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LLOYDS BANKING GROUP PLC

CMA RETAIL BANKING MARKET INVESTIGATION

Response to the CMA's update on personal current account pricing

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1. The CMA is coming to the end of its detailed and thorough investigation into personal and business current accounts. The CMA has correctly identified the Adverse Effect on Competition ("AEC") in the reference markets – a lack of customer engagement – and has proposed a comprehensive and effective package of remedies. The cumulative effect of these remedies, once implemented, will make it easier for all current account customers to benefit from the increasing choice on offer from new providers and new product launches. The remedies will also tackle the long standing issues faced by customers who use overdrafts and will make it easier for them to shop around and switch.

2. Unlike previous investigations, the CMA has attempted to understand in detail the key features of the competitive process, and has resisted calls for media-friendly, yet ineffective solutions, such as "breaking up the banks" or "banning free-if-in-credit" banking.

3. As part of its competition assessment, the CMA has invested considerable time trying to analyse Personal Current Account ("PCA") prices and estimate the potential customer gains from switching. Unlike previous investigations, which used a small number of "representative customer profiles", the CMA's PCA pricing analysis[1] uses a large sample of actual customer data and attempts to calculate prices for each of these customers for every PCA product in the market.

4. The CMA's approach provides an opportunity to develop a more accurate and robust assessment of PCA pricing than has been undertaken in previous investigations. This would correct for some of the obvious flaws in the analyses and conclusions previously drawn. Unfortunately, the **CMA's estimates of PCA pricing are wrong, not robust and contain material inaccuracies**. **LBG has engaged constructively with the CMA throughout the investigation** to try and avoid this outcome and help the CMA develop an accurate and robust pricing analysis. LBG has made a number of detailed submissions since the beginning of the inquiry setting out what data the CMA should request and how to use Runpath's pricing algorithm to calculate prices accurately using large samples of real customer PCA data. LBG has also submitted detailed responses to the CMA's working papers and carried out its own analysis using its own customer data.

5. **The CMA did not adopt most of these suggestions**. Given the impending statutory deadline for the inquiry it is unlikely that the CMA has the time to correct the analysis to address these errors, and consult with interested parties on any revised analysis. LBG remains willing to work with the CMA to try and produce a more robust analysis in the remaining time available until the final report is published.

6. **If the CMA is not able to correct its analysis in the remaining time then it cannot present its pricing estimates in its final report.** The CMA's model significantly overestimates the average prices charged by LBG and its three main brands. The CMA overestimates the price of:

    (a) LBG by almost **£[Confidential] per month**, or [40-60%];

    (b) Lloyds Bank by almost **£[Confidential] per month,** or nearly [70-90%];

    (c) Bank of Scotland by over **£[Confidential]per month**, or over [30-50%]; and

    (d) Halifax by [Confidential] per month, or almost [5-25%]. However, the relative accuracy of this estimate appears to be a coincidence given the **CMA does not**

[1] CMA, *Update on personal current account pricing,* May 2016 (the "Working Paper")

include the £5 reward for any Halifax Reward Account customers and applies returned item fees despite the relevant Halifax products not charging them.

7. Given the inaccuracy of its pricing estimates, the CMA does not have the evidence to support the findings set out in the working paper of a relationship between price and market share or of the expected relationship between price and quality.

The CMA’s pricing analysis is not robust

8. The CMA’s analysis is based on a complex model which relies on large volumes of price information data, a number of assumptions, and complex customer-specific calculations. Some of this complexity could have been avoided if the CMA has chosen to use disaggregated customer transaction data (“disaggregate data”) as LBG suggested.

9. When working with complex “black box” models like the one used by the CMA it is standard practice to perform sense checks of the model's outputs to make sure that the logic and calculations are correct, and that the model is robust and provides a reasonable representation of the pricing it is seeking to model. There is **clear evidence that the CMA’s model fails these basic sense checks** and therefore is not robust or producing accurate and reliable results in its current form.

10. Examples include:

    (a) the CMA’s **estimates of prices are materially different from what customers actually pay** on a like-for like-basis for Lloyds Bank and Bank of Scotland, and LBG as a whole;

    (b) the **CMA estimates that some products are more expensive than others** when simple analysis of the products’ tariff structures shows **this cannot be true** for any set of customer behaviour and usage;

    (c) the **CMA’s estimates for some products are simply incorrect**. For example, the CMA's analysis incorrectly assumes that the M&S Current Account pays customers almost £13 per month in shopping vouchers permanently. In reality, this only ever applied for the first 12 months after switching, and is no longer available to new customers. This error means this product is shown as the cheapest product in the market by a significant margin, and a key driver of a large proportion of the estimated switching gains.

