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Dear Alex

**Re: Lloyds Banking Group response to CMA Provisional Decision and Consultation on market investigation reference regarding PCAs and SME banking**

I am writing on behalf of Lloyds Banking Group ("LBG") to set out our observations on the CMA's Provisional Decision to make a market investigation reference in relation to the provision of banking services to small and medium-sized enterprises ("SMEs") and personal current accounts ("PCAs").

Although we do not consider that such a reference is necessary, we think that a properly conducted market investigation can provide the means by which customers and stakeholders can gain full confidence in the operation of these important markets. We will work constructively with the CMA towards the shared goal of ensuring that these markets function well for consumers. We recognise that the financial crisis has had a negative impact on the standing of the banking industry. A series of investigations and reviews by a range of bodies have largely updated each other using the same framework of assessment, which does not fully capture our experience in these markets. We hope that a thorough, objective, transparent and evidence-based investigation will create a more appropriate environment against which the industry can be viewed and resolve key regulatory questions for the long-term.

In order to facilitate a proportionate and effective market investigation, it is essential that the CMA reports fully and accurately in its reference decision, recognising where the evidence is inconclusive or ambiguous. It is also essential that the terms of reference are appropriately defined so that, *inter alia*, the scope of SME banking services to be investigated is clear and focused. Basic bank accounts ("BBAs") and packaged accounts should be explicitly included in any investigation into PCAs. SMEs that are part of large corporate groups should be excluded in any investigation into BCAs. We comment in more detail on the draft terms of reference below and in Annex 3.

We also comment below and in the attached annexes on key aspects of the Provisional Decision and underlying PCA and SME studies which we think require further consideration in preparing any reference decision or where certain evidence has been over interpreted or misconstrued in the Provisional Decision. We do not comment on every aspect of the CMA's analysis in this response, but will do so during any market investigation.

**Need for an appropriate benchmark**

The CMA refers to its "expectation" that the SME and PCA sectors should be "well-functioning", but does not provide a clear benchmark of a well-functioning market. It is important that the CMA takes a realistic approach in identifying such a benchmark. This will avoid specifying features that may be theoretically desirable but may not be feasible to achieve or achievable only at disproportionate cost, or which might have unintended consequences that harm customers and competition. Similarly, a realistic approach to

customer engagement requires setting aside purely theoretical and empirically unsubstantiated assumptions about how consumers might or should behave. The CMA should focus on evidence about how they actually do behave. This issue is not unique to business and personal current accounts and has been raised by a number of respondents to the energy market investigation.

### **Need for a dynamic and holistic view of competition**

The CMA's assessment of competition as set out in the Provisional Decision and the underlying studies should explicitly consider the collective future impact of key structural, behavioural and technological changes that are already taking place. These are changing the competitive landscape and directly address many of the CMA's concerns. Similarly, the new products and initiatives launched by LBG (and others) and, crucially, the motivation for such developments, have not been given sufficient weight. This continuous innovation and product development is driven by the threat of competition from small, medium and large providers, in order to retain existing customers as well as attract new customers.

The PCA and SME sectors are already highly regulated, and are becoming increasingly so as a range of regulators and legislators (including the European Commission, CMA, FCA, PSR, PRA, TSC and HM Treasury) have adopted wide-ranging measures in relation to individual issues or market segments. We think that many previous interventions have been disproportionate and/or ineffective. They have either been too far removed from real consumer behaviour, lacking in ambition and imagination, and/or have taken too long to implement. These concerns should be recognised in any reference decision.

### **Need to understand the diversity of PCA and SME customers**

The Provisional Decision contains a number of statistics and assertions relating to PCA and SME customers in general. The CMA should recognise and carefully consider the diversity of customers in any analysis of market structure, barriers to entry, customer engagement and customer outcomes. Such an approach will allow a more focused and proportionate diagnosis of any adverse effects on competition. For example, in relation to PCAs, it is essential to carefully consider the differences between personal customers with BBAs and those holding other PCAs.

### **Concentration and scale**

The Provisional Decision uses overall measures of PCA and SME market concentration as an indicator of weak competition. However, the CMA has found no clear link between concentration and customer outcomes and its theory of harm appears to be based on an unsupported hypothesis that effective competition in the PCA and SME markets necessarily involves rapid shifts in market shares, with entrants replicating the national scale and branch networks of the largest providers.

In fact, barriers to entry and expansion are falling, and entry is occurring. We face competition from a range of competing providers of all sizes, who are competing aggressively using a diverse range of business models. These entrants' business models often involve "cherry picking" the most profitable and significant segments of the market rather than seeking to replicate the national scale and branch networks of the largest providers.

