

**LLOYDS
BANKING
GROUP**



LLOYDS BANKING GROUP PLC

**ANNEXES TO THE RESPONSE TO THE CMA'S PROVISIONAL
DECISION AND CONSULTATION DOCUMENT ON MARKET
INVESTIGATION REFERENCE REGARDING PCAS AND SME
BANKING**

17 SEPTEMBER 2014

ANNEX 1

LBG'S COMMENTS ON THE CMA AND FCA SME MARKET STUDY

1. INTRODUCTION

- 1.1 LBG considers that the Provisional Decision presents a view of competition in the SME banking sector that is inconsistent with what LBG experiences on the ground. LBG believes that this is because the CMA has not given sufficient weight to the various structural, behavioural, regulatory and technological developments that have taken place and which continue to take place. The CMA has concluded that there are a number of features of the SME banking sector which give rise to competition concerns and would warrant a market investigation reference. These include:
- (a) demand-side issues in relation to a lack of customer activity. In particular:
 - (i) low levels of shopping around and switching by SME customers, which impacts on the ability of new or smaller providers to acquire a sufficient number of profitable customers; and
 - (ii) a lack of customer engagement, with SMEs not easily able to access, assess and act on information to ensure that they get the best deal, which results in low levels of shopping around and switching activity;
 - (b) the structure of the market with persistent levels of high concentration and relatively stable market shares among providers of both BCAs and business loans;
 - (c) the need for an extensive local branch network to acquire new customers and distribute products effectively; and
 - (d) a market structure characterised by close linkages between PCAs and BCAs and between BCAs and general purpose business loans, which the CMA alleges limits the scope for newer or smaller providers to expand.
- 1.2 LBG does not believe that this analysis accurately reflects LBG's experience of competition in the market and comments on each of these issues below. In addition, LBG comments on the CMA's analysis of adverse customer effects, aspects of which LBG considers require further analysis before justifiable conclusions can be drawn.

2. CUSTOMER ACTIVITY

Low levels of switching

- 2.1 Whilst the CMA accepts that a switching analysis is generally less relevant to business loans, given their relatively short-term nature,¹ the CMA has found that the SME BCA market is characterised by low rates of shopping around and limited switching.² However, for the reasons set out below, further analysis is required before the CMA can justifiably reach such a conclusion.

¹ Paragraph 8.31, CMA Provisional SME Decision.

² See, for example, paragraph 8.89, CMA Provisional SME Decision.

No clear switching level benchmark

- 2.2 The CMA refers to "low" rates of switching amongst BCA customers and to its expectation that the SME sector should be more customer focused with "higher" levels of switching, but has not provided a clear benchmark of switching levels in a well-functioning market.
- 2.3 The CMA has sought to make comparisons with other service industries, stating that "*switching [is] much lower than in many other markets, including energy provision, car insurance and mobile telephones*".³ However, as stated in the response to the PCA Provisional Decision in Annex 2 of this response, any such comparison between industries and sectors does not recognise the different features and dynamics of those sectors. In particular, these other industries and sectors are not subject to the same material level of churn that the SME banking sector is subject to. Such comparisons have also not typically featured in previous market investigations.

The potential impact of CASS

- 2.4 The CMA accepts that CASS will "*go at least some way to addressing certain of the actual and believed costs of switching*".⁴ However, LBG considers that the CMA has underestimated the potential impact of CASS on BCA switching in concluding that "*we cannot say that the CASS has had a substantial and sustained impact on SME switching behaviour*".⁵ LBG considers that more time is required to evaluate the full impact of CASS. The CMA itself recognises that, over time, CASS can have a greater impact than today's switching evidence suggests.⁶ In this regard, although awareness amongst SMEs of the applicability of CASS to SMEs may currently appear to be limited, as noted by the CMA, LBG would expect this level of awareness to increase over time,⁷ particularly as the next phase of CASS communications will focus on SMEs.⁸ Moreover, CASS is subject to a further review by the FCA in September 2014, which will provide further opportunity to assess its effectiveness and propose adjustments if required.
- 2.5 It is therefore too early to expect CASS to already have had a "*substantial*"⁹ impact on SME switching behaviour. As the CMA acknowledges, CASS is likely to have an increasingly significant impact in the future as SME awareness and confidence in the service increases, and this should be recognised in any competition assessment.

Further consideration needs to be given to alternative indicators of competition

- 2.6 The CMA recognises that "*the evidence [...] regarding levels of switching does not represent the full extent of the competitive constraints faced by BCA and business loan providers*". LBG agrees with this view, but is concerned that the CMA has understated these additional indicators of competition (which should be considered cumulatively in any competition assessment). In particular:
- (a) **Churn** – LBG is encouraged by the CMA's acknowledgement that "*churn rates in SME BCAs are considerable*"¹⁰ but notes that the CMA has materially underestimated its importance of churn (e.g. from new start-up SME businesses and businesses that close) in driving competition as providers seek to maintain and increase their market shares;

³ Paragraph 8.35, CMA Provisional SME Decision.

⁴ Paragraph 8.60, CMA Provisional SME Decision.

⁵ Paragraph 8.61, CMA Provisional SME Decision.

⁶ Paragraph 8.60, CMA Provisional SME Decision.

⁷ [Confidential]

⁸ Payments Council, The Current Account Switch Service – One Year On, September 2014, page 15

⁹ Paragraph 8.61, CMA Provisional SME Decision.

¹⁰ Paragraph 8.81, CMA Provisional SME Decision. The CMA acknowledges that churn rates were between 14 and 24% for the largest banks.

- (b) **"Stealth switching"** - As "stealth switching" cannot be identified by providers, it is not included within the CMA's switching analysis.¹¹ However, LBG estimates that "stealth switching" may account for 50–60 per cent of all switching;
- (c) **Changing BCA provider at the end of an introductory period** - The CMA observes that there is an increase in switching levels at the end of a BCA customer's free introductory banking period, but dismisses the importance of this switching as it does not have a prolonged effect and is, in any event, included in its overall (low) switching statistics.¹² However, there are a number of key aspects of the sector's competitive dynamic that LBG considers the CMA has given insufficient weight to:
 - (i) the level of churn for SMEs (i.e. from new start-ups in particular) means that providers are constantly competing to (a) attract new customers; (b) retain BCA customers whose introductory offers are coming to an end; and (c) win BCA customers from other providers;
 - (ii) SMEs that decided not to switch because their incumbent service provider has competed successfully to retain their business are not included in the CMA's switching analysis although they have clearly benefited from competition; and
 - (iii) the spike in switching rates at the end of the free introductory banking period provides evidence that SMEs are engaged and prepared to switch if there is a material difference in the relative pricing, features and service of BCAs between providers; and
- (d) **Relationships with different financial product providers** - Many SMEs will have pre-established relationships with a range of different financial product providers which they use. The CMA therefore needs to take into account that these alternative suppliers of finance and other financial products, many of which are substitutes for SME lending, are a material competitive constraint on SME business lending.

2.7 Moreover, switching levels should be considered in the context of SMEs' high satisfaction with their BCA provider, as explained in paragraph 6.3 below. The most common reason (76 per cent) for not switching reported by SMEs eligible to use CASS was a good relationship with their existing bank.¹³ The significant innovation and improvements to the customer experience made by LBG and other providers to retain customers contribute to these satisfaction levels and also benefit all customers, including those which do not switch or shop around.

