 14 July 2015, paragraphs 95, 96 and 98.

136 CMA, *Virgin Money case study* Working Paper, 5 June 2015, paragraph 58.

137 See the Payment Systems Regulator's General Directions to certain payment scheme operators.

delivering the technical functionality required for providers to access payment systems; clients will only require settlement services from a sponsor bank;

(d) **the PSR's role:** The PSR's program of work on access to payment systems, and as a new regulator in this sector more generally, will continue to support the development of these services in the interests of service users; and

(e) **the Payments UK Code of Conduct:** On 1 September 2015 Payments UK launched a code of conduct governing indirect access to payment systems for Payment Systems Providers ("**PSPs**").[138] The code sets out standards of best practice for key elements of the commercial arrangements between Indirect Access Providers and Indirect PSPs. The principal aim of the code is to improve the experience of Indirect PSPs by clearly setting out the responsibilities of Indirect Access Providers who have subscribed to the code to Indirect PSPs to whom they provide Indirect Access.

Full service provision

4.44 The CMA's case studies do not suggest that full-service provision is a prerequisite to entry,[139] and LBG agrees with this conclusion. However, the CMA is considering whether PCAs and BCAs are gateway products, and the extent to which full-service provision may therefore be a factor in expansion. LBG does not consider that this potential concern is well-founded for the following reasons:

(a) **a significant number of customers do not hold other products with their main provider**:

(i) 60% of SMEs sampled as part of the CMA-commissioned Charterhouse Survey did not have another product with their main provider;[140]

(ii) whereas 82% of PCA customers hold other financial products as well as a PCA, almost all of these people have some or all of these products with a different provider from their PCA – only 12% hold all of their other products with the same provider as their PCA;[141]

(b) **to the extent that customers choose to take multiple products from the same provider, this reflects customer satisfaction with the price and non-price elements** of a provider's offer, together with the customer benefits of having multiple products "under the same roof". In this regard:

(i) the GfK NOP PCA banking survey report[142] states that "nearly a half (49%) of those whose additional financial products are held with the same provider[143] do so because they like to have everything with the same provider. Other reasons, mentioned by at least one in ten, included the quality of products offered by the same provider (17%), the convenience of holding products at the same provider (16%), the good service (12%) and the trust in or satisfaction with the provider (10%)"; and

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138 See http://www.accesstopaymentsystems.co.uk/code-of-conduct.

139 CMA, UIS, paragraph 151.

140 Charterhouse SME follow-up survey results, 20 August 2015, slide 33.

141 *GfK NOP PCA banking survey report*, paragraph 21.

142 *GfK NOP PCA banking survey report*, paragraph 85.

143 12% of all respondents; 28% of the respondents who held multiple financial products.

(ii) satisfaction with their personal banking provider was the most common reason why SME start-ups did not search and went straight to their main provider for a BCA (56%);[144]

(c) **there is no material "gateway" between PCAs and BCAs which should act as a concern, and the conversion rate from PCAs to BCAs varies significantly between providers**. For example:

(i) when deciding to open a BCA, 38% of start-ups answered "I searched around. I didn't really take where I bank personally into account";[145]

(ii) only 2% of start-ups answered that they did not look elsewhere because "I prefer to have all my finance/accounts with one provider";[146]

(iii) 55% of start-ups searched other providers for their BCA requirements;[147]

(iv) only 13% of SMEs chose "They are my personal bank", as an important factor when choosing a bank to open their BCA, and only 17% chose it as the most important factor. In both scenarios, pricing was the leading response (19% and 26% respectively);[148]

(v) in 2013 these conversions rates were as follows: Lloyds 64%; Bank of Scotland 12%; RBS 52%; NatWest 59%; Barclays 65%; HSBC 61%; Santander 41%;[149] and

(vi) c.50% of LBG's BCA customers also have a PCA with LBG. In this connection, even though a customer might have a PCA with LBG, they may also have other PCAs with other providers and LBG does not know if it is a main banker or not. LBG therefore has to compete extremely hard to win its SME customers;

(d) **there is no material "gateway" between BCAs and general purpose SME loans**. There is strong competition to provide SME loans, and the 2002 Undertakings (which LBG fully supports and complies with) effectively prevent bundling of BCAs and loans. In this connection:

(i) LBG observes that there are pro-competitive reasons why many SMEs choose to apply for finance from their main provider: for those SMEs which only considered one organisation for their finance requirements, the most popular reason was because there were satisfied with their provider (49%);[150] and the main reason why SMEs applied to their main provider for finance was because of the value they put on the relationship they have with the provider (27%), with 23% stating that they applied to their main provider because they were "*satisfied with [their] bank or they have given [them] good service in the past*";[151] and

144 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 7 and 10.

145 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 9.

146 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 10.

147 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 7 and 9.

148 *Charterhouse SME follow-up survey results*, 20 August 2015, slides 11 and 12.

149 LBG, *Response to the First Day Letter*, Annex 10.03 – Low and Medium Turnover Fact Pack.

150 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 44.

151 *Charterhouse SME follow-up survey results*, 20 August 2015, slide 50.

(ii) whereas the CMA has suggested that SME's may look to their BCA provider for c.90% of their term loan requirements (primarily for the reasons outlined above), this figure is significantly lower when considering substitutes such as hire purchase/leasing, which are substitutes: in 2014 only 17% of SMEs which used leasing, HP and vehicle finance purchased such finance from their "main bank";[152]

(e) **entrants and smaller providers have been able to expand effectively**, as outlined in paragraphs 4.3 to 4.13 above, either by offering all of the reference products (PCAs, BCAs and SME loans) or by offering only one of those products; and

(f) **any residual benefits of proprietary information held by a customer's current provider are being eroded** by regulatory and technological change, as explained below.

Strategic advantages for larger providers

Access to distribution channels

4.45 The CMA has not found any compelling evidence to suggest that access to intermediaries is problematic for new entrants or that larger providers have any significant advantages in terms of access to intermediaries over new entrants and smaller providers to give rise to a barrier to entry or expansion in relation to BCAs or SME lending.[153] LBG agrees with this finding.

Activities that increase the cost of switching

4.46 The CMA intends to investigate whether larger providers engage in strategic behaviour which increases the cost of switching, such as tying and bundling, long contracts, exit charge/penalties and delays.[154]

4.47 LBG seeks to be the best bank for customers and to serve all customers well. It does not consider that there is evidence of such strategic behaviour acting as a barrier to entry or expansion, and any incentives for such behaviour would be eliminated by increasing customer engagement. In this connection:

(a) LBG does not generally tie or bundle any of the reference products, and the 2002 SME Undertakings (which LBG fully supports and complies with) effectively prevent bundling of BCAs and SME loans;[155]

(b) none of LBG's products in the reference markets (and very few competitors' products) require a long-term contractual commitment from the customer;

(c) LBG does not charge exit fees on PCAs or BCAs. It does not charge exit fees or early repayment fees on SME loans (with the exception of cost-reflective fees for fixed rate lending);

(d) LBG and a number of other providers agreed a common protocol in October 2014 to enable alternative lenders to agree standard form Deeds or Priority or Waivers for SME lending, typically within seven working days; and

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152 *BDRC SME Finance Monitor Q4 2014*, page 57.

153 CMA, UIS, paragraphs 152-153.

154 CMA, *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, Table 1.

155 Where LBG does bundle SME products, this is in the context of products which are outside the scope of the 2002 SME Undertakings.

(e) PCA and SME customers are able to switch providers quickly. For example:

(i) CASS allows PCA and BCA switching (for eligible SMEs) within seven days; and

(ii) a significant proportion of PCA customers (21% in 2014[156]) and SMEs ([Confidential][157]) multi-bank, which makes switching from one of their providers to another even more simple, as both accounts are already simultaneously open.