11. LBG has been unable to determine the full extent of all the inaccuracies and errors in the CMA’s analysis. The most basic sense check of the model is to compare, by product and brand and on a like-for-like basis, the average revenue per active account with the average price calculated for by the CMA. LBG was able to do this for its own brands and this revealed significant errors. The CMA repeatedly refused LBG’s requests to disclose to its advisors, within the confidentiality ring, equivalent average revenue figures for other providers. Therefore, LBG was unable to analyse or speculate about whether the CMA’s model accurately calculates prices for other providers.

Implications for the CMA’s Final Report

12. As the CMA’s current analysis is not accurate or robust and does not reflect the actual prices paid by customers, its PCA price estimates are unreliable. Consequently:

    (a) the CMA should not present any of its PCA pricing analysis in the final report unless it is able to identify and correct all of these errors and consult on any revised analysis in the time available;

(b) the CMA cannot reach any conclusions on the relationship between price versus market share; and

(c) the CMA cannot reach any conclusions on price versus "quality".

13. The charts presented throughout this investigation that attempted to show these relationships have been shown to be incorrect. Presenting inaccurate and misleading conclusions would damage the overall credibility of the investigation, and would harm the interests of LBG and any other provider that was inaccurately labelled as having higher than average prices. It also risks distracting from the real concerns that the CMA has correctly identified and the remedies package that will address those concerns.

14. The analysis in the Working Paper is not required to support the CMA's provisional findings of AECs, nor is it required to justify the proportionality of its proposed remedies package. The CMA has robust evidence to demonstrate that switching rates are relatively low, particularly for overdraft customers. The CMA has also identified that many customers find it difficult to compare and switch PCAs.

15. These findings are sufficient to support the CMA's provisional findings on AECs and its proposed remedies package. There is no need to draw on a pricing analysis that is not robust.

16. Across the PCA market, customer engagement and switching is currently relatively low, particularly for overdraft customers. At the same time there are a number of new entrants in the market, with innovative and often lower-cost business models. The CMA's proposed remedies package will increase customer engagement, make it easier for customers to switch, and facilitate technological change and innovation. **This will collectively lead to increased competition across the PCA market resulting in lower prices and improved customer experience.** In particular, as overdraft users engage and switch more, competition on overdraft pricing will intensify, which will likely lead to a re-pricing across the market. This will result in a redistribution of benefits towards overdraft users.

17. Whilst it is challenging to quantify the magnitude of these benefits, **the CMA estimates dynamic benefits to be worth £100m to £300m per year,[2] which is substantially greater than the estimated cost of the remedies package, at £75m to £100m of mostly up-front costs**.[3] The CMA's proposed remedies are clearly proportionate as a package (subject to considering the incremental cost and benefit of each proposed remedy) even without accounting for any estimate of the gains from switching.

18. The examples that show the CMA's analysis is not robust are presented in more detail below.

The CMA's estimates do not accurately reflect what customers actually pay

19. The CMA states that, "our analysis seeks to estimate the prices that are currently paid by customers".[4] If this is the case, then the key test of the accuracy of its model is how closely its estimates are to actual average prices paid by customers in reality. A basic

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[2] "a reduction in charges, or increase in rewards to customers, of only 1 to 2%, would deliver customer benefits of between £100 million and £300 million per year across these three markets" (PDR, p.347)

[3] PDR, paragraph 9.142

[4] Working Paper, paragraph 27

sense-check, therefore, is to compare the CMA's estimates, on a like-for-like basis[5], to the average revenue per customer[6] at a product and brand level.

20. LBG has conducted this simple cross-check on the CMA's estimates of LBG prices. It shows that the CMA's model does not accurately estimate what customers actually pay in reality. For example, the CMA estimates that for standard and reward accounts:

    (a) the group price for **LBG** is £5.85[7] per month, which is **[40-60%] higher** than actual average revenue per customer of £[Confidential] per month;

    (b) the price of **Lloyds Bank** is £6.74[8] per month, which is almost **[70-90%] higher** than actual average revenue per customer of £[Confidential] per month;

    (c) the price of **Bank of Scotland** is £5.66 per month,[9] which **is [30-50%] higher** than actual average revenue per customer;

    (d) the price of **Lloyds Bank Classic Account** is £7.22 per month[10], which is **[50-70%] higher** than actual average revenue of [Confidential] per month;[11] and

    (e) the price of **Club Lloyds** is £5.85 per month[12] which is **more than double** actual average revenue per customer of [Confidential] per month.

