

The Rt Hon George Osborne MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
SW1A 2HQ

11 September 2013

Dear Chancellor

I am writing to provide you with advice, as requested, concerning the impact on competition of the divestments by Royal Bank of Scotland plc (RBS) and Lloyds Banking Group plc (LBG) required by the European Commission under EU State aid rules.¹ The RBS and LBG divestments are referred to as Rainbow and Verde respectively (together, the divestments). You have requested advice on the impact of the divestments on competition in retail and small and medium sized business (SME) banking in the United Kingdom (UK) and whether anything can be done to strengthen competition through enhancing the divestments.²

This advice was requested in the context that the deadlines set by the European Commission for achieving these divestments will not be met, and that the UK may need to agree to a modified package of State aid commitments. Our recommendations are limited, given this context, to an assessment of the divestments as they currently stand and those enhancements which can be achieved through the existing EU State aid process. The OFT's Board discussed the substance of this advice at its meeting last Thursday.

Approach

We focus our analysis on the impact of the divestments on *competition* only in retail and SME banking in the UK, as requested. We do not address in our advice the viability (prudential and risk concerns) or authorisation requirements which are overseen by the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) respectively. We have, within the time available and subject to information disclosure gateway constraints, had limited discussions with the PRA and FCA in relation to these considerations. We have also discussed the State aid commitments with the European Commission.

¹ State aid No N 422/2009¹ and N 621/2009 - United Kingdom Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme and State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group

² The advice is provided under section 7 of the Enterprise Act 2002.



Our advice assumes that the divestments will not initially be acquired by or receive significant investment from a purchaser with a significant existing presence in UK retail and SME banking markets. In other words, the advice is in respect of the divestments on a stand-alone basis. It is also without prejudice to any future assessment, under the Enterprise Act 2002, of UK retail and SME banking markets or any merger control assessment concerning the divestments³ or other banks by the OFT or Competition and Markets Authority (CMA).

We have relied, to a great extent, on information supplied to us by RBS and LBG and the management teams of Rainbow and Verde together with evidence supplied by other major and smaller UK banks. We have also, in order to adopt a fair and transparent process, shared aspects of our analysis and assessment with RBS and LBG and given them a limited opportunity to respond.

Context and guiding principles

There has been widespread previous work pointing to competition concerns in the retail banking market, both for personal customers and small business customers.⁴ We have, to a large extent, used relevant previous analytical frameworks and conclusions to inform our advice, given the tight timetable for providing this advice.

Previous assessments of competition in retail banking have typically concluded that *personal current accounts* (PCA) and *business current accounts* (BCA) are important 'gateway' products for banks to provide customers with a range of services. We consider that these remain important products and, in any event, these products are an appropriate framework of analysis for this advice since the conditions which need to be met for EU State aid approval are, in part, based around the divestments reaching certain [] and [].

³ For example, if the divestments were at some time in the future to be acquired by, or merged with, another entity.

⁴ *Changing banking for good, Report of the Parliamentary Commission on Banking Standards*, June 2013; *Review of the personal current account market*, OFT, January 2013; *Independent Commission on Banking*, Final Report, September 2011; *Review of barriers to entry, expansion and exit in retail banking*, OFT, November 2010; *Personal current accounts in the UK: An OFT market study*, OFT, July 2008; *SME Banking: Review of undertakings: Confidential advice to the Competition Commission*, OFT, January 2007; *The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK*, Competition Commission, March, 2002.

We note that the OFT has a programme of work in retail banking and sees the sector as crucial for the efficient functioning of the UK economy and to ensuring that consumers thrive and businesses can grow. The OFT (and other competition assessments by the Independent Commission on Banking (ICB) and the Competition Commission) have found significant concerns in these markets such as high market concentration, low transparency of fees and charges, low levels of switching (customer inertia), and high barriers to entry, including in the operation of payment systems. All of these factors serve to hamper effective competition in this sector.