Proprietary information/information asymmetry

4.48 The CMA is considering whether a customer's existing provider has proprietary information on that customer's usage and behaviour which may enable it to make faster or better commercial decisions or to cross-sell and respond to the customer's needs more effectively.[158]

4.49 LBG does not consider that proprietary information is a barrier to entry or expansion for the following reasons:

(a) **switching between providers (including to newer and smaller providers) demonstrates that proprietary information is no a barrier**. Providers of substitute products have also been able to win business from PCAs, BCAs and SME loans, often by offering fast commercial decisions. For example:

(i) Boost operates a streamlined online application process that provides lending decisions for short-term SME loans within 24-48 hours;[159]

(ii) peer-to-peer and crowdfunding groups, such as Platform Black, Funding Circle and Zopa, which allow individual investors to offer credit to small corporates, are growing fast. Alibaba, the Chinese online marketplace, formed partnerships in March 2015 with fledgling lenders Iwoca and Ezbob, which bought Wonga's business-lending arm last month, to offer trade finance to small British importers of Chinese goods;

(iii) Metro Bank has become the first UK provider to lend through a peer-to-peer platform through its collaboration with Zopa;[160] and

(iv) personal customers have increased their usage of payday loans as an alternative to overdrafts, in large part due to the very fast approval decisions and access to cash offered by payday lenders;

(b) **proprietary information is not always easily accessible.** Although larger providers may store significant volumes of behavioural data on their customers, they may be limited in their ability to use it as it is held on a range of legacy systems across different departments.[161] Moreover, as Deloitte has identified, "*more established banks may need to invest additional time and resources in replacing legacy systems to ensure that the data they collect can be stored in one place and different sources can be linked and aggregated. This investment could potentially*

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156 LBG, *Response to the PCA Market Questionnaire*, 23 January 2015, question 35, citing *GfK NOP Financial Research Survey (FRS)*.

157 [Confidential]

158 CMA, UIS, paragraph 155.

159 LBG, *Response to the SME Market Questionnaire*, 23 January 2015, paragraph 55.4.

160 FT article, "Metro Bank strikes deal to lend through P2P site", 19 May 2015.

161 See Deloitte study, *The impact of innovation in the UK retail banking market*, 31 July 2015, page 51.

place incumbent banks at a disadvantage compared to newer entrants that do not have such legacy issues";[162]

(c) **the extent of the behavioural data held by established providers is declining**, due to the disintermediation of PCAs by new payment technologies, such as PayPal, WePay and Apple Pay (and soon, Samsung Pay[163]). Moreover, as Deloitte has identified, "*companies such as Amazon and PayPal that are beginning to enter he lending market enjoy an advantage in accessing alternative sources of information*",[164] such as an SME's sales data on PayPal or their Amazon transaction history;

(d) **providers have access to extensive external data sources**, which include: credit reference agencies, electoral register, Companies House (for example, registered charges), County Court judgments/defaults, bankruptcy orders, and previous applications to banks/building societies and finance/leasing companies. Even where an applicant is an existing customer, LBG will typically consult these external sources;

(e) **all providers can obtain behavioural data on prospective applicants**, for example for requesting bank statements, and as the CMA has identified,[165] recent developments will erode any residual advantages of proprietary information:

(i) the midata initiative aims to empower consumers to use their behavioural data to obtain offers from a range of providers. As LBG has explained,[166] the midata programme can be enhanced by what LBG refers to as "midata 2", to enable access to unredacted data for both personal and SME customers via multiple channels. This could be further supported by developing and implementing simple open API standards to enable midata 2 services to develop quickly; and

(ii) the Small Business, Enterprise and Employment Act 2015 has the potential to improve the ability of providers and alternative finance providers to conduct accurate risk assessments on SMEs. LBG has urged the CMA to look at how this legislation can have the greatest impact. There are two possible enhancements: the development of processes to support 'footprint- free' quotations to enable customers to be confident in shopping around without fear of harming their credit rating; and second, the promotion of central data portals, such that financial and other information of businesses can be readily uploaded by any finance provider given access and analysed by systems with less manual intervention (similar to midata). As with other potential improvements identified above, LBG believes that the CMA should use its influence to increase momentum for such developments now rather than to wait until the end of the inquiry;[167] and

(f) **qualitative information and the judgement of provider employees is as important as behavioural data**, especially when lending to SMEs, and start-ups in particular. For example, providers will consider the experience/qualifications of

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162 Deloitte study, *The impact of innovation in the UK retail banking market*, 31 July 2015, page 50.

163 See BBC article, "Samsung Pay: What is it and how does it compare to Apple Pay?", 19 August 2015. Samsung Pay is currently available in South Korea. But it will expand to the US on 28 September 2015, and the firm has indicated that the UK, Spain and China will be next to get the facility sometime in the near-future.

164 Deloitte study, *The impact of innovation in the UK retail banking market*, 31 July 2015, page 62.

165 CMA, UIS, paragraphs 156-157.

166 LBG, *Response to the UIS*, 11 June 2015, paragraphs 3.5(a) and (d).

167 LBG, *Response to the UIS*, 11 June 2015, paragraph 5.4(d).

the individual(s) behind the SME, the strength of the business plan, and (where relevant) the value of security.

"First mover" advantages

Brand/reputation

4.50 LBG understands that the CMA is considering whether advertising spend and consumer loyalty provide larger providers with an advantage and act as a barrier to entry or expansion.[168] To the extent that these issues are a concern, LBG considers that they are products of the existing level of customer engagement, and should be tackled in the context of Theory of Harm 1.

4.51 In this connection, LBG would also observe that:

(a) **smaller providers have been able to enter and expand successfully** using a variety of advertising strategies and have also been able to establish brands and consumer loyalty. For example:

(i) Metro does not spend significantly on product marketing, sales incentives or introductory incentive offers. Instead it relies more on word of mouth to attract and retain customers,[169] setting out to create "fans" rather than customers, even offering free dog biscuits to branch customers.[170] In this context, Metro's customer numbers increased by 63% to 447,000 in 2014;[171] and

(ii) Handelsbanken's has built its UK brand around a focus on hiring local people with a view to supporting their local communities.[172] Handelsbanken's operating profits rose 47% to £180.5m in 2Q 2015;[173]

(b) **smaller providers typically target specific customer segments** rather than seeking mass market appeal, and are therefore able to focus their branding and advertising on those segments;

(c) **established providers may be more closely associated with general dissatisfaction with and mistrust of the banking industry**, as a result of the global financial crisis and legacy conduct issues (whether or not the specific provider was involved). Smaller and newer providers may therefore have an advantage in being able to build their brands from a clean slate; and

(d) **more generally, branches have limited importance for customer acquisition**, where brand, the propositions offered, and to a lesser extent marketing activities, all have a much greater impact on the ability to attract customers. LBG strongly disputes any implication that branches are a necessary requirement in this regard. By way of illustration:

(i) it is clear from the success of providers such as First Direct that branches are not a requirement for acquiring customers; and

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168 CMA, *Barriers to Entry and Expansion: Capital Requirements, IT and Payment Systems* Working Paper, 14 July 2015, Table 1.

169 CMA, *Metro Bank case study* Working Paper, 21 May 2015, paragraph 65.

170 KPMG report, 'The game changers: challenger banking results, May 2015', page 12.

171 Daily Telegraph, 'Metro Bank plots further expansion after loans double', 21 January 2015.

172 KPMG report, 'The game changers: challenger banking results, May 2015', page 12.

173 Daily Telegraph, 'Challenger banks Handelsbanken and Secure Trust report surge in profits as consumer confidence grows', 21 July 2015.

(ii) examples from other retail financial markets e.g. insurance also indicate that it is possible to build brands without branches, or indeed any physical presence (e.g. Direct Line, Churchill). LBG has seen no evidence to suggest that this is any different in the reference markets.