Key LBG initiatives

2.8 LBG continuously seeks to improve its SME banking products and services in order both to win and to retain customers. For example, as previously explained, LBG has made significant investments in relation to:

- (a) online and mobile SME banking. The rapid growth of online banking services and mobile banking is the biggest change to the market, increasing transparency and facilitating shopping around, since the CC's 2002 Market Investigation.¹⁴ For example, as previously

¹¹ See, paragraph 16.1(d)(ii) of LBG's 13 November 2013 response to question 16 of the OFT's request for information of 15 October 2013.

¹² Paragraphs 8.74, CMA Provisional SME Decision.

¹³ Payments Council, The Current Account Switch Service – One Year On, September 2014, page 10

¹⁴ See, for example, LBG's 13 November 2013 response to question 21 of the OFT's request for information of 15 October 2013.

submitted, 68 per cent of SMEs prefer to use digital channels (online and mobile) for most of their banking needs and products, with a further 12 per cent preferring to carry out simple transactions and simple tasks digitally.¹⁵ Similarly, LBG experienced a [Confidential] per cent growth in digital payments (offsetting a [Confidential] per cent decline in manual payments) between 2010 and 2011;¹⁶

- (b) LBG's online "Finance Selector" and "Loan Calculator" tools, and a similar calculator indicating which of LBG's BCA tariffs would be best for a given customer, in order to increase transparency and facilitate shopping around;¹⁷
- (c) product innovations for SMEs, such as the Monthly PricePlan¹⁸ and discounted rates for new start-up businesses for an initial period;¹⁹ and
- (d) LBG's cooperation with the Business Finance Taskforce and its numerous initiatives, many of which relate to transparency and increasing awareness and understanding of the full range of finance options available to SMEs.²⁰

2.9 The importance of such initiatives (aimed at retaining customers and attracting new start-up customers), which are driven by competition, cannot be captured by a narrow switching analysis.

Customer engagement

2.10 As explained below, LBG does not consider that the CMA's findings on SME engagement levels accurately reflect the available evidence. The CMA claims that SME engagement levels (particularly for the smaller SMEs) are low because:²¹

- (a) very few SMEs shop around, reflecting the belief that there is limited differentiation between providers;
- (b) there are relatively few SMEs that are likely to be able to negotiate terms successfully. Those that do tend to be the largest SMEs, whereas most SMEs tend to be sole traders and micro-enterprises; and
- (c) BCA and loan pricing remains highly complex.

2.11 LBG has explained in previous submissions that there is a high and increasing level of transparency in markets for BCAs and general purpose business loans.²² Numerous developments and initiatives have already been undertaken to: (i) increase the availability and transparency of information; (ii) increase the accessibility of that information; and (iii) increase the comparability of information so that SMEs can make accurate and informed choices. In particular:

- (a) providers make a wide range of information readily available via websites and product literature, supplementing this with various tariff calculation tools in order to make it easier

¹⁵ Booz & Company's November 2012 report, "SME Banking Digitalisation", Annex 25 of LBG's 13 November 2013 response to the OFT's request for information of 15 October 2013.

¹⁶ See evidence previously submitted to the CMA.

¹⁷ See, for example, paragraph 17.3 of the LBG's 13 November 2013 response to the question 17 of the OFT's request for information of 15 October 2013.

¹⁸ Introduced in 2011, this offers SMEs fixed fee pricing with simplicity, cost certainty and significant savings over traditional BCA pricing. See LBG's 13 November 2013 response to questions 2 and 10 of the OFT's request for information of 15 October 2013 for further details.

¹⁹ See, for example, LBG's 13 November 2013 response to question 2 of the OFT's request for information of 15 October 2013 for further details.

²⁰ See, for example, paragraph 17.4 of LBG's 13 November 2013 response to question 17 of the OFT's request for information of 15 October 2013.

²¹ Paragraph 1.28, CMA Provisional SME Decision.

²² See, for example, LBG's 13 November 2013 response to the OFT's request for information of 15 October 2013.

for customers to find the right product²³, which is acknowledged as a positive development by the CMA;²⁴

- (b) there has been an increase in the transparency of particular SME products. For example, LBG has introduced its Monthly PricePlan, which offers SMEs fixed fee pricing with simplicity and cost certainty as well as significant savings over traditional BCA pricing;
- (c) information is readily available from third parties, including price comparison websites, brokers and professional advisers, (financial advisers, accountants and solicitors) and small business networks. The CMA itself notes the "*important role for external advisers and intermediaries in helping SMEs to obtain the best possible deal*";²⁵ and
- (d) the industry has, in general, been working to increase transparency to SME customers. In particular, the Business Finance Taskforce member banks, including LBG, have committed to a set of specific measures, many of which relate to transparency and increasing awareness and understanding of the full range of finance options available to SMEs.

2.12 The CMA's provisional conclusion that generally only larger SMEs are likely to negotiate terms (which the CMA seems to suggest implies that only the larger customers are able to obtain better terms through negotiation), does not recognise that this reflects customer preferences and is not due to any lack of transparency or customer engagement. As previously submitted,²⁶ customer research has shown that larger SMEs typically prefer a more bespoke and personalised service, reflecting their individual banking needs and often engage in multi-banking, while smaller SMEs typically prefer a simpler, more standardised service from a single bank. Accordingly, LBG's proposition for smaller SMEs is based on standardised, transparently priced services in order to meet their specific needs. The CMA needs to take such customer preferences into consideration and avoid mischaracterising some SMEs' preference for more bespoke and personalised services (in particular in relation to business loans) by labelling products as "complex".

2.13 With regard to the alleged complexity of BCA pricing in particular, the CMA should take into account the innovations introduced to simplify pricing, promote transparency and increase the comparability of BCA products. Although the CMA has recognised the greater use of tariffs with monthly fixed charges (such as LBG's Monthly PricePlan and Santander's BCA tariff), LBG believes that the CMA should also take these products into account when assessing price complexity.

3. MARKET STRUCTURE - CONCENTRATION

3.1 The CMA has provisionally concluded that the SME BCA and business lending markets "*remain concentrated*", that there has been "*very limited organic growth by smaller banks*" and that "*relatively high market concentration and, in particular, stable and high market shares over an extended period are often associated with poor market outcomes*".²⁷

3.2 LBG considers that the CMA has materially overstated the relevance of market structure and scale and has given insufficient weight to the dynamic changes that are already taking place. Accordingly, any finding that scale and low levels of switching work together as impediments to

²³ For example, LBG's online "Finance Selector" and "Loan Calculator" tools, and a similar calculator indicating which of LBG's BCA tariffs would be best for a given customer. See, for example, paragraph 17.3 of LBG's 13 November 2013 response to question 17 of the OFT's request for information of 15 October 2013.

²⁴ Paragraph 7.21, CMA Provisional SME Decision.

²⁵ Paragraph 8.21, CMA Provisional SME Decision.

²⁶ See paragraph 3.33 of LBG's 13 November 2013 response to the OFT's request for information of 15 October 2013, which refers to Quadrangle research.