Our work in this area is ongoing with our recently launched market study into SME banking due to report in early 2014. The work programme is designed to achieve a more competitive and consumer focussed retail banking sector. It will also help inform the OFT's response to the ICB's recommendation that the OFT, or the CMA as its successor, consider making a market investigation reference by 2015 if sufficient improvements in the market have not been made by that time.⁵ The OFT is working towards ensuring the CMA is in a position to make such an assessment within this timeframe. It is important to recognise that divestments from two individual banks, even large ones, cannot address or mitigate all of these concerns. We also recognise that there are several other developments taking place in the market aimed at addressing some of these concerns, for example initiatives aimed at facilitating switching (seven day switching service) and the transparency of product information.⁶

The divestments under consideration were originally conceived by the European Commission to remedy the distortion to competition as a result of the State aid received by the two banks. The extent to which they can be varied is likely to be limited, particularly given that the European Commission will be required to act reasonably and proportionately. **Accordingly, we have limited our recommendations to those options that we believe are likely to be broadly consistent with steps that the European Commission could consider appropriate in the current circumstances and which are consistent with the key objectives set out in the State aid decision.**

⁵ *Independent Commission on Banking, Final Report*, September 2011, paragraph 6.21.

⁶In order to address some concerns regarding transparency arising from the OFT's 2008 PCA Market Study, the banking industry agreed to take some steps to improve transparency through the publication of illustrative charging scenarios on banks' websites, the introduction of annual summaries and increased information on monthly statements..

We have not carried out a detailed cost-benefit assessment for our recommendations in the time available. However, we have taken into account, where possible, the possible costs resulting from each recommendation to the extent that they may therefore be regarded as unreasonable or disproportionate by the European Commission.

Finally, it should be noted that divestments of this scale in the retail and SME banking markets are relatively untested in terms of their impact. We note, in particular, that their effectiveness will depend on levels of customer attrition from the divestments and the success with which they are separated from their parent banks.

Market definition

In its assessments of competition, it is usual for the OFT to define a 'relevant market'. This is the arena within which competition takes place and within which any impact on competition (of a merger, cartel or other business activity, for example) is assessed. This is the approach we follow here. Given the time available, we have defined a relevant market by reference to how we have done so in our previous banking work. From a product market perspective, we have therefore assessed the impact on competition of the divestments in the supply of PCAs, BCAs and SME lending⁷ separately. We have not looked in detail at other banking products, loans, mortgages and savings.⁸ From a geographic perspective, we note that many parameters of competition, such as price, are set at the national level. However, an exclusive focus on the competition impact at the national level would omit important aspects of competition – in particular the branch network and provision of local banking services to customers and businesses – and key determinants of the success of the divestments as new independent competitors. We also observe that the geographic presence, and therefore likely impact, of the divestments is not evenly spread across regions in the UK. We have therefore considered the impact of the divestments at each of the national, regional and local level.

Market structure

We considered whether the divestments would have an impact on the overall structure of retail and SME banking in the UK. Consistent with previous

⁷ SME lending was assessed to a limited degree due to data availability.

⁸ Anticipated acquisition by Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform, OFT, October 2008, paragraph 91 and 143.

competition reports, we found that there remain high levels of concentration in the PCA and SME (BCA) banking markets.⁹ Pre-economic crisis, we had observed in our 2008 PCA market study and our 2007 SME Banking Review of Undertakings that challenger banks¹⁰ were beginning to have an impact on competition. However, consolidation in the sector pre-and post financial crisis has removed some of the benefits observed at that time.

Our market share analysis indicates that the divestments will only have a limited impact on overall structure in PCAs and SME banking. Verde will lead to a decrease in LBG's PCA market share from approximately 30 per cent to approximately 26 per cent in Great Britain. As a result of the Verde divestment alone, in Great Britain the combined PCA market share of the top four banks will fall from [70-80] per cent to [65-75] per cent and the HHI will fall by approximately [] to around [].¹¹ In England and Wales the effect will be similar, but in Scotland LBG's market share will decrease from [40-50] per cent to [20-30] per cent, with the combined market share of the top four banks falling from [80-90] per cent to [75-85] per cent. The top four banks, including the parent banks, will remain significant market players.