5. THEORY OF HARM 2 – CONCENTRATION LEADING TO WORSE OUTCOMES

5.1 The CMA has set out some theoretical mechanisms that may link concentration or market share to customer outcomes. LBG does not believe these mechanisms describe accurately competition in the reference markets, and that, in any event, it is an empirical question whether such relationships exist. In this connection, LBG believes that there is no evidence to support this theory of harm and the CMA has not put forward any such evidence. Accordingly this theory of harm should be abandoned.

5.2 The CMA's Theory of Harm 2 comprises the notion that concentration gives rise to market power for some providers leading to worse outcomes for customers. The CMA states that "*concentration may give rise to market power and lead to worse outcomes for customers through, for example, firms having unilateral market power or as a result of firms coordinating their behaviour*".[174] In this regard, the CMA has dismissed coordination of behaviour as a feature of the reference markets.[175]

5.3 Two theoretical mechanisms through which there might be a link between concentration or market shares and outcomes were put forward by the CMA in the UIS. Based on the UIS and further discussions, LBG's understanding is that:

(a) one mechanism attempts to explain a link between market share and outcomes ("active/inactive" mechanism in paragraph 99(b) of the UIS); and

(b) the other mechanism attempts to explain a link between concentration and outcomes ("differentiation" mechanism in paragraph 99(a) of the UIS).

LBG sets out its views on each of these theoretical mechanisms below.

5.4 LBG considers that, whatever the underlying theory, the link between concentration or market shares and outcomes can be tested empirically. The CMA should rely only on current empirical evidence relating to the reference markets in the UK. It should not base its findings on any theoretical relationship or on a review of the literature on this question. LBG's views on the relevant empirical evidence are summarised below.

The proposed link between market share and outcomes - UIS paragraph 99(b)

5.5 LBG understands that this mechanism is an attempt to explain how there may be a link between market share and outcomes, i.e. that larger firms have higher prices than smaller firms, for the same level of service or quality. The theory is that "*larger banks may lose more revenue than a smaller bank from…a reduction in price or incur greater costs through improving quality/innovation. In particular, a bank with a large market share may set relatively high prices in order to earn greater profits from its existing customer base and accept a lower share of new customers*".[176]

5.6 LBG understands this theory and considers that whether any theoretical conditions are satisfied for this mechanism to apply and whether there is, in fact, such a relationship are both empirical questions.

5.7 There are two conditions that must both be met for this mechanism to hold, neither of which LBG believes are satisfied in the reference markets:

(a) the inability to discriminate between active and inactive customers; and

(b) a relationship between size and the ratio of active and inactive customers.

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[174] CMA, UIS, paragraph 97.

[175] CMA, UIS, paragraph 98.

[176] CMA, UIS, paragraph 99(b).

The inability to discriminate between active and inactive customers

5.8 The first condition is that the mechanism only works where providers are unable to offer different prices to active/switching and inactive/non-switching customers. This condition is explicitly recognised by the CMA. More precisely, it is the ability to discriminate that forms the condition, and not whether providers choose to do so.

5.9 LBG submits that the type of market in which such a mechanism might apply is one where there is a degree of customer loyalty or inertia, but where it is not possible for the provider to identify which customers are active or inactive. For example, in high-street retail markets, a small new provider may be able to offer lower prices to attract customers but a larger older provider may not be able to do so as it will face a higher cost of discounting prices for its existing loyal customers, whom it is not able to identify at the point of sale.

5.10 In the case of the reference markets, the CMA notes that providers "*appear to some degree to be able to offer different prices and services to existing/inactive customers than to new/active customers*".[177] LBG believes that it is very clear that providers are able to discriminate in this way because they are able to identify which customers are new and offer them different prices:

(a) in relation to BCAs, all providers can offer free banking to new and switching customers. Negotiation of prices is also prevalent which means that providers are able to offer further incentives to acquire or retain customers; and

(b) in relation to PCAs, all providers can identify which customers are new or switching. All providers can offer different prices to new customers. This includes offers for new-to-market customers (e.g. youth and student accounts), and through switcher offers to existing PCA customers including one-off rewards and introductory credit interest rates (e.g. Nationwide's 5% offer for 12 months). Such introductory pricing is also prevalent in other retail financial services markets such as savings and credit cards.

5.11 As the condition is not satisfied, this mechanism should be abandoned by the CMA.

A relationship between size and the ratio of active and inactive customers

5.12 The second condition required for the CMA's theory linking market shares to outcomes to hold is not explicitly recognised in paragraph 99(b) of the UIS. The CMA proposes that providers "*will tend to have some unilateral market power over their existing customer base of inactive customers which would be expected to lead to higher price/cost margins on sales to such inactive customers*". However, the CMA recognises that this effect is "*irrespective of size*". LBG, therefore, does not understand how it then follows that there may be a link between size and outcomes.

5.13 LBG considers that the mechanism that the CMA has attempted to describe actually explains a link between outcomes and the ratio of active to inactive customers. That is that firms with a lower proportion of active customers, rather than a higher market share, may have "weaker incentives to lower prices or improve quality/innovation than those providers with a higher proportion of active customers.

5.14 The second condition for this mechanism to hold is, therefore, that there is a relationship between market size and the ratio of active to inactive customers. LBG considers that this condition does not hold as the ratio of active to inactive customers depends on business model rather than size. In this connection LBG observes the following:

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177 CMA, UIS, paragraph 32.

(a) newer providers are small and clearly have a higher proportion of active to inactive customers (in the extreme, a very recent entrant only has active customers). However, there is no such relationship for older providers, that can have the same ratio of active to inactive customers whatever their size. Yorkshire Bank is an example of an older provider that has a similar ratio of active to inactive customers as other larger providers. Moreover, the high level of churn in the SME BCA sector, in particular, means that a newer provider's book can mature to the average of the market quite quickly, and that larger providers may themselves have a high proportion of new customers even if their market share is not growing; and

(b) providers' business models will also determine the ratio. For example, the merger of HBOS and Lloyds TSB created a larger provider, but did not change the ratio of active to inactive customers.

Empirical evidence on the mechanism

5.15 LBG therefore considers that there is no evidence that this second condition is satisfied.

5.16 Whether or not the mechanism is a relevant description of how competition works in this market, whether there is a relationship between market size and outcomes is an empirical question. The CMA has considered evidence of pricing, non-price customer outcomes and profitability:

(a) in relation to BCAs, the CMA:

(i) found that evidence on BCA pricing did "*not show any clear association between price and market share*";[178]

(ii) did not find evidence of a relationship between retail banking financial performance and market share; and

(iii) has not yet completed its analysis of non-price factors, which LBG understands will be reported in the provisional findings;

(b) in relation to PCAs, the CMA:

(i) has not yet completed its analysis of pricing, which will be published in the provisional findings. As previously submitted by LBG, the CMA should not rely on its analysis based on representative profiles which it published in the UIS and which will be superseded by the proposed Runpath analysis;

(ii) found that "*larger banks have higher average revenues than the smaller banks*" (with the exceptions of two large unnamed providers);[179] and

(iii) has not yet completed its analysis of non-price factors, which will be published in the provisional findings;

(c) more generally, the CMA presented evidence in the UIS that was not consistent with this theory of harm. For example:

(i) Halifax has one of the lowest-priced PCAs and has attracted the second largest number of PCA switchers, and Lloyds Bank and Bank of Scotland both maintained interest-paying PCAs post-merger;[180]

178 CMA, *BCA and PCA pricing analysis* Working Paper, 7 August 2015, paragraph 27.

179 CMA, *Retail banking financial performance* Working Paper, 14 August 2015, paragraph 79(d).

180 CMA, UIS, paragraphs 103 and 106.

(ii) some of the larger providers are innovating at least as much as the smaller providers/new entrants;[181] and

