LLOYDS BANKING GROUP

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CMA RETAIL BANKING MARKET INVESTIGATION

Response to Nationwide's comments on LBG's PCA pricing analysis

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1. This note is a response to Nationwide's comments, published by the CMA on 4 March 2016,[1] on LBG's pricing paper of 18 January 2016.[2]

2. LBG welcomes Nationwide's comments. In its submission to the CMA, LBG outlined three steps the CMA should follow to improve its pricing analysis: (1) using the right data; (2) comparing the right prices; and (3) comparing like-with like. LBG believes that it is in agreement with Nationwide on step one and step three.

3. LBG would be willing to provide further details of its approach to Nationwide, as it did to the CMA. Indeed, LBG encourages Nationwide and other providers to test LBG's assumptions and approach on a sample of their own customers using disaggregate transaction-level data ("transaction data") by providing this to Runpath to process through its pricing algorithm.

Nationwide and LBG are in agreement on many factors

4. LBG has said to the CMA that it should use transaction data, rather than aggregated monthly data to avoid making a number of unnecessary assumptions which compromise the accuracy of its analysis. LBG notes that **Nationwide also supports this approach**, "using transaction data instead of aggregated monthly data should allow prices to be calculated more accurately". Nationwide also recognised the benefit of comparing providers by customer segments, rather than overall averages.

5. Nationwide questioned whether the sample of LBG's customers in LBG's analysis is representative of the whole market. LBG used a sample of its own customers as it does not have access to the customer data of other providers. **LBG agrees that it is important to verify this assumption and has encouraged the CMA to do so**. The CMA is best placed to test this assumption using transaction data from providers across the market.

6. LBG also agrees with Nationwide that it is **important for all recent price changes in the market to be reflected.** LBG's analysis includes the increase in the price of Santander 123 by £3 per month which has a material impact on Santander's price. Other price changes, such as Barclays Blue were also included. However, given time constraints the analysis was not able to reflect the price cuts (via an increased cashback offering) to RBS Reward or Co-operative Bank's Everyday rewards. Directionally at least, reflecting these recent price changes would lower the estimated prices for RBS and Co-operative Bank. The CMA is well placed to reflect these recent price changes in its updated pricing analysis and to assess the materiality of them.

7. LBG also agrees that quality of service and other account benefits (such as travel insurance and lifestyle benefits) form an important part of a customer's decision on provider, in addition to prices. An assessment of quality and account benefits can be used, in part, to explain

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[1] Nationwide's comments on Lloyds Banking Group's response to the CMA's PCA pricing analysis, 4 March 2016 (https://assets.digital.cabinet-office.gov.uk/media/56d963f340f0b60379000007/Nationwide_comments_on_LBG_s_response_to_the_PCA_pricing_analysis.pdf).

[2] LBG Verification of CMA's pricing analysis and results from an alternative approach, 18 January 2016 (https://assets.digital.cabinet-office.gov.uk/media/56b48f6d40f0b617db00000a/LBG_Verification_of_CMA_pricing_analysis.pdf).

differences in prices between providers. However LBG has encouraged the CMA to keep its estimates of account benefits separate from pricing. This is because account benefits are hard to value correctly. In particular, the correct valuation should depend on how many customers actually utilise account benefits, which is hard to estimate. The CMA has implied it is currently attempting to improve its valuation of account benefits to ensure all benefits are treated consistently across providers; it previously valued some benefits offered by some products but not others. If account benefits are not valued correctly and on a consistent basis then the CMA's analysis may be distorted in favour of some products.

LBG believes that a "most likely comparator" approach is more realistic than an "existing mix" approach

8. LBG used the most likely comparator approach to estimate prices for providers with multiple accounts. The most likely comparator approach assumes a customer is likely to choose the most appropriate product for them (i.e. based on the lowest cost or best value account). In contrast, Nationwide believes the CMA's existing mix approach is more appropriate, which assumes that a customer selects a product on the basis of a provider's historical mix of existing products.

9. LBG believes that the correct approach depends on what question is asked:

   (a) **If the question is about what customers currently pay** then the existing mix approach could be used to answer this. But if this approach is used, it is important to include a provider's full mix of products, including basic and packaged accounts, to get a complete view on what their customers are currently paying. However, a **better approach would be to use the average gains from switching** for each provider. This would tell you simply what each customer pays relative to what they could pay elsewhere given their pattern of usage and current product choice. Understanding which customers are currently paying potentially more than they could do with their existing provider is important. The CMA's provisional findings suggest that this is particularly the case for some heavy overdraft users. Where this is the case, the CMA's proposed remedies will help improve customer engagement and remove perceived barriers to switching.

   (b) **If the question is about what prices providers offer then the "most likely comparator" approach should be used.** This approach is consistent with:

      (i) how the CMA have calculated average BCA prices;

      (ii) the inclusion of switching incentives within the CMA's price estimates. These incentives would not be included if the analysis was attempting to understand what customers currently pay; and

      (iii) including new products and recent price changes in the analysis. These new products would not need to be included in an 'existing mix' approach.

10. LBG believes that the CMA is trying to answer the latter question about what prices providers currently offer in the market through its pricing analysis. This gives a current view of the market and **therefore tells you more about how competition in the market is working now.** In contrast, the question about what customers currently pay gives a backwards looking view of the market as there is a lag between providers making new, better offers and customers choosing to take these up. **Therefore, the CMA should address the question of**

what prices providers currently offer in the market, and as such use the most likely comparator approach in its revised pricing analysis.