Rainbow will lead to a decrease in RBS's market share in BCAs from [25-35] to [20-30] per cent.¹² RBS would remain []. In England and Wales, Rainbow will have a [0-10] per cent market share in BCAs and there would be a reduction in HHI by about [] to [] as a result of the Rainbow divestment alone. In Scotland, however, Rainbow [] comprises [] branches and [] and RBS will retain a market share of [35-45] per cent. Accordingly, the divestment will not have a significant impact on market structure. We note, however, that Rainbow appears to have a stronger position, relative to RBS, in [] than it does in [].

⁹ Review of the personal current account market, OFT, January 2013, paragraph 1.3 and [].

¹⁰ *Personal current accounts in the UK: an OFT market study*, OFT, July 2008. Table 3.1 identified three 'challenger' banks, HBOS, Nationwide and Abbey. Similarly, for SME banking, the OFT's *SME Banking: Review of undertakings: Confidential advice to the Competition Commission*, OFT, January 2007, Table 4.3 identified Abbey, Alliance & Leicester and HBOS as 'challenger' banks.

¹¹ The Herfindahl-Hirschman Index (HHI) is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market. Any market with a HHI exceeding 1,000 may be regarded as concentrated and any market with a HHI exceeding 2,000 as highly concentrated. *Merger Assessment Guidelines, A joint publication of the Competition Commission and the Office of Fair Trading*, OFT, September 2010, paragraph 5.3.5.

¹² Based on [].

In terms of the combined impact of Verde and Rainbow on the PCA market structure, the combined market share of the top four banks in PCAs in Great Britain will fall from [70-80] per cent to [65-75] per cent and the HHI will fall by approximately [] to around []. In England and Wales the effect will be similar, but in Scotland the combined PCA market share of the top four banks will fall from [80-90] per cent to [75-85] per cent. The combined impact on the national SME banking market will not be materially different from the impact of Rainbow alone in terms of market share; however, we note the complementary strengths of Verde in serving the needs of small SMEs and Rainbow in serving larger SMEs.

Consistent with our previous work, the OFT remains concerned about the level of concentration in retail and SME banking markets. However, changes in concentration alone cannot be the sole basis for analysing the effect on competition of the divestments. Small banks can, in certain circumstances, have an effective competitive impact, as their incentives are not aligned with existing banks enabling them to compete through differentiation and innovation, including on non-price parameters such as service and quality. This means they can represent effective competitors which are potentially stronger than their market shares suggest.

We have therefore considered what characteristics would suggest either of the divestments would, in future, represent effective competitors in retail or SME banking and the factors that, if enhanced, could enable the divestments to improve their ability to compete effectively.

Effective competitors in the retail and SME banking market

Based on previous observations on effective competitors in the PCA and SME banking markets,¹³ and responses we have received from third parties, we have identified the following factors as important in determining whether a bank is likely to be an effective competitor in either the PCA or SME banking market (these apply to both unless stated otherwise):

- sufficient national and regional scale, including, for PCA and smaller SME banking services, through a branch network given the demand from many customers for a local bank branch presence

¹³ See footnote 11 above.

- an ability to offer a breadth of products, including to expand and change that product mix over time
- in banking services to retail customers and smaller SMEs, a base in PCAs from which to grow into other retail and SME products
- in banking services to larger SMEs, the ability to offer a breadth of SME products in order to cater for the wide variety of SME demands
- brand and reputation
- ability to generate profit to invest in growing the business
- ability to innovate and differentiate their offering compared to the incumbent banks
- strong management team and staff

The factors identified are broadly consistent with those of other commentators.¹⁴ We consider that a smaller bank can have an impact but scale remains important to achieve this and incentivise the major banks to compete. We use market share as a proxy for a bank's national and regional scale and, especially for PCA and smaller SME customers, the size and density of the branch network. Our own work on PCAs observed effective competitor banks as occupying a market share of roughly 5 to 14 per cent, noting, in particular:¹⁵