(iii) early evidence shows that providers with similar market shares appear to have adopted different strategies and achieved different outcomes as a result.[182]

5.17 In relation to the ongoing analysis in relation to pricing, LBG has previously provided the CMA with substantial comments on how it should approach this analysis. However, LBG has concerns that the CMA will not reflect these comments in its analysis. In particular:

(a) **verification of Runpath analysis:** Whereas LBG welcomes the CMA's use of Runpath analysis to conduct its PCA pricing analysis, it is concerned that the Runpath analysis published in the provisional findings may not be accurate or robust as it is based on aggregate data. In a letter to the CMA dated 18 August 2015[183] LBG offered to verify the output from the aggregate Runpath analysis against the more accurate disaggregated daily data based on individual midata files for its own customers, therefore confirming that the CMA's approach is robust. However, the CMA's has stated that its timetable would not allow sufficient time for this verification to be conducted prior to the publication of Provisional Findings;[184]

(b) **value market shares:** LBG has emphasised on a number of occasions the importance of looking at value rather than volume market shares. PCA and BCA income is concentrated in a small number of customers and the business models adopted by some providers specifically target these customer segments. LBG believes this means that value shares will be materially different from volume shares, particularly for entrants and smaller providers. However, this is an empirical question and the CMA is uniquely placed to consider it. LBG believes this analysis is proportionate and can be conducted relatively straightforwardly using data from the Market Questionnaire and comparing across providers,[185] and that any such calculation should also include an adjustment for the increased value of packaged accounts. (Adjusting for packaged accounts is particular important given that not all providers offer packaged accounts in the same volume, and many providers have stopped selling them altogether.) It may be that value shares are not materially different from volume shares. However, LBG would be concerned if any of the CMA's findings, for example, in relation to concentration metrics or rates of expansion, were based on volume market shares without consideration of value shares; and

(c) **non-price factors:** The CMA recognises that differences in prices may reflect "quality of service differences" and LBG understands the CMA will present its analysis in this regard in its provisional findings. However, the CMA has not made clear how it will consider differences in quality. A comparison of quality will need to consider the scope and level of service provided, and not only customer satisfaction as a measure of quality. Customer satisfaction may be the same for different providers as it reflects different expectations about a selected service level and relative price. For example, LBG offers relationship managers to many businesses with turnover of less than £2m which other providers do not usually offer; Santander requires its BCA customers to use Post Office branches.

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181 CMA, UIS, paragraph 104.

182 CMA, UIS, paragraph 109.

183 LBG, Letter from Steve Smith of LBG to Christiane Kent of the CMA, 18 August 2015.

184 CMA, Letter from Christiane Kent of the CMA to Steve Smith of LBG, 26 August 2015.

185 As outlined in LBG's letter to the CMA of 18 August 2015 (letter from Steve Smith of LBG to Christiane Kent of the CMA).

Different service levels and business models will also have different costs to serve. These differences may affect quality, but the economics of these offers may also determine prices, such as operating a metropolitan-only network or serving lower cost customer segments. Such factors should also be considered in addition to quality metrics.

5.18 In summary, LBG considers that the evidence produced to date does not support a relationship between market size and outcomes and that this mechanism should be abandoned by the CMA. LBG understands that further analysis is underway. However, as this analysis will not be presented until the Provisional Findings, LBG is unable to comment further at this stage.

The proposed link between concentration and outcomes - UIS paragraph 99(a)

5.19 As the CMA's theory regarding the "*ability of banks with higher market share to differentiate products and exercise market power*" was not sufficiently clear in the UIS,[186] and LBG raised this at its Hearing. LBG now understands that this theory is an attempt to explain how a relationship between the level of concentration in a market and customer outcomes might exist, i.e. prices in a more concentrated market will be higher than in a less concentrated market across all providers whatever their size (or more generally customer outcomes will be worse). LBG considers that there can be no presumption that concentration will lead to higher prices or worse outcomes. This will depend on how competition takes place in a particular market, with some models of competition predicting no relationship between concentration and outcomes.

5.20 The CMA has put forward a mechanism to explain why there might be a relationship between concentration and pricing in the reference markets. LBG understands this mechanism to be that, in a market with differentiated products, if there are fewer firms, each firm has a higher degree of market power over those customers that have preferences that are closest to its product positioning than if there are many firms. However, for this theory of harm to stand, the CMA must:

(a) identify the conditions required for theory to hold and test that these conditions are satisfied;

(b) identify a threshold above which concentration outcomes are materially worse for customers; and

(c) show empirically that pricing is higher and/or customer outcomes are worse than in a comparable less concentrated market.

Conditions

5.21 LBG understands that there is at least one condition that may need to be satisfied for this mechanism to hold. This is that there must be barriers to other existing or new providers adopting any form of product differentiation. Such barriers would prevent providers competing for the same customer niches or segments.

5.22 LBG does not consider there to be such barriers. Any provider could, if it chose, introduce a product that matches the pricing and product offering of a competitor. No evidence has been put forward to show that this condition is satisfied. LBG therefore considers that this condition is not met and so the mechanism does not hold.

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186 CMA, UIS, paragraph 99a.

Materiality

5.23 Even if this mechanism is relevant, the level of concentration must be high enough for the effect on customer outcomes to be material. At lower levels of concentration, prices will not be materially above an unconcentrated market. It is not clear at what threshold level of concentration the CMA would consider there to be a material impact on customer outcomes.

5.24 LBG notes that in each of PCA and BCA markets there are at least nine leading independent providers and a range of other smaller providers. By way of comparison, the CMA's merger guidance says that "*previous OFT decisions in mergers involving retailers suggest that the OFT has not usually been concerned about mergers that reduce the number of firms in the market from five to four (or above)*".[187]

5.25 The CMA will need to explain what the threshold for concentration is in each of the reference markets and how (and why) this is more stringent than in other retail markets. In the absence of such explanation and evidence, LBG considers that this mechanism should be dismissed.

Empirical evidence

5.26 Whether there is a relationship between concentration and outcomes is ultimately an empirical question. Such evidence could compare outcomes before and after a change in concentration, for example, or compare outcomes in the UK reference markets with comparable markets in other geographies, accounting for any other explanatory factors that may have changed. The CMA has not produced such evidence to support the existence of a relationship in the reference markets.

5.27 LBG notes instead that:

(a) **customer satisfaction in the reference markets is very high**, as outlined by the illustrative facts set out in Section 3 above. If there was a relationship between concentration and outcomes, and concentration in the reference markets was above a relevant materiality threshold, it should be expected that worse pricing or other outcomes would lead to low levels of customer satisfaction. These levels of customer satisfaction are inconsistent with the mechanism or materially worsened customer outcomes in the reference markets; and

(b) **levels of innovation in the reference markets is high**, as outlined by the illustrative facts set out in Section 2 above. If the relationship held, it should be expected that innovation in the reference markets would slower, with providers lacking the incentives to improve products and service. LBG considers that this is clearly not the case and that the innovation seen in the reference markets today is not consistent with the mechanism. In this connection, LBG notes that the analysis by Deloitte LLP concludes that "*there does not appear to be evidence that the UK is systematically lagging in terms of innovation*".[188]

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187 OFT1254, Merger Assessment Guidelines, paragraph 5.3.5.