²⁷ Paragraphs 4.58-4.59, CMA Provisional SME Decision.

competition from new and smaller entrants is highly speculative. In addition, it is not sufficient merely to assert that there is a causal link between levels of concentration and customer outcomes in the BCA and business lending markets. In fact the evidence shows that:

- (a) **LBG's market share growth in business lending reflects its competitive service and products:** This is illustrated by the fact that LBG's business lending share is growing (as are some of the smaller banks) compared to some other larger banks, which are in decline.²⁸ The CMA's analysis should take into account the competitiveness of each provider's offering in determining the effect of concentration on market outcomes;
- (b) **It is the aggregate constraint that is relevant:** SMEs have the choice of a wide range of SME banking providers, regardless of their size, location, sector, or product and service expectations. The number of SME BCA and business loan service providers in the UK is significantly higher than it was in 2002.²⁹ When analysing market concentration and the competitive nature of the BCA and lending markets, the CMA should consider the aggregate constraint provided by all competitors;
- (c) **Scale is not an impediment to competition:** The CMA seems to assert that scale is in some way an impediment to competition. However, the heterogeneity of SME customers and the flexibility of smaller providers mean that they have the ability to grow market share by targeting specific customers, and they are not hindered by the large costs of operating a branch network or by legacy IT costs. In this regard, the CMA should consider the scalability of costs incurred by smaller competitors and the extent to which such providers are profitable at a smaller scale;
- (d) **Key structural changes are already taking place:** LBG believes that the CMA has given insufficient weight to the likely future impact of the structural changes already taking place which will re-shape the market. For example:
 - (i) the CMA has stated that the TSB and Williams & Glyn divestments will only have a "*limited impact on overall structure in PCAs and SME banking markets*".³⁰ However, it is too early for the CMA to draw such a conclusion. The divested businesses will have material market shares and will have incentives to compete aggressively for new customers to gain market share,³¹
 - (ii) although the CMA has acknowledged market entry (such as by Metro Bank and Atom) and expansion (such as by Aldermore, Shawbrook and Handelsbanken), LBG believes that the CMA has dismissed the potential impact of these providers prematurely without fully understanding their respective growth strategies. A more forward-looking assessment of these structural changes is therefore required;
 - (iii) a number of other new competitors are considering entering the market, such as PayPal (which is expected to enter the online business loans market in the UK from

²⁸ See, for example, Figure 4.5 of the CMA Provisional SME Decision which shows that since 1999 LBG has increased its share of the business loan segment, whereas RBS and Barclays have been in decline.

²⁹ See LBG's 13 November 2013 response to question 7 of the OFT's request for information of 15 October 2013 and LBG's follow-up response to question 7 of June 2014.

³⁰ See, for example, paragraph 4.33 of the CMA Provisional SME Decision which refers to the OFT's advice and recommendations to the Chancellor of the Exchequer, 11 September 2013.

³¹ Paragraph 4.32, CMA Provisional SME Decision. The CMA has acknowledged that the divestment of TSB is expected to lead to the creation of an 8 per cent market share in Scotland; and the divestment of Williams & Glyn is expected to lead to the creation of a 5 per cent market share in England and Wales.

Autumn 2014) and Tungsten Corporation (which is planning to enter the SME lending sector); and

- (iv) there is the clear potential for larger providers such as Nationwide, Virgin Money and others to launch BCA and business lending products in the future – a number of these providers are already providing banking services to SMEs (e.g. to those who operate their business through their PCAs); and
- (e) **There are competitive constraints from alternative forms of lending:** The CMA's statement that alternative forms of finance (such as invoice finance, asset finance, trade finance, equity finance and alternative platforms like peer-to-peer lending) "*play an important but currently limited role in providing finance to SMEs*",³² must be considered in light of the growing competitive constraints exerted by these products. For example:
 - (i) just as many SMEs have asset finance or hire purchase arrangements as have bank loans, which are close substitutes in most circumstances;³³ and
 - (ii) LBG considers that the CMA pays insufficient regard to the role of consumer finance as a substitute for loans (particularly in the case of start-ups and smaller SMEs). For example, according to SME Finance Monitor, 37 per cent of SMEs that make use of a bank overdraft, bank loan, commercial mortgage or credit card hold one or more of these in the personal name of one of their owners or directors,³⁴ which is significant³⁵ given that only approximately 33 per cent of SMEs use external finance at all.³⁶

4. THE DIMINISHING IMPORTANCE OF THE BRANCH NETWORK

4.1 The CMA's Provisional Decision concludes that there is a need for SME banking providers to have an extensive local branch network, both to acquire new customers and to distribute products effectively. LBG considers that the CMA has overstated the importance of a branch network to SME customers. Any assessment of the relevance of branches should be considered in the context of the large and general shift towards online and mobile banking, and the diminishing importance of branch access. The survey evidence cited by the CMA is inconsistent with the following evidence:

- (a) as recognised by the CMA, the usage of local branches by SMEs has diminished in recent years, predominantly as a result of increased online use and, increasingly, mobile banking.³⁷ 70-80 per cent of SMEs transact more than half of their business banking online³⁸ and, as previously submitted, 46 per cent of SMEs now transact all or nearly all of their banking business online (with an additional 7 per cent using other non-branch means – telephone or postal banking – for all or nearly all of their business.³⁹ See also, for example, the growth rates outlined in paragraph 2.8(a) above). In relation to LBG, [Confidential] per cent of its SME customers are currently active users of internet banking (which has increased by

³² Paragraph 5.18, CMA Provisional SME Decision.

³³ SME Finance Monitor. See paragraph 9.2 of LBG's 13 November 2013 response to question 9 of the OFT's request for information of 15 October 2013.

³⁴ SME Finance Monitor Q2 2013: The changing mix of external funding?, page 44, period from Q4 2012 to Q2 2013.

³⁵ See LBG's 13 November 2013 response to question 9 of the OFT's request for information of 15 October 2013 for further details on examples of alternative SME finance.

³⁶ SME Finance Monitor, Q1 2014: <http://www.bdrc-continental.com/EasySiteWeb/getresource.axd?AssetID=7684&type=full&servicetype=Inline%20>

³⁷ Paragraph 5.78, CMA Provisional SME Decision.

³⁸ SME Banking 2013, YouGov (2013).

³⁹ SME Banking 2013, YouGov (2013), Figure 63, cited in paragraph 11.5(c) of LBG's 13 November 2013 response to question 11 of the OFT's request for information of 15 October 2013.

[Confidential] per cent in 2014), approximately [Confidential] per cent of which are already using LBG's SME mobile app following its launch in March 2014 (take up of which is expected to increase further [Confidential]); and

- (b) many of the larger providers are contracting their branch networks, as noted by the CMA.⁴⁰ In the case of LBG, although there has been some investment in branches in recent years, this has been driven by the need to update branch designs to reflect the changing use of branches and to rebrand following the TSB divestment.

4.2 Moreover, LBG notes that any assessment of the importance of a branch network should recognise the diversity in providers' business models:

- (a) entry and expansion is viable without the need for a branch network (e.g. Atom, PayPal and Tungsten, which are expected to enter the SME financing sector in the UK via an online-only platform). These providers do not bear the costs of operating a large branch network and are in a more dynamic and flexible position to target SME customers; and
- (b) competitors such as Santander, Nationwide, Co-op, TSB and Williams & Glyn already have extensive branch networks.