- The scale required to offset certain costs. In the past, effective competitor banks were able to compete successfully (that is, to win additional business and grow market share) with market shares in this range and a branch network of around 700 branches or more. This may provide some indication that a branch network of this magnitude is consistent with a bank being a cost effective, national player.
- The likelihood of having a mix of customers that is consistent with having the incentive to compete. Previous analysis indicates that a bank's incentive to compete is, in part, driven by the proportion of active (or 'marginal' customers) in its customer base.¹⁶ Active or marginal customers are those

¹⁴ Independent Commission on Banking, Final Report, September 2011; *Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger*, Competition Commission, July 2001.

¹⁵ 2008 PCA Market Study, paragraph 3.6.

¹⁶ *Independent Commission on Banking*, Final Report, September 2011, paragraph 8.27. In addition, effective competitor banks in the past were found to have small market shares because they had higher shares of active customers than inert ones. See Anticipated acquisition by

that are more likely to switch to or from a bank in response to changes in the deal it offers customers. The greater the proportion of active or marginal customers in its customer base, the greater the pressure will be for the bank to retain them by offering them a good deal. Because banks are not able to perfectly target good deals only at marginal or active customers, the benefits of these good deals spill over to the bank's inert (or 'infra-marginal') customers. So the (actual or possible) actions of marginal or active customers protect the interests of inert or infra-marginal ones and the bank represents a competitive force offering good deals in the market.¹⁷ Because there is limited overall customer switching in banking, there are far fewer active or marginal customers than inert or infra-marginal ones.¹⁸ What matters is not the bank's market share in and of itself but what that market share says about the proportion of active or marginal customers the bank has and what this means for its incentive to compete in the market.

There is a trade-off between these two factors: a sub-scale bank is not able to compete yet a super-scale bank is not incentivized to. Our past work identified effective challengers between these extremes as occupying the 5-14 per cent market share range.

It is important to recognise, however, that this market share range is not determinative. Some banks within the range may not, in practice, operate as effective competitors and some banks outside the range may represent a significant competitive constraint on the whole, or a part, of the market.

This range has been observed in the context of the PCA market but there is good reason to believe that a similar market share range (albeit slightly lower) might apply to the market for banking services to the smallest SMEs, given that their demands will, to a certain degree, not differ radically from PCA customers. However, based on the evidence available, it is less clear that falling within a market share range is as indicative of a bank's ability to compete in the banking market for larger SMEs or those with complex banking needs.

Lloyds TSB plc of HBOS plc: Report to the Secretary of State for Business Enterprise and Regulatory Reform, OFT, October 2008, paragraph 114.

¹⁷ In contrast, a bank with a high proportion of inert or infra-marginal customers in its customer base feels less pressure to retain its active or marginal customers because it can 'milk' its inert or infra-marginal customers.

¹⁸ The current switching rate in PCAs is [] per cent ([]) and [] per cent in BCAs ([]). This is low in comparison to customer switching rates in comparable sectors (utilities for example).

Assessments of the proposed divestments

We have considered the potential short- to medium-term impact of the LBG and RBS divestments on competition against the factors relating to effective competitors set out above in order to assess their ability to compete. We have also considered the extent to which they are likely to change some or all banks' incentives to compete. Both LBG's and RBS's incentives to compete may change, both with their divested entities (for example, through drawing customers back) and with other existing competitor banks. The incentives of other competitor banks to compete may also change, given that they now face four competitors, rather than two.

Verde

Verde has a sizeable branch network of 631 branches. In comparison to other non-major banks, its reach is extensive, with [30-40] per cent of the Great Britain adult population living within one and a half miles of one of its branches and [55-65] per cent within three miles. Those branches are less concentrated in some regions, including South-East England.

Its share of the PCA market is estimated at [4.0-4.5] per cent. Verde's market share in Scotland is significantly higher than in the rest of Great Britain – at about 15-20 per cent of PCAs.