188 Deloitte study, *The impact of innovation in the UK retail banking market*, 31 July 2015, section 9.1.

6. PRODUCT AND GEOGRAPHIC MARKET DEFINITION

6.1 LBG considers that the proposed product market definitions in the UIS are broadly useful as a frame of reference.

6.2 As regards geographic market definition, LBG does not consider Scotland to be a separate market from England and Wales for any of the reference products, as:

(a) there is strong competition across Great Britain, with key parameters of competition and strategy set on a Great Britain-wide basis (e.g. product, product characteristics and pricing). Certain elements of the reference products are also typically provided on a Great Britain-wide basis (e.g. telephone and digital banking);

(b) the impact of digital banking has further eroded any differences between UK nations; and

(c) historical differences in brands between Scotland and the rest of Great Britain are also being eroded, with the Lloyds TSB Scotland business being divested to TSB, Halifax expanding into Scotland, and the creation of Williams & Glyn.

6.3 However, as the CMA recognises, market definition is not an end in itself. First, the CMA must recognise the diversity of customer segments within the defined markets, as explained above. Secondly, there are a range of full or partial substitute products outside the defined markets that exert a competitive constraint on providers in the reference markets. This competitive threat is increasing due to rapid innovation and adoption of digital banking (as explained above).

6.4 Substitutes for PCAs include:

(a) **credit cards**, which compete with PCA overdraft facilities. There are a number of credit cards with long interest free periods.[189] Increased competition from credit cards has contributed to a [10-20] fall in LBG's overdraft balances since 2012, a trend seen across the market.[190] Some credit card providers also offer money transfers, providing the ability to transfer money from a credit card directly to a PCA. This allows customers to pay-off overdrafts quickly and transfer lending to the credit card. This is particularly attractive to many customers given that some providers are offering 0% interest for over two years on transfers. For example, the new Fluid credit card offers 0% on money transfers to a PCA for up to 30 months;[191]

(b) **flexible loans**, which have similar functionality to overdrafts. For example, Lloyds Bank's Flexible Loan allows customers to borrow between £1,000–£25,000 for between one and seven years. It provides instant access to money and flexible repayment options, including repayment holidays and no early repayment charges. Many other providers offer similar products. There are also an increasing number of providers offering very low prices on fixed-term personal loans, such as Sainsburys, Nationwide and Tesco;

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189 These include the following LBG cards, all of which offer 0% interest on purchases over long periods of time: a version of the Halifax credit card which offers 0% for up to the first 24 months from account opening on balance transfers within the first 90 days; and a version of the Lloyds Bank Platinum card which offers 0% interest for up to 19 months from opening your account on balance transfers made within 90 days. Searching most comprehensive comparison sites will provide an extensive list of other credit cards with long interest free periods on purchases from other providers.

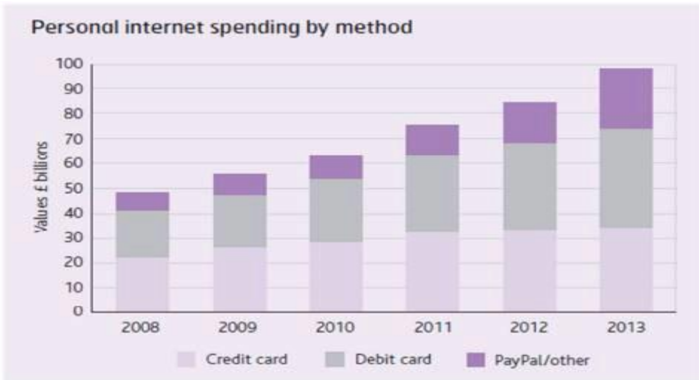
190 LBG, *Response to the PCA Market Questionnaire*, paragraph 23.4.

191 See www.fluid.co.uk.

(c) **payday loans**, which offer very fast approval decisions and access to cash, as well as offering loans of a smaller size and duration than would be available through a personal loan. Although many payday loan customers would be outside LBG's risk appetite, [Confidential] of LBG customers used a payday loan in 2013, with an average transaction value of [Confidential]; [50-60]% of these customers were eligible for unsecured credit with LBG;[192] and

(d) **payment technologies.** There are a number of innovative changes occurring in payments. This has been driven by new online providers. For example:

(i) ***PayPal***, has experienced considerable growth over the last few years. This has in part been driven by the customer experience it offers. It provides customers with an easy log-in (often just a mobile number and a four digit pin); customers can choose which current account or credit card to pay from using their mobile wallet; and customers do not have to give out their personal financial information to the merchant. The share of personal interest internet spending through PayPal and other non-traditional online payment methods increased from 19% to 25% between 2012 and 2013, as shown below:



Source: Payments Market Review 2014, Payments Council

(ii) ***competitors in consumer payments increasing.*** Competitors now include digital technology companies (such as Apple, Amazon and Google) and mobile network operators (such as Vodafone); and

(iii) ***innovation is also occurring in relation to in-store, face-to-face payments***. Large internet firms have made it simple to pay within their own ecosystems, and may look to expand into face to face payments via smartphones. Growth in these digital services could cause customers to use these services as the primary way of checking balances and reviewing transactions, resulting in brand recognition shifting from the PCA provider to the digital wallet provider. Over the next few years, these changes are likely to advance further. It is likely that such customers may be able to store funds with providers of digital wallets, reducing further the dependency on PCAs.

6.5 Substitutes for BCAs include:

(a) **PCAs**, which have the same functionality as BCAs but no monthly or transaction fees. Charterhouse results suggest that PCA use is more prevalent among very small businesses, particularly those with turnover below the UK VAT threshold. Among businesses with a turnover of £100,000 or less, 7% use a PCA as their main bank account. The equivalent figure for businesses with a turnover exceeding

192 LBG, *Response to the PCA Market Questionnaire*, paragraph 23.9.

£500,000 is 2%. Significant variation in the prevalence of PCA use by businesses can be observed across providers and across industrial sectors. For example, the research suggests 15% of Bank of Scotland's business customers use a PCA as their "main bank account", compared to 4% of Lloyds Bank customers;[193]

(b) **savings products**, which are an alternative to BCAs for holding deposit balances. For example, due to faster payments and mobile banking, instant access savings accounts and fixed term bonds now have much of same functionality for holding deposits in terms of flexibility and ease of access/transfer to a BCA. Savings accounts also have much the same functionality as BCAs for receiving money;

(c) **credit cards**, which allow both recurring and one-off payments to be made. They are substitutes for BCAs for making payments, and now represent nearly a third of combined debit and credit card purchases by value.[194] Buyer protection features give a further incentive for customers to make payments using credit cards. Recent innovations have included standalone pre-paid cards, which can be topped-up with cash at the Post Office, not requiring any other bank accounts. Credit cards also have similar functionality to overdrafts in that they can be used to make transactions or to withdraw cash;

(d) **online payment platforms**, such as Google Wallet and Paypal;

(e) **business loans,** either secured or unsecured. A business loan tends to be larger in size and longer in duration than a BCA overdraft. However, entrants like Boost are offering lending products that are relatively close substitutes to an overdraft. In particular, Boost's business model relies on a streamlined application process, in which no business plan is needed and a principle lending decision is made within 24-48 hours;

(f) **invoice financing**, which helps businesses to manage their cash flow and therefore can act as a substitute for overdraft borrowing. For example, Tungsten, which entered the market in June 2014, has built on its e-invoicing business to offer competitive invoice financing, thereby helping to meet business cash flow management requirements; and

(g) **other forms of finance**, including asset finance, supplier finance, trade credit and personal retail finance, such as mortgages, are also substitutes to BCA overdrafts to some degree.

6.6 Substitutes for general purpose SME loans include:

(a) **hire purchase and leasing**, which is as large a market as term lending: the hire purchase and leasing sector came to c.£26 billion in 2014,[195] whereas the total value of terms loans for the 12 months ending in March 2015 came to c.£24 billion;[196]

(b) **peer-to-peer lending**. Some peer-to-peer lenders, such as Funding Circle, specifically target small businesses. These loans are competitive with those available from providers, and have terms that make them close substitutes for

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193 LBG, *Response to the SME Market Questionnaire*, 23 January 2015, paragraph 3.5.