5. LINKAGES BETWEEN PRODUCTS

5.1 The CMA claims that the market is characterised by a number of linkages between SME and PCA products which limit the scope for newer or smaller providers to expand. In particular, there is:

- (a) a strong tendency for SMEs to use their PCA provider for their BCA and business loans;
- (b) a preference for SMEs to use a single bank for all their relevant banking needs; and
- (c) limited SME awareness of alternative provider brands.⁴¹

5.2 However, the following key factors are relevant:

- (a) as recognised by the CMA, most SMEs value continuity of relationships with their banking supplier. LBG recognises this (as well as the fact that there is a significant number of alternative SME product providers to choose from) and aims to build deep and lasting relationships with all its customers in both personal and business banking and offers a very competitive BCA product. In relation to SME banking in particular, as previously submitted, LBG offers, *inter alia*: telephone access to a team of dedicated business managers; (for larger SMEs) access to local specialist relationship managers; and access to local senior managers with a discretion to negotiate loans up to a certain value;⁴²
- (b) the CMA relies on evidence which suggests that 60 per cent of BCA customers at the four largest UK banks also have a PCA with the same bank.⁴³ However, this analysis does not recognise the significant differences between providers. Charterhouse data⁴⁴ on the conversion of personal to business customer accounts shows that start-up customers that

⁴⁰ Paragraph 5.70, CMA Provisional SME Decision.

⁴¹ Paragraphs 5.147-5.148, CMA Provisional SME Decision.

⁴² For further details on how LBG differentiates itself from other providers, see LBG's 13 November 2013 response to question 8 of the OFT's request for information of 15 October 2013.

⁴³ Third bullet on page 9 of the CMA Provisional SME Decision, for example.

⁴⁴ Charterhouse YEQ1 2014 PCA conversion rates for SMEs with turnover up to £25 million - Table 18B from the Charterhouse UK Business Banking Survey 2014.

have an HBOS PCA are about as likely to open a BCA with Barclays (23 per cent) as with Lloyds Bank (24 per cent) ([Confidential]), and only 33 per cent of HBOS' start-up customers with a PCA have a BCA within the wider Lloyds Banking Group. Similarly, only 50 per cent of HSBC's start-up customers with a HSBC PCA also had a HSBC BCA, and the figure is only (48 per cent) for LBG as a whole;

- (c) as noted by the CMA, providers with narrower product ranges have been successful in expanding their business, suggesting that a bank's ability to offer other services has a limited impact on its ability to compete; and
- (d) many smaller SMEs use their PCAs for business purposes. Therefore, PCA providers that do not offer BCAs, such as First Direct and Nationwide, may nevertheless exert a further competitive constraint on providers in the BCA segment.

6. MARKET OUTCOMES FOR SME CUSTOMERS

- 6.1 The CMA's analysis of alleged adverse customer effects requires further consideration and does not accurately reflect LBG's experience of competition in the market.

Customer satisfaction

- 6.2 LBG recognises that there is some dissatisfaction with the banking sector generally, in substantial part due to the financial crisis, and has been working hard to build relationships with its clients and with the SME sector in general. This forms a key part of LBG's competitive strategy, as already outlined in paragraph 5.2(a) above. However, LBG considers that the CMA's conclusions in relation to customer satisfaction (for example, that *"overall [...] the evidence indicates that banks are underperforming in satisfying SME customers"*⁴⁵ and that *"there is considerable room for improvement"*⁴⁶) do not accurately reflect LBG's experience of the sector or indeed the survey evidence considered as a whole.
- 6.3 First, the CMA has taken a particularly conservative view in assessing customer satisfaction, suggesting that customers need to be more than "satisfied" in order for the market to be regarded as working properly. For example:
- (a) in referring to Charterhouse research (which finds that 52-54 per cent of SMEs rated the overall quality of service as "excellent" or "very good"), the CMA has not included customers that rated service quality as "good".⁴⁷ The CMA has dismissed a "good" rating as an indication that providers 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,⁴⁸ which is a false and inappropriate assessment. Taking into account all three categories of responses ("excellent", "very good" and "good") shows that a much higher figure of 78 per cent of SMEs rated the overall quality of service as good or above;⁴⁹ and

⁴⁵ Paragraph 9.66, CMA Provisional SME Decision.

⁴⁶ Paragraph 1.32, CMA Provisional SME Decision.

⁴⁷ Paragraph 9.43, CMA Provisional SME Decision.

⁴⁸ Footnote 285, CMA Provisional SME Decision.

⁴⁹ Paragraph 9.43 of the CMA Provisional SME Decision states that 22 per cent of SMEs rated the overall quality of service as fair/poor in the Charterhouse survey rather than excellent, very good or good.

- (b) when commenting on the YouGov 2013 survey,⁵⁰ the CMA refers to only 23-32 per cent of SMEs as being "very satisfied" with their bank, whereas the same survey found that 82 per cent of SMEs were "satisfied" or "very satisfied" with their current bank.⁵¹

6.4 Second, the CMA itself has recognised that the evidence shows a significant variation,⁵² with some surveys indicating much higher levels of customer satisfaction than the CMA's conclusions would suggest.

Innovation

6.5 The CMA has acknowledged the significant investments made in mobile and digital SME banking and in pricing structures (such as LBG's BCA Monthly PricePlan) as evidence of innovation and providers seeking to improve their services and relationship management for SME customers.⁵³ However, LBG believes that the CMA's conclusion that "*the levels and extent of innovation we have observed in the SME banking sector are arguably more limited [compared to the PCA market]*" does not fairly reflect the innovation currently taking place within the SME sector:

- (a) the CMA accepts that "*It is challenging to identify an appropriate 'benchmark' against which to measure optimal levels of innovation*". In this regard, without such a benchmark, a comparison with levels of innovation within the PCA market provides little insight as to whether innovation in SME banking is consistent with a well-functioning market; and
- (b) the CMA's reference to Mintel's statement that there was seemingly "*scant innovation and product development activity among the UK's largest banking groups' in 2013 with the exception of Barclays*"⁵⁴ materially understates the level of innovation that has taken place and, in particular, those innovations developed by LBG. In this regard, the Provisional Decision notes LBG's launch of the Monthly PricePlan in July 2011 and Santander's competitive response, the launch of the Paym mobile banking mechanism, the growth of mobile and internet banking and online business tools in the market generally, as well as recent entry into some specialist niches of the SME banking sector.⁵⁵ Moreover, the Provisional Decision ignores LBG's double discounting on Funding for Lending, LBG's transparent fixed rate loan product with an upper limit on break costs.⁵⁶ Other, more recent LBG innovations include the launch of LBG's capital goods import facility.⁵⁷

6.6 The CMA should adopt a more forward looking approach to assessing innovation by taking into account the growing rate of innovation in the SME sector and the future impact of those innovations. For example: [Confidential]; and, [Confidential].⁵⁸

Impact of the changes already taking place

6.7 LBG believes that the CMA's analysis has placed insufficient weight on the cumulative impact of the numerous structural, behavioural, regulatory and technological developments that are taking

⁵⁰ SME Banking 2013, YouGov (2013), cited in paragraph 9.44 and footnote 286, CMA Provisional SME Decision.

⁵¹ See page 63 of the SME Banking 2013, YouGov survey: 37 per cent of the SME managers and owners questioned were "very satisfied" with their current banking provider, 45 per cent were "satisfied" and only 5% were dissatisfied.

⁵² Paragraph 9.43, CMA Provisional SME Decision.

⁵³ Paragraph 9.39, CMA Provisional SME Decision.

⁵⁴ Small Business Banking – UK, Mintel, (December 2013), cited at paragraph 9.40, CMA Provisional SME Decision.

⁵⁵ Such as specialist lending, or on specific customer groups, such as larger SMEs.

⁵⁶ For further details on these and other LBG innovations, see LBG's 13 November 2013 response to question 10 of the OFT's request for information of 15 October 2013.

⁵⁷ Launched in Q2 2014, this is an end-to-end funding facility for SMEs that want to import equipment for their business. The product grants the SME funding at the point on which the Letter of Credit is issued to the seller by LBG. The credit is then transferred smoothly to LBG's hire purchase team at point of receipt.