The legacy C&G network of 164 branches has only just started to offer personal current accounts. This network, which will form part of Verde, provides a good prospect for growth in PCAs, although this may require significant investment in the branches, marketing and staff training.

Verde's market share is below the scale associated with an effective competitor in the past (5 to 14 per cent) and we consider that it is important that Verde is in a position to grow its PCA share. We consider that account should be taken of the risks inherent in attracting new customers. To the extent that Verde develops a new customer base, these new customers may be more marginal and the bank will need to remain competitive to retain their business.

We note that the TSB brand is reasonably well-known and especially strong in Scotland. The analysis undertaken by LBG and Verde management points to a strong brand and the management's strategy to position the bank as a 'home of local banking' indicates a degree of differentiation from the major banks. This strategy implies the maintenance, and possibly growth, of its branch network.

We understand from LBG and Verde management that Verde will be able to use the LBG platform to offer products and services from a platform and suite shared by brands under LBG ownership (such as, Lloyds, Halifax, and Bank of Scotland) and to innovate with new products and services on that platform. LBG and Verde management are currently negotiating on an arm's length basis business and IT services agreements¹⁹ to provide Verde with outsourced IT capability. We recognise LBG's assurances about Verde's ability to modify and innovate and the efforts made to reduce the overall cost base for the IT platform and the overall benefit that a transitional arrangement can provide stability for Verde in its early years. However, there remain concerns about the impact on competition arising from any Verde dependence on LBG, the influence that LBG will retain over the operational flexibility of Verde, including its ability to innovate and differentiate its product offering as well as any information flows between the parties.²⁰

Verde's presence should be seen in the context of its strategy which is based around local banking. Verde will need to, at least, maintain its branch network and may require targeted growth in some areas in order to sustain scale and PCA share. We consider the ability to fund and invest in growth in its network including the legacy C&G network to be important in order to achieve this growth.

Verde's ability to compete in SME banking is constrained by the lack of products, services and IT functionality to provide complex business banking services. Verde is capable of providing services to smaller SMEs with basic banking needs and has a market share of 2 per cent in Great Britain and 8 per cent in Scotland. We consider this capability is welcome in the context of the aggregate benefit to competition across the two divestments. However, we note that Verde is not intended to be a business bank: the intention as reflected in the State aid agreement was to constitute a business competing in the retail

¹⁹ The Transitional Services Agreement (TSA) and Long-Term Services Agreement (LTSA) are the arrangements by which LBG will provide IT and operational services to Verde. Both agreements include IT and business services, and some payments capabilities (including ePayments and cheque clearing). The TSA also includes some wider payments capabilities and other services. The TSA is expected to run until 2016, while the LTSA is expected to run until 2023, with the potential for renewal. The OFT understands that these agreements are still under negotiation.

²⁰ The OFT's concerns are compounded by the fact that, although Verde already has a separate management team, its ability robustly to negotiate the terms of the LTA with LBG in order to preserve Verde's long-term interests may be limited while Verde is still part of LBG.

banking business.²¹ It will only be able to service SMEs with basic needs, and will have only a small proportion of the overall SME market, with a limited presence in SME lending. As noted above, we consider it appropriate to provide recommendations which relate to the conditions and objectives of the EU State aid process and we have not therefore considered Verde's impact on competition in SME banking further.

Verde's impact on other banks' (including LBG's) ability to compete will depend on the balance of potential gains from competition and the costs of competing. In markets such as PCAs and BCAs where switching rates are low, the incentives to compete are reduced at any given market share (and may be further dampened the larger the bank is), as the potential gains resulting from an improvement in a bank's competitive offering will be more limited. Although Verde would represent an additional competitive constraint on LBG and other banks, we consider that its relatively small size means that it is unlikely to alter their incentives to compete significantly, nor to reduce LBG's size to such an extent that its incentives to compete are significantly altered.