194 In Q1 2015, credit card transactions amounted to £43.3 billion, out of a combined total for debit and credit cards of £148.9 billion. See UK Cards Association, *Quarterly Market Trends Q1 2015*.

195 Finance & Leasing Association. See http://www.fla.org.uk/index.php/asset-finance/.

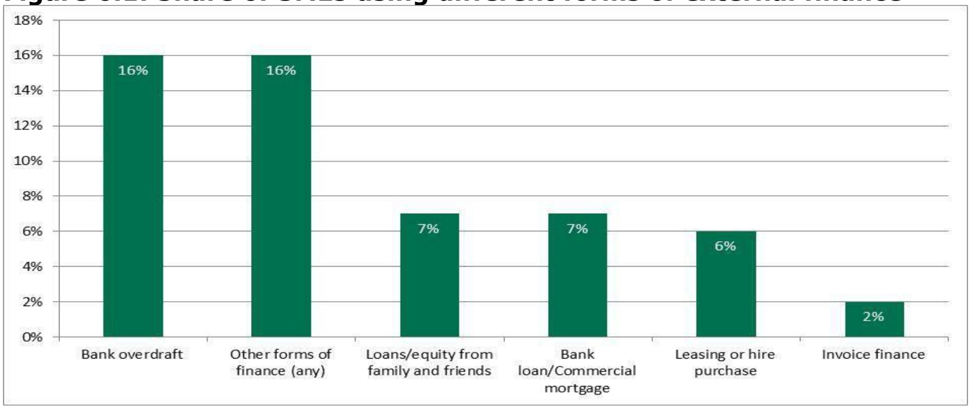
196 British Bankers' Association. See "BBA Statistics - Bank support for SMEs – 1st Quarter 2015", which states for the 12 months ended March 2015 "value of new loans drawn" totalled £6,519 million for small loans (see page 4) and £17,177 million for medium loans (see page 5).

general purpose loans. Peer-to-peer business lending has been growing rapidly; and

(c) **equity and "equity-like" finance.** Multiple third party providers, including angel investors, government-supported venture capital funds, early stage venture capital, mezzanine finance and private equity funds, compete to provide equity financing options.

In this context, Figure 6.1 below illustrates that the use of 'non-core' finance (products other than overdrafts, term loans and credit cards, of which asset finance is the largest) accounts for 16% of the SME finance market as a whole, compared to 29% for those core products.

Figure 6.1: Share of SMEs using different forms of external finance



Source: SME Finance Monitor Q4, 2014, page 56.
Note: "Other forms of finance (any)" covers leasing, hire purchase or vehicle finance, loans/equity from directors/family/friends, invoice finance, grants and loans from other third parties.

7. REVIEW OF 2002/2003 UNDERTAKINGS

7.1 With regard to the remainder of the 2002/2003 SME Undertakings, LBG continues to support a fresh review of those undertakings and the extent to which they remain appropriate in light of the market developments and initiatives outlined in this submission, as previously submitted to the CMA.[197]

7.2 In particular, LBG would welcome a review of the following:

(a) **the Switching undertakings (clauses 6 to 16 of the 2002/2003 Undertakings):** as previously submitted to the CMA,[198] there are inconsistencies between CASS and the 2002/2003 Switching undertakings. LBG considers that CASS is superior to the 2002/2003 Switching undertakings for those SMEs to which it applies (such as automated seven day switching and CASS Guarantee) and agrees with the CMA that maintenance of two different switching frameworks in parallel (where they both apply) is undesirable. LBG therefore supports the CMA's view that CASS substantially supersedes the 2002/2003 Switching undertakings as far as they relate to smaller SMEs that qualify under CASS;

(b) **the Portable Credit History undertaking (clauses 15 and 16 of the 2002/2003 Undertakings):** LBG considers that this undertaking has not had a significant effect on the SME banking market because alternative lenders can learn more by a prospective borrower simply providing its last six months of statements. LBG considers that HM Treasury's promising initiative to require providers to share SME customer information with other lenders through credit reference agencies will ultimately provide an effective and more compelling alternative. LBG suggests that the CMA should consider that this undertaking has been superseded by the HM Treasury initiative which, together with the Small Business, Enterprise and Employment Bill to help match SMEs rejected for finance with alternative lenders, will more effectively enhance SME's access to credit; and

(c) **the Bundling undertaking (clauses 17-20 of the 2002/2003 Undertakings):** LBG would welcome a fresh review of the terminology used in those undertakings. In particular, LBG considers that the exclusions in clause 18 could be further clarified.

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197 See LBG's *Response to the CMA's provisional decision and consultation document on market investigation reference regarding PCAs and SME banking*, 17 September 2014, section 8 of Annex 1.

198 See LBG's 13 November 2013 response to question 19 of the OFT's request for information of 15 October 2013 and LBG's follow-up submission of June 2014.

ANNEX 1

Illustrative LBG PCA and SME banking product innovations

PCA	SME
Halifax Reward - Originally launched in February 2009 this account pays a £5 monthly reward to all customers who fund their account with £750, pay out two direct debits/standing orders during the month, and remain in credit. **Cashback Extras/Everyday Offers** - launched in September and October 2013, customers can now receive cash back rewards. The service (called Cashback Extras in Halifax, and Everyday Offers in Lloyds Bank and Bank of Scotland) gives customers cash back of up to 15% of the value of purchases with certain retailers, based on customers spending patterns on debit and credit cards **Club Lloyds** - a new current account proposition launched in March 2014 that offers customers variable, tiered credit interest on their balances of up to 4% (capped at £5,000), a fee and interest free overdraft, rewards and exclusive access to improved offers on other products – currently savings, mortgages and certain credit cards, loans and insurance products, a choice of non-banking benefits (either six cinema tickets, membership of the gourmet society, or a magazine subscription). The account is free provided customers pay in at least £1,500 per month, otherwise a £5 monthly fee applies. **It's on us** - Lloyds Bank and Bank of Scotland customers can participate in 'It's On Us'. Launched in January 2014, Each week the purchases of selected customers who have signed up for the 'It's On Us' offer will be selected at random and have one of their debit or credit card transactions reimbursed in full, up to the value of £500. The 'It's On Us' offer will be presented in a customer's Everyday Offers homepage within online banking and can be activated by simply clicking on the offer. Money is paid back at the end of the following month and will be included in a customer's monthly cash back balance. **Initiatives to help meet the needs of the social banking segment** - LBG is seeking to make products and services more accessible to the social banking segment through the following initiatives: • provision of full, free Link ATM access (this was rolled out during 2014); • ability to open BBAs in branch; • BBA customer enquiries and cash transactions to be serviced at the counter in Halifax (Lloyds customers are already able to do this) **Making international payment simpler** - using customer insight and market analysis, LBG changed its international payments pricing structure to ensure it is simple, fair and consistent across channels". **Improving travel money exchange rates** so customers get better value for money when buying or selling foreign currency in all channels.	**Monthly price plan:** LBG has introduced a monthly price plan ("MPP"), whereby SME customers can choose from a range of fixed monthly fees, allowing a certain level of transactions within the set price, and a "pre-transaction" fee structure above that level. **Fee free switching for BCAs:** After an initial pilot, LBG's SME banking unit launched a fee free switching campaign for SMEs in December 2014. LBG is offering six months of free day-to-day banking (i.e. waiving money transmission fees on cheques, standing orders, cash, direct debits, deposits and withdrawals) and waiving lending arrangement and security fees associated with new term loans and overdrafts. **Free banking offer for BCAs:** LBG offers free day-to-day business banking for 18 months for start-ups and 6 months for switchers. **Funding for Lending Scheme:** Since the introduction of the Government's Funding for Lending Scheme ("FLS"), from October 2012, LBG has introduced a series of new FLS offers, with enhanced benefits for SME customers. While the focus of the initiative and the guidance issued has primarily been directed at attracting switchers, the offers have also been made available to all existing clients across all sectors. **Waived arrangement fee offers:** For new and existing business customers signing up for new term loans, LBG frequently provides special waived arrangement fee offers in addition to an interest rate discounts for the full term of the loan. **Loan discounts:** LBG ran a targeted campaign in Q4 2014 - Q1 2015, with new pricing discounts for lending deals of greater than £500,000, depending on the market sector in which the SME is active. These range from a maximum discount of 1.1% in the healthcare sector, to 1.7% in the property sector. **Simplified lending:** In July 2013 LBG launched a simple fixed rate loan product, which increased certainty through: • agreement on the fixed rate up to three months before drawdown; and • capping maximum break costs at the outset, by reference to a 1% fall in market rates below the fixed rate of the loan. **Cobweb:** A comprehensive online encyclopaedia and reference resource containing several thousand practical, factual and digestible reports, guides, factsheets and reference resources to help business owners develop their own business. The Cobwebb tool is in the process of being enhanced and upgraded to meet RBB customers' needs.