Moreover, the CMA should consider the aggregate competitive constraint of all providers, together with providers of substitute products, such as asset finance and consumer finance for SME lending, and disruptive payments systems offered to individuals by Amazon, Apple, Google and others. On the ground, we have no doubt that we face significant competitive constraints from a range of competitors.

### **Customer engagement**

The analysis of customer engagement in the Provisional Decision continues to focus on relatively narrow switching measures. This is inconsistent with our experience of the cumulative competitive impact of a wide range of activity by engaged customers, which include:

- *churn*, which forces providers to compete aggressively for new to market customers to replace those who leave the market every year. The CMA has found that "*churn rates in SME BCAs are considerable*", and approximately 6 million PCAs are opened every year (8.1 per cent of the total);
- *multi-banking*, as this includes customers shopping around for the best deal or trying out a new provider with a view to switching. The risk of losing customers is also greater where they already have relationships with other providers;

- *intra-group and intra-brand switching* (i.e. customers changing products with their own provider to an account that better meets their needs) is good evidence of customer engagement and activity and is important in considering how providers compete and the competitive constraints they face;
- *shopping around without switching*, as the threat of switching by these engaged customers disciplines their existing bank; and
- *manual and gradual switching*, which is not included within the CMA's BCA switching analysis. However, in our experience such switching is a significant competitive constraint and may account for 50-60 per cent of all switching by SMEs.

Moreover, many SMEs value continuity of relationships with their banking supplier. We recognise this (as well as the fact that there is a significant number of alternative SME product providers to choose from) and aim to build deep and lasting relationships with all our customers.

The CMA has also dismissed the impact of CASS on the basis that it "*has not led to a transformative change in the switching rate*" for PCAs. CASS is a world class innovation and is bedding in successfully with universal market coverage, strong customer awareness, and reliable switching mechanics. It is unrealistic to expect CASS to have led to a transformative change in its first year. Given the recent new entry and product launches by new and existing providers, it is too soon to conclude that CASS will not have a significant impact in the short to medium term.

The Provisional Decision also makes direct comparisons with switching rates in other markets (such as mortgages, telecoms, energy and insurance) that are completely different from PCAs and BCAs in a range of relevant respects. These simplistic comparisons are not appropriate as any assessment of customer engagement and switching needs to consider and recognise that:

- BCAs, and particularly PCAs are a relatively low cost service for the majority of customers and financial gains from switching are limited relative to the other products the CMA refers to. The relatively low cost of PCAs and BCAs also facilitates multi-banking, manual and gradual switching as an alternative to formal switching, whereas such behaviour is not possible for insurance and utilities;
- as the CMA has recognised, unlike PCAs and BCAs, "*other industries have features which may make switching easier, for example, a break point in a contract*". This is highly relevant as car insurance and mobile phone contracts are typically for fixed terms. Similarly, customers must reconsider their energy and home insurance contracts when they move house;
- customers (particularly SMEs) value the advice and support their bank can provide in the context of a long-term relationship. Such relationships are of very limited relevance in the other markets the CMA has cited; and
- many of these non-banking markets are not subject to the same material level of customer churn that SME banking experiences.

### Customer satisfaction

The CMA's concerns in relation to PCA and SME customer outcomes are primarily based on surveys indicating that customer satisfaction is "too low", and that there may be a link between bank size and customer satisfaction. Surveys on "customer satisfaction" can lack robust meaning and measurement and are prone to bias. It is therefore unsurprising that there is a wide range of reported customer satisfaction levels between surveys, as the CMA has recognised. However, we would like the CMA to be clearer about the robustness of the statistics it has cited in the Provisional Decision, which we do not believe are conclusive of poor customer outcomes and which are inconsistent with our own experience. For example:

- any comparison of customer outcomes should be based on a holistic assessment of the price, quality, range and service offered by different providers. It is not clear that the CMA has controlled for price and other relevant variables in its analysis of potential links between bank size and satisfaction;
- in referring to Charterhouse research (in which overall quality of service was rated "very good" or better by 52-54 per cent of SMEs and good or better by 78 per cent of SMEs), the Provisional Decision has dismissed a "good" rating as an indication that banks are not satisfying SME's needs on the basis that "good" is the equivalent to the midpoint (i.e. three) on the survey's five-point scale. Similarly, the

Provisional Decision does not consider that the 50-59 per cent of SMEs who told YouGov they were "satisfied" with their provider are being well served; and

- the Provisional Decision has dismissed a Mintel survey showing that only 3 per cent of PCA holders are unhappy with their provider. It has also focused on a single year increase in complaints to the FOS regarding packaged accounts, despite the fact that such complaints represent 1 in 1,750 packaged account customers, and has ignored the FOS's statement that there has been "*encouraging improvement in the way some banks investigate and deal with these complaints*".