Set against this, Verde and LBG may initially be close substitutes (for example, because of similarity in their product offerings) meaning any impact may be marginally more pronounced for LBG than other banks. Similarly, LBG may be a close substitute to Verde. Pre-divestment, Verde was subject to the same competitive constraints as LBG. Post-divestment, Verde is subject to these same constraints but also competition from LBG. Some of Verde's customers have at some stage chosen the LloydsTSB brand as their first choice bank, suggesting that the propensity of some Verde customers to switch away (to the Lloyds brand) may be greater than previous switching away from LBG and Verde has suggested.²²

Overall, we believe that Verde has potential to provide a competitive constraint in the retail banking market, although its impact on other banks is unlikely to be significant. The impact is most likely to be felt in Scotland, where Verde's PCA

²¹ State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 185.

²² LBG submitted to us that switching back to LBG from Verde is unlikely to be high given that they are subject to a non-compete clause which prevents them from targeting Verde customers and any customers wishing to switch will have already done so under the "stay/go" option which allowed customers to opt to remain with LBG. The OFT notes this but considers that the risk of attrition back to LBG remains, particularly given that LBG was not permitted to present the "stay/go" option to customers explicitly, but only in response to customer requests.

market share is much higher and we believe that the TSB brand may be particularly strong.

We have identified three areas of concern which, if addressed, we consider would improve Verde's ability to compete and should serve to improve its overall impact on competition in retail banking:

- the business and IT services agreements with LBG may impair Verde's ability to compete independently in the market;
- Verde's financial position and profitability may dampen its ability to compete and grow; and
- Verde's initial market share falls below the range which has previously been observed in effective competitors in PCA markets.

The first two concerns relate to Verde's ability to expand and grow its share of PCAs (and other retail banking products and services) including into the legacy C&G network and to consider strategic investments, such as, in new products and services or opening new branches. Verde is, to a degree, below the scale associated with effective competitors in the past. Moreover, regardless of scale, our analysis of its financial projections indicates that its profitability in the period 2014–2017 [] in a strategy consistent with being or becoming an effective competitor. We consider that this financial situation risks limiting the achievement of any or some of the benefits to competition which could flow from Verde's potential to act as an effective competitor given its branch network (including legacy C&G growth potential), products and services, TSB brand, and experienced management team. Similarly, if residual links remain with the parent, through Verde's reliance on its business and IT agreements with LBG, this may reduce Verde's flexibility to expand and grow, and to differentiate itself from LBG. It also creates a degree of risk that LBG could inhibit the operational freedom of Verde.

Rainbow

Rainbow has a share of [0-10] per cent in the market for banking for the provision of BCAs.²³ It has [] SME business centres located across the UK and a

²³ This market share is based on [], consistent with []. However, the OFT notes that this may overstate Rainbow's market share, due to the methodology adopted by []. Therefore, the OFT has additionally examined market shares based on []. Based on this, Rainbow's market share is [0-10] per cent, which is []. However, RBS explained to the OFT that the [] may underestimate the actual market share held by Rainbow, as it does not account for all of Rainbow's customers. The OFT thus estimates that the actual market share held by Rainbow is likely to range between [] and [] per cent.

small network of 314 branches. The branch network, although covering Great Britain, is stronger in some parts (such as North-West England) than others (it has a very limited presence in Scotland). We note that extensive work has been undertaken by RBS and Rainbow with external consultants to [] to support the delivery of a full product suite for its core business customers. We have, based on the evidence available to us, no reason to question its financial ability to compete in this market.

We have considered closely Rainbow's ability to service primarily smaller SMEs with branch based needs outside of []. We have also considered [] in PCAs will impact its growth prospects in SMEs overall. Whilst we have some concerns, we consider it appropriate to set this against its ability to compete to attract customers for its wide range of SME products and services without the need for a local branch since it has a range of SME centres with trained staff to support the needs of most SME customers across the UK. On the basis of the evidence available, we consider that Rainbow has the ability to compete in a number of SME market segments including the £1m to £25m turnover range.

We also note that Rainbow's share of the PCA market is about [0-10] per cent and its branch network is not sufficient in size or scale to compete effectively in the PCA market on a national scale. We note, however, that the State aid decision states that Rainbow was created to compete in the SME and mid-corporate banking business in the UK,²⁴ and is silent on its impact on the PCA market. We have therefore not considered its impact in that market further.