ANNEX 2

Illustrative LBG initiatives aimed at enhancing engagement

PCA	SME BANKING
MONEY MANAGEMENT TOOLS	
Push Alerts: LBG is developing new Push Alerts capability within its mobile banking app which will provide customers with easier access to an expanded range of alerts (beginning with those currently offered via text message, and expanding this over the coming two years); **Mobile App:** More generally, LBG's free mobile app enables customers to review their transactions to avoid going into their unplanned overdraft; **Balance Extra:** An innovative new service which will help Halifax Reward Current Account and Ultimate Reward Current Account customers to manage their money better by providing an estimate of the money they have left to spend once their pending payments, standing orders, direct debits and account fees before their next payday have been taken into account. This will give customers an early warning if upcoming payments are going to push them into overdraft. Whilst LBG believes that Atom and Starling may be developing similar services, LBG was the first to introduce this to the PCA UK market on 2 September 2015, and already has 4,000 users. LBG expects this figure to grow significantly in the near future, as c.550,000 Halifax customers are currently eligible.	[**Confidential**] **Improvements to the mobile app** to align desktop and mobile functionality and deliver a more consistent customer experience across all devices. **Payments:** Improvements to allow payments to be made to existing beneficiaries using a password providing a quicker and simpler payments process. **Fixed term deposits:** Improvement to [Confidential]. **Business ToolBox**: An online portal that gives business customers access to a range of tools to help entrepreneurs start, manage and grow their businesses. The ToolBox adds value to LBG customer's existing products by offering unrestricted access to nine online management tools covering day-today activities like accounting, receipt management, website development, online data backup and credit checking.[199]
TRANSPARENCY INITIATIVES	
Halifax credit checker: This is an online tool that gives customers access to their credit report, credit score and advice on how to improve that score. **Enhanced overdraft transparency and customer information:** These include: • the launch of an online overdraft calculator for Halifax customers to help them understand how much their overdraft fees may be. Lloyds Bank has already implemented the overdraft calculator; • highlighting in annual summary statements where other forms of borrowing may be more suitable for customers; and • piloting communications in 2015 to customers who are at risk of incurring unplanned fees to inform them if they may be eligible for a larger planned overdraft limit to help them avoid unplanned fees.	[**Confidential**] **Lending product simplification:** [Confidential]. **Online Monthly PricePlan Calculator** which is used for BCAs and calculates the PricePlan tariff which is most suitable for a given customer's needs based on estimated transaction volumes and cash paid in, withdrawn and exchanged over the counter. **The Tariff Calculator** which is used for BCAs and provides SMEs with a detailed comparison of the banking rates which would be applicable under each of LBG's tariff schemes. **The Loan Calculator** which generates an indicative cost of a loan at a selected interest rate based on its amount and term. A projection of the monthly repayments and the total repayable amount is also provided. **The Finance Selector** which identifies products likely to match customers' specific financing needs. The Finance Selector gathers information on the customers' specific borrowing needs by reference to term, purpose and size and summarises all suitable forms of finance. The Finance Selector is designed to increase awareness of alternative types of financing, such as invoice financing and asset finance, so that SMEs do not restrict themselves to traditional forms of financing, such as loans and overdraft facilities, which are not always the cheapest solution.

199 See https://toolbox.lloydsbank.com/marketing.

PCA	**SME BANKING**
MEASURES WHICH PROMOTE SWITCHING	
Halifax: LBG continually seeks to refine the switching proposition for Halifax, for example: • In 2014 LBG offered selected Halifax customers an enhanced switching incentive of £200. • A Halifax scheme (called Making Switcher Overdrafts Extra Easy) was introduced in March 2015 designed to overcome a lack of comparability in overdraft offers due to a lack of credit history for new to bank customers. **Further promotion of CASS.** **Improvements to the application journey:** Optimising the journey for all devices, tailoring it to the customer's specific needs, and minimising the effort a customer needs to put in to complete the form. Includes enabling customers to open a joint account online. **Photo eID&V:** Failed or referred identification and verification checks are a major driver of customers dropping out from online PCA applications because referral to a branch or postal application is a poor experience for online customers. The digital transformation programme includes [Confidential] a project to allow customers to submit identification documents online or via a smartphone with the aim of minimising customers that drop out from online PCA applications because of a referral to a branch. **AVA journeys:** Allowing customers to up- or down-grade to the target PCA of their choice.	**[Confidential]** **An enhanced switching lending proposition:** Lending fees (arrangement, security, valuation and/or legal) can be waived for existing customers and non-bank customers switching lending from a competitor. **Fee-free lending for switchers** (for six months). **Exit fees:** In order LBG does not charge exit fees to any of the reference products. It instead applies a break costs/gains for certain fixed rate loans to ensure both that the repaying borrower is not penalised, and that LBG is not placed in a worse financial position by the early repayment.[200] **Streamlined lending application and affordability assessment** for new lending application up to £25,000. Further promotion of CASS (through all RBB channels and aggregator websites).

200 See LBG, *Response to the SME Market Questionnaire*, 23 January 2015, question 15.

ANNEX 3

Response to the CMA's Small and Medium Enterprise Customer Research into the Retail Banking Market

1. OPENING REMARKS

1.1 LBG welcomes the further insight provided by the qualitative survey (entitled "Small and Medium Enterprise Customer Research into the Retail Banking Market, Qualitative Research Report", July 2015) into how SME customers behave and think across a range of issues relevant for the CMA's investigation ("**SME Qualitative Research**"). Many of the findings in the SME Qualitative Research are consistent with LBG's own qualitative research, which has been shared with the CMA previously. These include:

(a) the end of free banking period was identified as a potential time for switching;

(b) critical growth points, driven by size or type of transactions, or a requirement for new facilities, were potential points at which established businesses might consider switching BCA provider; and

(c) overdrafts are seen as a way of contending with cash-flow issues. Awareness of how overdrafts worked is generally lower for those who had little cause to use their overdrafts.

1.2 The findings support LBG's observation that, particularly for smaller SMEs, more could be done to improve engagement in the market. The findings may be relevant for the CMA's Theory of Harm 1 analysis, where findings may be helpful for providing stimuli for market-wide trials.

1.3 Importantly, the CMA report itself recognises that the findings have "no statistical validity or reliability" and "no quantitative accuracy in terms of identifying proportions of populations holding stated views".[201] Accordingly, descriptions such as "some", "most", "many", "a number", "a selection" etc., which attempt to quantify the magnitude of responses, have no statistical validity, and therefore such generalised findings should not be made.[202] The purpose of qualitative research of this nature is to give indications of the drivers underlying behaviour and attitudes, by exploring responses in greater detail and depth, but no extrapolation can be made as to the behaviour and attitudes for the market as whole.