⁵⁸ [Confidential]

place, which LBG believes will mitigate or address the CMA's concerns. In this regard, historic evidence may not be a reliable indicator of future developments as the pace of change is increasing, reflecting the aggregate impact of a variety of measures which are changing the SME banking sector. These include:

- (a) the impact of the structural changes already taking place, including the creation of TSB and Williams & Glyn as two new challenger banks;
- (b) regulatory initiatives to lower barriers to entry and expansion and promote switching, such as: CASS (and its review); changes to the authorisation process for new entrants; changes to capital requirements; establishment of the PSR; improvements to the sharing of credit information; legislation to match SMEs who have been turned down with alternative credit providers; agreement between major providers to process most claims for a "deed of priority" or "waiver" within seven working days; and agreements between major providers to provide standardised documentation;
- (c) important examples of market entry (including, Santander's acquisition of Alliance & Leicester creating a new nationwide scale player in SME banking, TSB, Metro, PayPal, Tungsten, Atom) and expansion (for example, Aldermore, Shawbrook and Handelsbanken);
- (d) the impact of technology and innovation, including significant increases in the usage and functionality of digital banking, which has contributed to the decreasing importance of a branch network (with the likes of PayPal, Atom and Tungsten entering the market on an "online-only" basis);
- (e) the impact of the financial crisis more generally on business conditions for SMEs and the cost of funding for lenders, which have resulted in turn in Government schemes such as Funding for Lending to mitigate the effect on SMEs; and
- (f) the growth of alternative finance.

7. UILS

- 7.1 In the lead up to the CMA's Provisional Decision, LBG, together with HSBC, RBS and Barclays, offered the CMA a set of proposed undertakings in lieu of a market investigation reference ("UILS"). The participating banks all believed that the UILs would have addressed many of the concerns raised in the CMA Provisional Decision. However, given the CMA's assessment of the proposed UILs in the Provisional Decision, LBG has decided not to proceed with the proposed UILs. However, irrespective of the CMA's reference decision, LBG will continue to consider initiatives either unilaterally or multilaterally that it considers will benefit SMEs.

8. REVIEW OF 2002/2003 UNDERTAKINGS

- 8.1 With regard to the remainder of the 2002/2003 Undertakings, LBG would welcome a fresh review of those undertakings and the extent to which they remain appropriate in light of the market developments and initiatives outlined in this note. In particular, LBG would welcome a review of the following:

- (a) **the Switching undertakings (clauses 6 to 16 of the 2002/2003 Undertakings):** As previously explained to the CMA,⁵⁹ there are inconsistencies between CASS and the 2002/2003 Switching undertakings. LBG considers that CASS is superior to the 2002/2003 Switching undertakings for those SMEs to which it applies (such as automated seven day switching and CASS Guarantee) and agrees with the CMA that maintenance of two different switching frameworks in parallel (where they both apply) is undesirable. LBG therefore welcomes the CMA's proposal to remove the 2002/2003 Switching undertakings as far as they relate to smaller SMEs that qualify under CASS;
- (b) **the Portable Credit History undertaking (clauses 15 and 16 of the 2002/2003 Undertakings):** LBG considers that this undertaking has not had a significant effect on the SME banking market because alternative lenders can learn more by a prospective borrower simply providing its last six months of statements. LBG considers that HM Treasury's promising initiative to require banks to share SME customer information with other lenders through credit reference agencies will ultimately provide an effective and more compelling alternative. LBG suggests that the CMA should consider that this undertaking has been superseded by the HM Treasury initiative which, together with the Small Business, Enterprise and Employment Bill to help match SMEs rejected for finance with alternative lenders, will more effectively enhance SME's access to credit; and
- (c) **the Unbundling undertaking (clauses 17-20 of the 2002/2003 Undertakings):** LBG would welcome a fresh review of the terminology used in those undertakings. In particular, LBG considers that the exclusions in clause 18 could be further clarified.

⁵⁹

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

ANNEX 2

LBG'S COMMENTS ON THE CMA PCA MARKET STUDY UPDATE

1. KEY FEATURES OF THE PCA MARKET

- 1.1 The objectives for the PCA Market Study Update ("**PCA Update**") were to *"update the findings from the OFT's 2013 review of the PCA market; assess the effectiveness of a number of current and forthcoming initiatives identified as having the potential to increase competition; and enable the CMA to form a view on whether this market should be the subject of an MIR."*⁶⁰
- 1.2 However, the PCA Update has not taken into account certain key features of the PCA sector, in particular Basic Bank Accounts ("**BBAs**") and the free-if-in-credit ("**FIIC**") model for PCAs in the UK. Consideration of these features would materially affect all aspects of the CMA's analysis, as explained below.

Basic Bank Accounts

- 1.3 BBAs are current accounts targeted at customers who may otherwise be unable to open a bank account, for example, due to an incomplete credit history. The main PCA providers committed to the Government in 2003 to offer BBAs, without an overdraft facility or chequebook, for free. The aim of this commitment was to ensure everyone had access to a transactional bank account with certain essential features. LBG fully supports this aim.
- 1.4 The CMA has noted that there are now 5.4 million active BBAs in the UK,⁶¹ representing 8.3 per cent of all active PCAs.⁶² Many of these BBAs would meet the CMA's definition of a funded PCA,⁶³ with BBAs accounting for around [Confidential] per cent of LBG's funded PCAs.⁶⁴ Moreover, the OFT identified BBAs as an important segment of the PCA market in 2013, noting that *"... while basic bank accounts accounted for a similar proportion of the market in 2007 and 2011 (12 per cent of all accounts), in 2011 they represent 17 per cent of new accounts and may also therefore represent a growing proportion of the market."*⁶⁵
- 1.5 It is therefore surprising that the main part of the PCA Update makes no reference at all to BBAs in the UK.⁶⁶ LBG considers that 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 the impact of BBAs on the wider PCA market are properly considered in the CMA's final Phase 1 decision and in any Phase 2 inquiry. In particular, the CMA should consider whether the important social objectives that BBAs aim to deliver (and which LBG supports) can be achieved via policies which better promote competition in the supply of BBAs and which minimise any distortions to competition.

⁶⁰ PCA Update, paragraph 1.8

⁶¹ LBG would observe that other organisations have reported that there are a significantly higher number of BBAs. For example, *The best of British banking* report by Accent on basic bank accounts for Consumer Focus reports a figure of 8.4 million BBAs (<http://www.consumerfocus.org.uk/files/2012/10/The-best-of-British-banking.pdf>, page 7).

⁶² Derived from PCA Update, Annex A, Table 1

⁶³ A PCA receiving at least £500 pcm - PCA Update, paragraph 2.9.

⁶⁴ LBG Response to CMA Questionnaire, May 2014, page 16

⁶⁵ 2013 OFT Review of PCAs, paragraph 3.11

⁶⁶ There is one reference in footnote 42, one reference in Annex A and a handful of references to the EU Payment Accounts Directive.