We also considered the impact of Rainbow on other banks (including RBS) to compete. Again, although Rainbow would represent an additional competitive constraint on RBS and other banks, its relatively small size means that it is unlikely to alter their incentives to compete significantly especially in relation to services supplied to SMEs with strong branch needs. Rainbow may be a closer substitute to RBS than other banks (given []) and therefore any impact may be marginally more pronounced for RBS than other banks.

Similarly, Rainbow, subject to the same competitive constraints as RBS prior to the divestment, will be subject to the additional competitive constraint from RBS, its previous parent. This additional competitive constraint may be especially strong, such that switching may be expected to be greater than has

²⁴ State aid No N 422/2009 and N 621/2009 - United Kingdom Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme, paragraph 244.

been the case for RBS customers prior to the divestment, due to RBS representing a closer competitive constraint to Rainbow than Rainbow faced pre-divestment (as part of RBS).²⁵

Subject to the broader points above about the extent of switching in the SME banking market,²⁶ we believe that Rainbow has the ability to be an effective competitor in a market segment for businesses in the £1-25 million turnover range. We have not identified any significant concerns relating to its ability to be an effective competitor in the SME banking market, other than the fact that its branch network is limited in some parts of the country, inhibiting its ability to compete for smaller SMEs (and PCAs).

Recommendations

We have considered the impact of the divestments on competition in retail and SME banking in the context of the EU State aid decisions in which the divestments were designed to remedy any distortion to competition as the result of restructuring aid received by Lloyds and RBS. We have limited our recommendations to those which can reasonably be expected to be achieved in the context of the current EU State aid process.

We consider that, in order to improve competition in UK retail and SME banking markets, it is important that both divestments are able to grow and develop their business models and strategies in the coming years, including, through investing in their branch networks and brand and customer offers and to undertake additional investment (including as a result of mergers and acquisitions activity). **We recommend that the detailed arrangements for Verde and Rainbow, and in particular any ongoing arrangements with their parent banks, are scrutinised to ensure that they would not hamper any future mergers, acquisitions or other strategic developments.**

Verde

We set out three recommendations for the Verde divestment which are intended to improve its ability to compete in UK retail banking taking due account of the objectives of the EU State aid decision.

²⁵ RBS submitted to us that switching back to RBS from Rainbow is unlikely. This is in part due to [] and to the fact that many of the customers wishing to switch will have already done so as part of the divestment process to date. In addition, the fact that there will be no remaining RBS-branded branches in England and Wales, or Natwest-branded branches in Scotland, makes attrition to the original brand less likely.

²⁶ As set out above, the switching rate in BCAs is [] per cent ([]).

- First, service agreements. We note that the business and IT services agreements between Verde and its parent, LBG, needs to give Verde the flexibility to grow and develop, including differentiating itself in terms of strategy in the future. We understand that these agreements are not yet finalised.
- **We recommend that:**
 - **Steps be taken to ensure that the arrangements do not: (i) allow LBG to influence Verde’s competitive behaviour, (ii) facilitate the coordination of the behaviour between Verde and LBG or (iii) render Verde vulnerable to poor quality of service.**
 - **A transparent mechanism should be included to determine cost (or a suitable dispute resolution mechanism).**
 - **An appropriate break clause should be included to allow Verde to terminate the agreement, particularly if Verde is acquired by another bank with its own systems.**
 - **An expert and independent monitoring trustee or equivalent should scrutinise the terms of the business and IT services agreements and continuing compliance with those terms.**
- Second, profitability. We note that Verde’s level of profitability, in particular in a low interest rate environment, may provide it with insufficient incentives or funding to invest and grow into its branch network including the legacy C&G network over the next three to five years and therefore to compete with other banks. We further note that the State aid decision envisages a potential further 2 per cent market share growth in PCAs if the purchaser extends the legacy C&G product range to PCAs.²⁷
- **We therefore recommend that measures are taken to strengthen Verde financially with the objective of providing it with a higher income (while not worsening its risk profile) to enable it to invest and grow into its branch network including the legacy C&G network and to allow it to compete more vigorously in retail banking.**

²⁷ State aid No. N 428/2009 – United Kingdom Restructuring of Lloyds Banking Group, paragraph 76.