1.4 Therefore, while the SME Qualitative Research findings can be helpful in providing ideas and other stimuli for diagnosing potential issues in the market (and for considering remedies if appropriate), any findings will need to be tested against the relevant customer data and trialled to check whether they are relevant for the generality of SME customers.

2. SPECIFIC CAVEATS TO THE RESEARCH

2.1 While the SME Qualitative Research findings are a useful input for the CMA's work, they should be complemented with other sources of data (for example, checked against the extensive customer data requested from the parties), and findings from other sources of customer research (such as the quantitative survey, and other research submitted by LBG and other parties).

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201 *SME Qualitative Research*, section 2.3.

202 To the extent that the CMA were to rely on such statements in its Provisional Findings report, LBG would request access to the underlying data set.

2.2 LBG refers to the note by Frontier Economics submitted to the CMA.[203] In this note, Frontier Economics outlines the ways in which traditional market research may not be effective at delivering insights into why consumers have acted in the way they have. The less conscious and considered thinking is, the less effective market research methods will be; and customers of retail banking markets frequently exhibit the use of unconscious and heuristic processes in making decisions. LBG emphasises the importance of complementing traditional research methods such as this customer survey with a broader set of tools, such as field trials, laboratory experiments and other testing.

2.3 In addition, LBG observes that the pre-interview task for the SME Qualitative Research contains some negative priming, which may influence the results of the survey. For example, participants were asked to "*consider and note down ways in which [their] current banking and product set up might be improved*" and were asked to consider what "*might prompt [them] to consider switching banks, or negotiating elements of [their] banking arrangements*".[204] LBG believes that this task may have primed participants to think negatively about their banking arrangements, and consequently influenced the findings of the research.

2.4 Moreover, as mentioned above, the nature of qualitative surveys means that it cannot be used to provide any robust or statistically reliable results, which is acknowledged on page 5 of the report itself. Whilst the report has avoided referring to the magnitude of specific responses (for example, in percentages), it has referred to descriptions such as "some", "most", "many", "a number", "a selection" etc.,[205] which appears to be an attempt at quantifying responses without providing any explanation as to what these terms mean. The nature of the qualitative survey means that no statistical validity applies to such quantifications, whether on the basis of specific metrics or using the broader terminology used in the report, and therefore such generalised findings should be avoided.

2.5 The issues over the statistical validity of the results are even more relevant where the report has sought to make comparisons between the different sized categories of SMEs (for example, in section 4.1 of the SME Qualitative Research) as the sample is limited to just 16 customers interviewed within each category. Such comparisons are likely to be wholly unreliable.

Points to note from the SME Qualitative Research

2.6 Notwithstanding the limited value of the SME Qualitative Research results as a standalone set of data, as explained above, the findings can be helpful in providing ideas and other stimuli for diagnosing potential issues in the market, provided that are tested and trialled. In this regard, LBG makes a number of illustrative observations from the SME Qualitative Research results.

Switching

2.7 It is evident from the survey that a number of triggers for switching BCA accounts were identified by respondents, as would be expected in a competitive market. These include:

(a) the end of free banking;

(b) loan applications rejected;

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203 Frontier Economics, "How behavioural economics can improve customer research in retail banking markets", 26 November 2014.

204 See *SME Qualitative Research*, Annex F.

205 For example: (a) "there was little evidence of an appetite to switch"; (b) "many of our SME sample preferred to have all their product holding with a single provider"; (c) "for some, a perception that banks were 'all the same'"; (d) "few felt able to make comparisons between providers"; (e) "there was a lack of awareness across the SME sample".

(c) the providers not being perceived to be supporting businesses;

(d) free banking or lower charges elsewhere;

(e) extended opening hours elsewhere; and

(f) promises of support from relationship managers elsewhere.

2.8 The identification of these factors suggests that, if there is a material deterioration in service, SME customers may be prepared to switch, which should be explored further by the CMA.

2.9 A perception that existing banking arrangements were working well was also identified as a reason for not switching.

2.10 Accordingly, to the extent that the CMA simply observes low levels of switching by SME customers (as mentioned in the CMA's UIS), it needs to be clear in distinguishing between customers that are satisfied and well-served by their existing provider (and therefore would not be expected to switch) from customers that have faced a material deterioration in service, and therefore may be more likely to switch.

Multi-product holding

2.11 The SME Qualitative Research observes that "*many of our SME Sample preferred to have all their product holding with a single provider*". However, as the survey does not provide any robust or statistically reliable results, such a generalisation cannot be made to the SME market as a whole. The evidence needed to support this statement would have to include a wider range of products than those in the reference markets. LBG would encourage the CMA to cross-check this statement with the actual customer data.

Negotiations and the role of advisors

2.12 The SME Qualitative Research identifies negotiations between SMEs and their providers as being a feature of the market (including in relation to loan applications). A relevant factor for the CMA to consider therefore is the extent to which SME customers are able to negotiate better terms and discounts with their existing provider without physically switching provider. Clearly, focusing solely on the levels of switching will fail to recognise this competitive dynamic, which is reflective of competition working effectively.

2.13 The role of specialist advisors (such as accountants) is also identified by the SME Qualitative Research as being a factor that influences SMEs choice of provider. As advisers/accountants will typically advise a number of different clients, they will generally have visibility of the charges of (and possible relationships with) a number of different providers. This means that, whilst some SMEs may not be fully aware or engaged with the banking process, their advisers are engaged in the process and therefore able to pass on that knowledge to their clients.

3. MAKING USE OF THE OUTPUTS

3.1 LBG believes the SME Qualitative Research findings may be helpful in providing stimuli for ideas for market-wide trials. A number of illustrative potential trials are set out below. In LBG's view, the findings of the SME Qualitative Research are not robust, and cannot be generalised to the wider population of SMEs. For this reason, any practical implementation of these ideas would need to rely on evidence other than the qualitative research to conclude there was an issue in the market to be addressed. The trials noted would need to be tested as part of a wider set of trial ideas.

(a) **providing greater confidence in CASS**. The findings in the SME customer research suggest that SME customers assume that they themselves "*would need to* *sort out any problems with payments if anything were to go wrong*". The advisor sample "*reported that they tended to advise against established businesses switching providers (although comparisons may have been at the start up stage). This was due to a fear of potential problems*."[206]

These findings suggest that a potential commitment might be changes to CASS marketing or other messaging around this issue – directed at both SME businesses and their advisors including the degree to which the provider takes responsibility for any payment issues and the low level of problems experienced by those in switch in practice;

(b) **providing quality metrics across providers**. The SME Qualitative Research also suggests that quality across providers was difficult to compare. "*Quality was often perceived as something that was difficult to measure unless through local word-of-mouth recommendations, from a trustworthy source*."[207]

These findings suggest a potential commitment might be to enhance and promote consistent and publicly available quality metrics across all providers for SME banking; and

(c) **improving awareness of comparison sites**. The SME Qualitative Research suggests that comparison websites were welcomed by respondents. "*Typically, respondents envisaged using comparison sites either to form a short-list of providers by focussing on their main choice criteria or, in the case of Business Banking Insight, as a final check in the choice process*."[208] "*A number of respondents said that they would now be comparing different banking offers*."[209]

These findings suggest that a potential commitment might be to improve the marketing of different independent comparison sites.

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206 See *SME Qualitative Research*, Paragraph 4.6.3.

207 See *SME Qualitative Research*, Paragraph 4.4.5.

208 See *SME Qualitative Research*, Paragraph 4.4.7.

209 See *SME Qualitative Research*, Paragraph 4.4.6.