BBAs are loss-making

- 1.6 The OFT found in 2013 that "[w]hile basic bank accounts represent 12 per cent of total account numbers, they only represent two per cent of revenues. Revenues from these accounts are typically lower than for other account types, due to the limited functionality of many basic bank accounts which limits the ability of providers to earn revenue from the services provided."⁶⁷
- 1.7 The PCA Update does not update these findings or consider their implications. LBG estimates that it made a loss of around [Confidential] in 2012 in providing BBAs,⁶⁸ and that while BBAs make up [Confidential] per cent of LBG's active PCA base, they only generate [Confidential] per cent of LBG's PCA income.⁶⁹ This is because BBA customers are typically more costly to serve (as they tend to make greater use of more expensive transaction channels such as ATMs and branch counters) and generate no overdraft income, and lower net credit interest and interchange revenues than other PCA customers.
- 1.8 The CMA has not considered the implications of the continuing discussions between HMT and each of the main PCA providers, which aim to increase the functionality of basic accounts and, for certain groups of customers, remove any fee income (including returned item fees, which generate [Confidential] of revenue for LBG). These proposals, together with the proposed EU cap on interchange fees, will make BBAs even less attractive to provide.

Implications for the CMA's analysis

- 1.9 As BBAs are loss-making, it is unsurprising that the OFT concluded that "[s]ome PCA providers may find basic bank accounts unappealing to provide, particularly if a significant proportion of those consumers do not move to standard and other account types over time. This may explain why some providers have sought to limit the availability of basic bank accounts they offer (for example by restricting account eligibility), or limit their functionality to make them less attractive and reduce their cost."⁷⁰
- 1.10 However, the CMA does not appear to have taken this into account in considering whether "consumers have a broad choice of provider" and whether "credible new players are able to join the market and have reasonable prospects for attracting the scale of customer base needed to achieve the economies of scale required to operate effectively."⁷¹ The majority of providers which do not offer BBAs are unlikely to focus on this segment. It is also likely that the costs of providing loss-making BBAs will need to be recovered from other customers. The CMA should therefore go beyond its finding that PCA pricing is "unlikely to be perfectly cost-reflective,"⁷² and seek to understand the cross-subsidies involved.
- 1.11 Providers have limited scope to differentiate or innovate their BBA products as the price (free) and minimum features have been specified by the Government, and providers have little commercial incentive to incur the costs of enhancing a loss-making product with no possibility of increasing revenues. This limited scope to differentiate or innovate is highly relevant in considering whether, for BBAs, "...providers' products are well suited to their customers' needs [and] competition between banks (and from non-banks) is driving providers to operate more efficiently and to

⁶⁷ 2013 OFT Review of PCAs, paragraph 3.28

⁶⁸ LBG Response to CMA Questionnaire, May 2014, page 36

⁶⁹ LBG Response to CMA Questionnaire, May 2014, page 16

⁷⁰ 2013 OFT Review of PCAs, paragraph 3.29

⁷¹ PCA Update, Summary paragraph 4

⁷² PCA Update, paragraph 2.68

innovate"⁷³ Moreover, the presence of BBAs inhibits the development of innovative providers (such as Secure Trust and Thinkmoney) which offer very high functionality accounts aimed at customers who want control and support in managing their incomings and outgoings but which charge fees to cover the additional costs of these extra services.⁷⁴

- 1.12 BBAs also distort competition and innovation in the supply of standard accounts. As the Government requires increased functionality of BBAs, this sets a "floor" as regards the functionality of other unfunded accounts, whose features must be superior otherwise customers would simply switch to BBA products. Accordingly, any entrant that wished to target the basic end of the market cannot charge an economic price because the banks which have committed to provide BBAs are being forced to price below cost.⁷⁵
- 1.13 Customer engagement and switching will inevitably be lower for BBA customers as all banks provide very similar products. Moreover, many BBA customers are ineligible to switch to standard PCAs. Accordingly, the CMA's findings on market structure are skewed by the inclusion of the BBA segment (which, for the reasons set out above, cannot reasonably be expected to be characterised by material entry or expansion).

The free-if-in-credit model for PCAs

- 1.14 A central feature of the PCA market in the UK is the FIIC model, under which customers do not pay a monthly fee or transaction fees, and providers primarily generate revenues through net credit interest, interchange fees and overdraft charges.
- 1.15 The CMA has expressed concerns in relation to the FIIC model on the basis that it:
- (a) results in cross-subsidies between categories of customers: *"This pricing model is unlikely to be perfectly cost-reflective, and it might result in cross-subsidies between different categories of customers. For example, customers who use their overdrafts regularly and customers who keep large balances on non-interest-bearing accounts may subsidise other categories of customers which could, in itself, be distortive of competition"*,⁷⁶
 - (b) involves complex costs for customers: *"...customers pay for their PCAs primarily through the interest foregone on their credit balances and the overdraft charges paid when their PCA is in debit. These costs are typically more complex to grasp for customers than, for example, a monthly fee"*,⁷⁷ and
 - (c) limits PCA product variety, as the demise of the FIIC model *"could lead to more heterogeneous pricing structures applied in the market as PCA providers seek to offer products which appeal to different types of customers who previously all benefited from 'free if in credit' banking."*⁷⁸
- 1.16 As explained below, LBG considers that the CMA has not fully appreciated the value to customers of the FIIC model and the implications of the FIIC model for its assessment of the market:

⁷³ PCA Update, Summary paragraph 4

⁷⁴ LBG Response to CMA Questionnaire, May 2014, page 71

⁷⁵ LBG Response to CMA Questionnaire, May 2014, page 71

⁷⁶ PCA Update, paragraph 2.68

⁷⁷ PCA Update, paragraph 3.3

⁷⁸ PCA Update, Annex A, paragraph 16

- (a) the FIIC model continues to offer significant value to customers, as it does not involve any payments to the provider (for PCAs which remain in credit). Consequently, the end of universally available FIIC PCAs would be likely to involve significant customer detriment;
- (b) the nature of customer activity in a "well-functioning" market is likely to be different in a market with a zero headline price. The only cost to customers of a FIIC PCA which remains in credit is interest foregone, which the CMA has found is of limited interest to customers because of the current low interest rate environment.⁷⁹ Consequently, as the CMA has identified, for many customers *"...service is likely to be a more significant dimension of competition than price..."*⁸⁰ and switching should be considered in this context as explained below. Moreover, the FIIC model leads to multi-banking and the retention of inactive accounts as customers are more likely to retain products with multiple providers where the product has no monthly fee;
- (c) nearly all 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 over time and for different customer segments, 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. 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; and
- (d) as explained above, the main PCA providers are required to provide BBAs in accordance with Government policy on financial inclusion. On the basis that any CMA intervention regarding the FIIC model would not apply to BBAs, LBG considers that the introduction of fees for standard PCAs would result in the migration of customers to BBAs.

1.17 Moreover, the PCA Update makes scant reference to packaged accounts, which typically charge a monthly fee in exchange for a range of features and benefits. Packaged accounts represent 15 per cent of all active PCAs (10 million)⁸¹ and nearly [Confidential] of LBG's funded PCAs.⁸² Accordingly, the CMA's consideration of FIIC should recognise that customers can and do choose from a wide range of non-FIIC PCAs.