### Basic Bank Accounts

We are fully committed to financial inclusion and consider that access to a bank account is an important element of this objective. HMT requires a number of banks to provide BBAs, in order to deliver financial inclusion, and BBAs were identified by the OFT as an important segment of the PCA market as recently as 2013. We were therefore very surprised that the Provisional Decision makes no reference to BBAs. It is essential that the nature of BBAs (and the limited competitive dynamics which may be expected in relation to these accounts in a well-functioning market), together with their impact on the wider PCA market are properly considered in the final reference decision and in any Phase 2 inquiry. This will allow the CMA to identify whether the important social objectives of BBAs can be achieved with less distortion of competition. In this connection:

- *BBAs are loss-making*, and will become even less attractive to provide as HMT requires increased functionality and reduced charges, and if the proposed EU cap on interchange fees is implemented. It is therefore unsurprising that many banks who are not required to provide BBAs have no interest in doing so, and that providers of BBAs have limited scope to differentiate and innovate BBAs;
- *the current framework for the provision of BBAs distorts competition*. The requirement on some, but not all, banks to provide loss-making BBAs distorts competition between providers and requires banks to cross-subsidise the costs of BBA provision from other customers. The presence of BBAs also sets a "floor" on the functionality of other PCAs, thereby distorting competition and innovation in the supply of standard PCAs, and inhibits the development of higher functionality accounts with monthly fees aimed at BBA customers; and
- *BBA customers have limited ability and incentive to switch*, as all banks provide similar BBA products (for the reasons above) and as many BBA customers are ineligible to switch to standard PCAs. This has implications for the CMA's analysis of concentration and customer engagement.

### The Free If In Credit (FIIC) model

A central feature of the PCA market (but not the BCA market) is the FIIC model, under which many customers do not pay a monthly fee or transaction fees, and providers primarily generate revenues through net credit interest, interchange fees and overdraft charges. The CMA has expressed concerns in relation to the FIIC model on the basis that it results in cross-subsidies between categories of customers, involves complex costs for customers (i.e. overdraft charges and interest foregone) and limits PCA product variety, as the demise of the FIIC model "*could lead to more heterogeneous pricing structures*".

The FIIC model is highly valued by many customers and if the CMA wishes to explore this, a more comprehensive analysis of the impact of the FIIC model on the PCA market is required. Many well-functioning competitive markets exhibit a degree of cross-subsidy in the sense that different categories of customers will make different levels of contribution to fixed costs, and it is difficult to envisage a "*perfectly cost reflective*" pricing model for PCAs. It is therefore unclear what level of cross-subsidy (if any) funded by which category of customers the CMA considers might be consistent with competitive outcomes, given that FIIC encourages multi-banking. Moreover, PCA customers already have a wide choice of packaged accounts, which typically have a monthly fee but provide a range of features and benefits including fee and interest free overdrafts. These accounts are popular - there are 10 million active packaged PCAs. The CMA should also assess whether more heterogeneous pricing structures would improve comparability and customer engagement, particularly given the CMA's concerns regarding the variety of overdraft pricing structures.

### Draft terms of reference and scope of market investigation

We comment on the CMA's draft terms of reference in Annex 3, but by way of summary:

- BBAs and packaged accounts must clearly be included in any investigation into PCAs;
- the definition of "retail banking services" to SMEs is unclear, and should be focused on general purpose loans and liquidity management services, as these have been the subject of the CMA/FCA market studies and the consultation process;
- businesses with a turnover of under £25 million but which are part of a group with turnover exceeding £25 million should be outside the scope of any SME investigation, as they have corporate banking (rather than SME banking) needs and behaviours; and
- any terms of reference should be sufficiently flexible to accommodate an assessment of the role of asset finance, hire purchase, invoice finance, consumer finance products and alternative finance platforms as alternatives to SME general purpose loans and overdrafts, as these products are increasingly used by SMEs.

#### **Detailed comments on the Provisional Decision**

In order to assist the CMA's case team, we attach our more detailed comments on the Provisional Decision and associated studies on SME banking (Annex 1) and PCAs (Annex 2), together with comments on the CMA's draft terms of reference (Annex 3) and responses to the CMA's consultation questions (Annex 4).

Yours sincerely,

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