21. LBG's model used disaggregate data, rather than the monthly data used by the CMA.[13] LBG conducted the same cross-check on its own price estimates for LBG and each of its brands. All of LBG's price estimates were within a 10-20% margin of actual average revenue per customer. Therefore on the key test of how closely the respective pricing analyses model observed average prices in reality, **LBG's model is materially closer to average revenues than the CMA's model**.

22. Unlike monthly data, disaggregate data does not require a number of unnecessary assumptions about customer behaviour. It is likely that these assumptions are one cause of the inaccuracies in the CMA's model. For example:

    (a) **Unarranged overdraft balance**. Many PCAs have <u>tiered daily charges</u> for using an unarranged overdraft, where the <u>fee charged depends on a customer's unarranged overdraft balance that day.</u> In particular, many PCAs have a fee-free buffer of £10.

        (i) LBG's model contains <u>daily data</u> for each customer showing when they went into their unarranged overdraft and <u>what their balance was</u>. This means that daily unarranged overdraft fees can be calculated accurately.

        (ii) In contrast, the CMA's model only contains the number of days a customer was in their unarranged overdraft each month but <u>no data on a customer's actual unarranged overdraft balance</u>. This means that daily unarranged overdraft fees are calculated based on an assumption of a customer's balance.

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5 When excluding revenue from credit balances and interchange. The CMA notes that, "prices should not be confused with the revenues that providers generate from credit balances and interchange", Working Paper, paragraph 18

6 Based on active accounts and excluding revenue from credit balances and interchange

7 Working Paper, Appendix 3, Table 9

8 Working Paper, Appendix 3, Table 6

9 Working Paper, Appendix 3, Table 6

10 Working Paper, Appendix 3, Table 12

11 This difference does not appear to be due to different customer mix in the CMA's analysis compared to Lloyds Bank Classic Account customers. The CMA's estimate is still over £7 when controlling for customer mix.

12 Working Paper, Appendix 3, Table 12

13 LBG, *Verification of CMA pricing analysis*, January 2016

(b) **Credit interest.** Many PCAs offer tiered credit interest on balances where the interest rate varies on a customer's balance each day. For example, Club Lloyds offers 1% AER on balances up to £1,000 but 4% AER on balances between £4,000 and £5,000.

(i) LBG's model contains daily data for each customer showing what their credit balance was each day. This means that LBG's model estimates credit interest accurately using a customer's balance each day.

(ii) The CMA's model contains average monthly data on a customer's credit balance. This means the CMA's model does not accurately calculate the correct amount of credit interest received, as this requires daily balance data.

23. The CMA recognises that, "using disaggregate transactions data would require fewer assumptions" [14] yet still dismisses LBG's approach on the basis that it still, "had limitations". [15] However, **LBG's sense-check clearly shows its approach is more accurate**, at least for LBG products.

24. LBG cannot be certain whether the CMA's estimated prices for other providers are also wrong. The CMA would not disclose to LBG's advisors the necessary information to test this, nor would it provide the results of the sense-check itself. However, given that LBG accounts for over 20% of the market and has a broad customer demographic, it seems reasonable to conclude that the problems will also apply to other providers.

25. The CMA should conduct this key sense-check and calculate the average revenue per customer for products and brands across the market, as LBG has done for its own products. This will show how accurately the CMA's model estimates the prices that customers actually pay across the market.

The CMA incorrectly estimates that some products are more expensive than others when this is not true in reality

26. The CMA estimates that some products are more expensive than others when a simple analysis of the products' tariff structures shows this cannot be true for any set of customer behaviour and usage. **In the time available LBG has identified two clear examples of this for LBG products.** It is probable that there are other examples of this in the CMA's estimates and that the problems with the CMA's analysis are more widespread than just for LBG products.