2. CUSTOMER ACTIVITY

Low levels of switching

- 2.1 The CMA has found that *"switching [is] at relatively low levels, especially compared with switching rates in other markets"*⁸³ and that *"a large share of the customer base remains 'sticky' and thus does little to drive competition"*.⁸⁴
- 2.2 Any assessment of whether the PCA market is well-functioning in terms of switching and shopping around must take into account the inherent features of the PCA market, as the simple

⁷⁹ PCA Update, paragraph 3.64
⁸⁰ PCA Update, paragraph 2.31
⁸¹ PCA Update, Annex A, Table 1
⁸² LBG Response to CMA Questionnaire, May 2014, Annexes A1 and A2
⁸³ PCA Update, paragraph 4.76
⁸⁴ PCA Update, paragraph 4.34

comparisons with levels of switching in other markets made in the PCA Update⁸⁵ are unlikely to be informative:

- (a) **PCAs are a low cost service** – the ICB found that PCAs cost less than £120 a year (less than £2.50 per week) for 95 per cent of customers, including less obvious costs such as foregone interest.⁸⁶ This is significantly lower than the average weekly expenditure per household on mortgages (£138.60),⁸⁷ energy (£23.20), car insurance (£9.90) and telephone services (£10.10);⁸⁸
- (b) **Overdraft pricing is inapplicable to most customers** – as only 30 per cent of customers use overdrafts, the terms and pricing of overdrafts are inapplicable to most customers. Moreover, many of the customers who use overdrafts have chosen packaged PCAs, which provide them with an interest and fee free overdraft for some or all of their borrowing;
- (c) **Financial gains from switching PCA are limited** – as PCAs cost less than £120 per annum for 95 per cent of customers, the typical financial gain from switching PCA are limited. In comparison, MoneySupermarket claims that 51 per cent of switchers could make annual savings of up to £227 on car insurance, and £180 on energy,⁸⁹ and householders can make even greater savings by switching mortgages;
- (d) **PCAs are a continuous service** – the CMA notes that, unlike PCAs, *"other industries have features which may make switching easier, for example, a break point in a contract"*.⁹⁰ This is highly relevant as car insurance and mobile phone contracts are typically for fixed terms, while customers need to make an active choice of fixed line and broadband provider when they move house;
- (e) **PCAs do not become obsolete** – there is significant continuous innovation in PCAs (e.g. improved functionality of digital banking) which customers benefit from automatically. In contrast, customers wishing to enjoy faster broadband speeds or a better mobile handset must typically make an active selection of a new contract and/or provider; and
- (f) **Customers can easily maintain multiple PCAs** – as explained above, the FIIC model allows customers to manually switch, gradually switch, try before they buy or multi-bank at zero cost. In contrast, it is costly for customers to have multiple providers for mobile phone, fixed line or broadband services, and it is only possible to have one supplier of electricity, gas, car insurance or mortgages at any one time. Consequently, narrow measures of switching are likely to capture a greater proportion of all customer activity in those industries than for PCAs.

Impact of CASS

- 2.3 The CMA has found that CASS has had a significant initial impact since it was launched in October 2013, noting that CASS is *"an effective switching service"* which is *"relatively risk free"*.⁹¹ It has almost 100 per cent market coverage,⁹² and two-thirds of customers are aware of CASS.⁹³ PCA

⁸⁵ PCA Update, paragraphs 4.57-4.58, which compare PCA switching rates with levels of switching for credit cards, mortgages, energy, car insurance and telecoms.

⁸⁶ LBG Response to CMA Questionnaire, May 2014, page 9

⁸⁷ ONS survey on Family Spending, 2013 Edition (http://www.ons.gov.uk/ons/dcp171776_335332.pdf, page 16)

⁸⁸ ONS survey on Family Spending, 2013 Edition

⁸⁹ <http://www.moneysupermarket.com/> (accessed on 4 September 2014)

⁹⁰ PCA Update, paragraph 4.58

⁹¹ PCA Update, paragraphs 4.75 and 4.79

⁹² PCA Update, paragraph 4.12

⁹³ PCA Update, paragraph 4.15

providers have worked to resolve teething problems with 99 per cent of switches completed within seven days,⁹⁴ 65 per cent of customers expressing confidence in CASS,⁹⁵ and 83 per cent of switchers being satisfied with the switching process.⁹⁶

- 2.4 The overall PCA switching rate in the first half of 2014 was 16 per cent higher than in the first half of 2013,⁹⁷ with full year data showing a 19 per cent increase.⁹⁸ However, the CMA considers that CASS "*...has not led to a transformative change in the switching rate*".⁹⁹ LBG considers that it is unrealistic to expect CASS to have brought about transformative change within nine months following its successful launch. It is too soon to conclude that CASS will not have a significant impact on PCA (and relevant BCA) switching in the short to medium term. It is reasonable to expect increased customer awareness and confidence in the service to reduce "*lingering perceptions that there will be problems with the switching process*,"¹⁰⁰ and that providers will continue to develop "*specific switching advertising campaigns and developing different products targeted at switchers*"¹⁰¹ to take advantage of CASS.

Customer engagement as a whole

- 2.5 The CMA has recognised that "*it is not necessary for many consumers to switch in order to drive competition among providers*."¹⁰² LBG endorses this statement and considers that a focus on relatively narrow measures of switching is inappropriate when assessing whether the PCA market is well-functioning as other forms of customer engagement have a competitive impact.
- 2.6 In this connection, the CMA accepts that there are different ways in which consumers can switch and that CASS switching is likely to underestimate the true switching rate.¹⁰³ The CMA appears to accept that manual and gradual switching provide a competitive constraint, but does not place sufficient weight on the cumulative competitive impact of other groups of engaged customers, who could be attracted by rivals, including:
- (a) **new to market customers** such as immigrants and young people. Around 6 million PCAs are opened every year (8.1 per cent of all PCAs).¹⁰⁴ Providers must compete for new PCAs in order to replace the large number of PCAs that are closed every year (around 4 million);
 - (b) **multi-bankers**, whom the CMA accepts may be using multi-banking to shop around for the best deal or are trying out a new PCA with a view to switching.¹⁰⁵ LBG agrees that and further investigation is required to consider this competitive constraint;¹⁰⁶
 - (c) **intra-group switchers**, as it is generally no easier to switch to another provider within the same banking group than to switch to a competitor, and customers may not be aware of, or place any emphasis on, the fact that their new bank is part of the same banking group;
 - (d) **intra-brand switchers**, as these engaged customers are actively choosing a product that is best suited to their requirements, and could easily switch to competing providers. LBG has

⁹⁴ PCA Update, paragraph 4.23
⁹⁵ PCA Update, paragraph 4.20
⁹⁶ PCA Update, paragraph 4.25
⁹⁷ PCA Update, paragraph 4.27
⁹⁸ http://www.paymentscouncil.org.uk/media_centre/press_releases/-/page/3105/
⁹⁹ PCA Update, paragraph 4.76
¹⁰⁰ PCA Update, paragraph 4.79
¹⁰¹ PCA Update, paragraph 4.72
¹⁰² PCA Update, paragraph 4.4
¹⁰³ PCA Update, paragraph 4.39
¹⁰⁴ Source: CACI data
¹⁰⁵ PCA Update, paragraph 4.41
¹⁰⁶ PCA Update, paragraphs 4.47-4.48

explained that its customers who use overdrafts are much more likely to pay for a packaged account with an interest and fee free overdraft than have a standard account, and that customers who stay in credit and have relatively high balances are more likely to have accounts offering attractive rates of credit interest;¹⁰⁷ and

- (e) **customers who shop around without switching**, as the threat of switching by these engaged customers disciplines their existing bank.

2.7 Moreover, customers' main reason for not switching is satisfaction with their current provider, with a Which? survey finding that 67 per cent of consumers were happy with their PCA,¹⁰⁸ OFT research finding that 81 per cent of customers who did not consider switching due to the fact that they were "happy" with their existing PCA,¹⁰⁹ and independent research demonstrating that customer satisfaction is higher than reported by the CMA, as explained below.