- We consider that the most appropriate option to achieve this aim is likely to be to improve Verde's profitability to the extent necessary to enable it to grow into the legacy C&G network in the next three to five years. We also note that an alternative option might be to consider a suitable, broadly equivalent, direct injection of capital from LBG into Verde.
- Third, market share. We note that the original State aid divestment term sheet included a condition that the divestment would be launched with a 4.6 per cent market share in PCAs in the UK. The Verde divestment currently has around [4.0-4.5] per cent share of PCAs. As outlined above, the market share figure captures the trade-off between Verde being able to compete and being incentivized to. It is not possible to say with any degree of accuracy how different that trade-off is at a [4.0-4.5] per cent market share than at a 4.6 per cent but we see no reason to depart from the analysis at the time that the divestment was designed, which anticipated the need for a starting market share of 4.6 per cent.
- **We recommend that LBG should be required to enhance Verde to reach 4.6 per cent PCA market share within a period of two years from the date of the divestment or Initial Public Offer. We advise that any response to this recommendation should be over and above any measures taken to enable Verde to grow into the legacy C&G network. However, we recognise that a further divestment of branches risks incurring further delay and additional sunk costs. We would therefore recognise that alternative mechanisms might be more appropriate to mitigate the lower market share, and therefore boost Verde's ability to compete. Such alternatives might include either (i) providing Verde with an option to acquire further branches with PCA customers at a later date, or (ii) further strengthening Verde's balance sheet to provide it with the resources to develop its own branch network or incentivise further PCA growth.**

We note that the second and third recommendations may be considered together. We would be very happy to provide further advice on potential branches for transferring to Verde to maximise their impact on competition if this is the preferred approach for dealing with the third recommendation. We recognise that you may wish to seek advice from the PRA or Bank of England regarding the financial strengthening of Verde and the prudential consequences of such action.

Rainbow

We note that the current plans for Rainbow are intended to lead to the launch of an SME bank with the requisite []. We also note our analysis is that Rainbow has the ability to grow and compete in SME banking especially for SMEs in the £1m to £25m turnover range. We also note the objectives of the EU State aid decision to create a bank to compete in the SME and mid-corporate banking business in the UK.

On this basis, we do not recommend any further enhancements to strengthen Rainbow's ability to compete.

Other issues

We have also considered the possibility of requiring a merger between Rainbow and Verde as part of the State aid divestment process. Given the limited basis of the evidence currently available to us, we have not conducted a full merger analysis, and therefore this advice does not prejudice any potential future merger assessment.

We consider that, *prima facie*, there might be some potential benefits to competition from such a merger: the strengths of the two divestments are to a large extent complementary in terms of products, services, customers and geography.

However, we also see some possible downsides for competition, including: the duplication of branches in some [] or so locations would have the potential to reduce competition in those localities (and to raise the possibility of branch closures); the merger would preclude some other alternative investments in either of the divestments which might be more suitable for them; and continuing engagement between two of the largest UK banks over an extended period of time could raise concerns about sharing of information between competing businesses.

In addition, such a merger would likely cause very significant delay to the divestment processes, involve extensive technical integration issues and represent a very significant change from the current State aid term sheet requirements. Accordingly, on the limited basis of the evidence we currently have available, **we do not recommend that such a merger be required.**

Conclusions

The OFT's advice is set out above, as requested. As explained, the advice is provided in the context of the European Commission's State aid process for LBG and RBS and on the basis that the current proposals for the divestments by LBG and RBS proceed as planned. Ultimately, decisions about State aid are a matter for the European Commission. If any relevant circumstances described above were to change significantly, the OFT would be happy to provide further advice if requested.

Yours sincerely



Clive Maxwell
Chief Executive