27. First, **the CMA estimates that the Halifax Reward Account is more expensive than the Halifax Current Account**. This cannot be correct as Halifax Reward has:

(a) the same overdraft prices;

(b) a larger fee-free overdraft buffer (£50 versus £10); and

(c) a £5 reward per month for any customer meeting the eligibility criteria.[16]

28. LBG would expect that Halifax Reward should be around [10-30%] cheaper than Halifax Current Account, based on analysis of average revenues. Investigation of the CMA's analysis by LBG indicates that this error is due to the CMA's model not including the £5 reward for any customers. This is a significant omission as the reward is a key attraction of

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14 Working Paper, p.4, para. 12
15 Working Paper, p.4, para. 13
16 A customer must pay in £750 per month, make two direct debits and stay in credit.

the Reward Account, and is paid to approximately two thirds of customers each month.[17] This raises questions about the robustness of the CMA's analysis. In particular, whether sufficient sense-checking has been conducted and whether there are similar errors for other products.

29. The CMA's analysis also assumes that some unarranged overdraft customers for both Halifax Current Account and Halifax Reward Account incur £2.50 per month in unpaid item fees. **This is despite these products not charging for unpaid items.**

30. Secondly, the CMA estimates that the price of the Classic Account for Lloyds Bank is £1.33, or 20%, higher than the price of the Classic Account for Bank of Scotland. **This is despite both products having exactly the same pricing structure**.[18] Investigation of the CMA's analysis by LBG indicates that this error is due to some customers being estimated to have materially higher unarranged overdraft charges for Lloyds Bank compared to Bank of Scotland in the CMA's model, despite the same overdraft usage. **This difference is over £100 per month for some customers.** The pricing schedules used by Runpath are identical for the two products, which means that there is an error in the model the CMA's analysis is based on.

The CMA's estimates suggest M&S Current Account pays customers almost £13 per month

31. The CMA's treatment of account benefits is not robust. LBG has previously recommended that the CMA should not use the face value of account benefits, and should maintain a clear separation between prices and account benefits to avoid the risk of misrepresenting prices.[19] The CMA's valuation of account benefits is incorrect and does not take account of:

    (a) **how the value of a benefit depends on whether customers use it**. For example, a customer with alternative travel insurance or who does not travel abroad does not receive any value from an account benefit offering travel insurance. The same applies for lifestyle benefits, such as cinema tickets and magazine subscriptions.

    (b) **varying quality in account benefits across the market**. For example, different levels of insurance coverage should be valued differently; and

    (c) **how the value of a benefit varies by the type of user**. For example, the cost of travel insurance for an older person is likely to be higher than for a younger person. Equally, the cost of a cinema ticket in Central London may be higher than in other parts of the country.

32. Unfortunately, the CMA has added the face-value of a number of benefits to its price estimates. Consequently, the CMA presents a number of misleading prices. **This is particularly prevalent for M&S Current Account**.

33. The CMA estimates that M&S Current Account is the cheapest product in the market with a price of -£12.92 per month, or in other words a net payment to customers of almost £13 per month. £12.50 of this value is due to the inclusion of account benefits in the form of M&S shopping vouchers. These shopping vouchers were a temporary offer for the first 12 months after a customer switched[20], and this offer is now no longer available to customers.

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17 Based on LBG's T3 data.

18 The CMA's analysis is based on the same customer sample so a different customer mix should not be an explanation for this difference.

19 LBG, *Response to Information Request on Account Benefits,* January 2016.

20 The offer gave £10 a month is M&S shopping vouchers for the first 12 months to spend in store for customers paying in at least £1,000 per month, in addition to a £100 voucher as a switching incentive. It is not clear to LBG how the CMA's £12.50 figure has been derived.

The CMA's analysis also applies this benefit incorrectly in two ways (in addition to the points above):

(a) the CMA assumes a customer receives these benefits for five years (i.e. a total payment to the customer of £775), rather than just the first 12 months; and

(b) the CMA does not take into account the requirement for customers to pay in £1,000 each month to be eligible for the shopping vouchers.

34. The M&S Current Account also offers a maximum £500 overdraft. Many customers included in the CMA's analysis have an arranged overdraft of more than £500 and are unlikely to switch to a product with a smaller overdraft limit. This comparison is not like-for-like for the customer, but the CMA does not take account of this in its analysis.

35. The brand price for M&S is also lower than the price for non-overdraft users.[21] This does not make sense given that the brand price also includes overdraft users. This suggests there is an issue with the CMA's approach to aggregating prices for M&S.

The CMA has not considered new entrant acquisition pricing

36. There are a number of reasons that could explain why a provider has significantly lower prices than its competitors. It may be because the low-price provider:

(a) **has a lower cost base than its competitors**. For example, if it had a modern, efficient IT system or a more cost-effective branch network (or no branch network);

(b) **has made a strategic error about expected revenues or cost.** This would not be sustainable in the long-term and the provider would likely have to either increase prices or exit the market;

(c) **is following an acquisition pricing strategy** whereby it charges promotional prices to gain new customers, before subsequently increasing its prices to a more sustainable level.

37. The CMA has not considered these factors in its analysis,[22] or the implications this would have for its conclusions about PCA pricing. The CMA should conduct this additional analysis to determine whether the pricing of the cheapest PCAs are sustainable.

38. There are recent examples in the PCA market which are consistent with an acquisition pricing strategy or strategic errors. For example:

(a) Santander recently increased the account fee for Santander 123 by £3 per month. Prior to this, Santander was the fastest growing PCA provider in the market;

(b) M&S recently ended its temporary Current Account offer of giving customers £10 per month in shopping vouchers.

39. Other relatively new entrants – Tesco Bank, the Post Office and Metro Bank – have some of the lowest estimated prices in the CMA's analysis. It is possible that these providers have also adopted acquisition pricing strategies and may subsequently re-price in the future, or have made strategic errors and have overestimated their revenues or underestimated their costs.

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[21] See Table 6 in Appendix 3 of the Working Paper. The brand price should be between the price for non-overdraft users and overdraft users respectively. This is the case of all brands except for M&S. It is also the case of the product prices for M&S which suggests it is likely due to the CMA's approach to aggregation.

[22] Based on the analysis presented in the Working Paper.

40. The CMA needs to address these issues if it seeks to rely on any cross-provider comparison of pricing and potential gains from switching over a five year time horizon. The CMA needs to satisfy itself that any relatively low prices are sustainable.

The CMA should take a different approach to calculating averages for each brand

41. When a brand has multiple products, any estimate of average price across for that brand needs to weight the cost of each of these products. LBG suggested to the CMA that it should use a 'most likely comparator' approach. This means that the estimate assumes that each customer in the sample holds the product that they would be most likely to switch to. This approach produces the average price of products that customers would choose from each brand in the market.

42. The CMA used a different approach because it wanted to calculate prices that are "currently paid" by customers. Its approach requires a complex weighting adjustment to estimate average prices, which may be a cause of some of the unintuitive results described above. The CMA's inclusion of switching benefits (only available to new customers) and monthly fees (that are waived for nearly all customers that actually hold a product) are also inconsistent with what is "currently paid".

43. The CMA should not try to calculate average prices in this way, as there are better and simpler alternatives to answer the question of what is "currently paid". Using either a simple average revenue by brand, or calculating the average *relative* price for each brands' customers will answer this question and avoid the problems in the CMA's approach.[23]

The CMA overestimates the gains from switching

44. The errors in the CMA's analysis also apply to its estimates of gains from switching. The CMA's analysis significantly overstates the gains from switching, in part due to its inclusion of account benefits. Despite total UK PCA revenues of £8.7bn in 2014[24], the CMA estimates that the aggregate annual gains from switching are £7.1bn.[25] Switching gains of this magnitude are clearly implausible. For standard and reward accounts, this breaks down to an average gain of £9.69 per month for each customer in GB.[26] **Over one third of this gain is due to the inclusion of M&S shopping vouchers.**

45. The CMA's valuation of account benefits is incorrect. If all account benefits are removed, including Nationwide travel insurance and Club Lloyds lifestyle benefits, **average gains from switching almost halve to £5.40 per month**. If the other errors in the CMA's analysis were corrected, these estimated gains would be likely to fall further.

46. Despite the flaws in its analysis, the CMA rightly identifies that many customers could make financial gains from switching PCA provider. In particular, the heaviest unarranged overdraft users often have the most to gain from switching, yet are the least likely to switch. LBG's analysis of its own customers found that around 15% of customers have the potential to gain £10 or more per month by switching PCA.[27] The CMA's estimates excluding account benefits show that a similar proportion of customers could gain £10 or more per month.

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23 The average relative price shows the average difference in price for each brand's customers comparing what they currently pay with the lowest cost alternative, and is equivalent to Table 13 of the Working Paper.

24 PDR, p.347

25 Working Paper, Table 10

26 Working Paper, Table 9

27 LBG, *Verification of CMA pricing analysis*, Jan 2016