2.8 LBG would also observe that customer activity is driving product and process innovation which benefits all customers. The combination of the forms of customer activity summarised above has forced providers to deliver continuing product and process innovation (e.g. in digital banking functionality, such as LBG's Money Manager service), which is available to all customers, including those who do not switch or shop around.

3. MARKET STRUCTURE AND BARRIERS TO ENTRY

Concentration and market structure

3.1 The CMA considers that the UK PCA market is concentrated as a whole, and in Scotland and Wales is highly concentrated.¹¹⁰ LBG considers that concentration is more appropriately assessed by reference to funded accounts following the state aid divestments. As the CMA has accepted, concentration is significantly lower on this basis, particularly in Scotland. The UK-wide HHI on this basis would be around 1,450,¹¹¹ which is not particularly concentrated.

3.2 The CMA has found that concentration is unlikely to reduce to its pre-crisis level in the near future.¹¹² However, LBG would observe that the structure of the market today is not materially different from 2009. In addition to LBG, RBS, Barclays and HSBC, there is a provider with around 10 per cent market share (2009: HBOS; 2014: Santander) and providers with around 5 per cent market share (2009: Abbey, Alliance & Leicester and Nationwide; 2014: Nationwide and TSB).

PCA concentration does not demonstrate weak competition

3.3 The CMA considers that concentration levels "*indicate that competition in the PCA market is weak*",¹¹³ although the CMA also accepts that "*...the effect of concentration on market customer outcomes is not straightforward...*" and that it is "*...not able to conclude at this stage whether concentration is, in and of itself, a cause of consumer harm.*"¹¹⁴ However, LBG does not consider that the alleged historic stability of market shares demonstrates that competition is weak, as no compelling relationship has been established between bank size and customer outcomes, as explained in Section 4 below.

¹⁰⁷ LBG Response to CMA Questionnaire, May 2014, page 9

¹⁰⁸ PCA Update, paragraph 4.67

¹⁰⁹ OFT 1282, Review of barriers to entry, expansion and exit in retail banking, November 2010, Annex B, Q3

¹¹⁰ PCA Update, Summary, paragraph 17

¹¹¹ LBG calculation based on data in CMA PCA report (figures 2.2 and 2.3)

¹¹² PCA Update, paragraph 2.76a

¹¹³ PCA Update, paragraph 2.78

¹¹⁴ PCA Update, paragraphs 2.76-2.78

- 3.4 Moreover, the CMA's analysis is heavily focused on whether small and medium-sized competitors are able to achieve a similar national scale to the leading banks:
- (a) the CMA refers to "*entry by the Post Office, on any big scale*" as being "*far from certain*"¹¹⁵ and dismisses Tesco, Virgin Money and Atom as "*relatively small-scale entrants as providers of PCAs*"¹¹⁶;
 - (b) in considering the relevance of branch networks, it concludes that "*it seems doubtful that large-scale entry is possible without branch networks*"¹¹⁷ noting that "*there is as yet no example of a bank reaching a significant scale without a network of branches*",¹¹⁸ and
 - (c) it discounts TSB's impact on competition due to its "*relatively small size*"¹¹⁹ and dismisses the ability of W&G "*to compete effectively in the PCA market on a national scale*."¹²⁰
- 3.5 This approach is at odds with the CMA's own benchmark for a well-functioning market, in which "[c]redible new players are able to join the market and have reasonable prospects for attracting the scale of customer base needed to achieve the economies of scale required to operate effectively".¹²¹ There is no stipulation that these effective new players must also be significant, large-scale or national.
- 3.6 LBG considers that PCA providers of all sizes operate effectively and there are clear competitive interactions between all players in the market. As the CMA has noted, "*small PCA providers can, in certain circumstances, compete effectively through differentiation and innovation as their incentives are not aligned with those of their larger competitors*."¹²²
- 3.7 In this connection, a wide range of competing providers of all sizes have the ability and incentive to compete aggressively to increase their market shares using a diverse range of business models. These business models often involve "cherry picking" the most profitable and significant segments of the market rather than seeking to compete nationally across the market, including for BBA customers, which is clearly unnecessary for effective operation (e.g. Santander 1-2-3 targeting customers with higher incomes; Atom targeting digital-only customers who are less expensive to serve; Metro targeting customers in London and the South East; and Clydesdale targeting customers in Scotland). This clearly demonstrates the very limited role that "scale" plays as a barrier to both entry and expansion. The CMA should seek to understand the entry and growth strategies of these competitors, which is of greater relevance than their stock of PCAs.
- 3.8 When considering competitive effects, the aggregate dynamic effect of all competitors is a key element of the assessment (i.e. a number of smaller competitors cherry-picking the most profitable customers can result in a substantial competitive constraint), and not whether each entrant can achieve the same "scale" as the leading banks and replicate their business models. When considered on this basis, the CMA's findings are not inconsistent with a well-functioning market:
- (a) **Small and medium-sized competitors are winning market share.** Santander and Nationwide have significantly increased their market share of funded PCAs relative to their

¹¹⁵ PCA Update, Summary, paragraph 20 (emphasis added)

¹¹⁶ PCA Update, Summary, paragraph 20 (emphasis added)

¹¹⁷ PCA Update, Summary, paragraph 23 (emphasis added)

¹¹⁸ PCA Update, paragraph 2.57 (emphasis added)

¹¹⁹ PCA Update, paragraph 2.22

¹²⁰ PCA Update, paragraph 2.23 (emphasis added)

¹²¹ PCA Update, Summary, paragraph 4.

¹²² PCA Update, paragraph 2.16

sizes in 2011, with HSBC and LBG losing market share.¹²³ TSB has also been created with a *"strong and stable customer base of 4.5 million retail customers and comprehensive product and distribution capability, including 631 branches"*,¹²⁴ has a strategic priority to increase its market share,¹²⁵ and is considered by the CMA as willing to differentiate itself from its competitors;¹²⁶

- (b) **The market is being targeted by a number of new entrants.** As the CMA has recognised, Metro, Tesco and the Post Office have all recently entered the PCA market in recent years and are aiming to achieve significant growth. Their plans, which do not involve establishing extensive national branch networks, are clearly inconsistent with a theory that entrants are unable to grow. Moreover, Virgin Money, Atom and the 25 other organisations who have held pre-application discussions with the FCA would be unlikely to target the PCA market if they did not consider they could achieve a profitable scale;
- (c) **Existing developments will assist entry and expansion.** The CMA has found that *"new providers can more easily enter the market now and mid-size PCA providers are able to grow at the expense of some of the larger PCA providers"*.¹²⁷ CASS will increase customer engagement and switching, as explained above, and the regulation of payment systems by the PSR will reduce the costs of entry. Technology and innovation also facilitate entry and expansion, with Metro's Chairman recently stating that *"...We all read about how Apple had three or four per cent of the market share. They innovated their way out. Metro Bank in lots of ways is that"*,¹²⁸
- (d) **Branch networks are becoming less relevant.** Technological innovation and digital banking are significantly reducing the role of branches in the opening and servicing of PCAs, as the CMA has acknowledged. First, many providers now allow customers to open PCAs without attending a branch. Secondly, LBG expects a continued decline in the use of branches to service PCAs, which will accelerate when cheque imaging is introduced. This has different implications for each type of PCA provider:
 - (i) branch networks represent a high fixed cost for larger providers, with the *"significant amount of money"* invested by Lloyds in its branches between 2011 and 2013 not being driven by the PCA relationship [Confidential], but by the need to update branch designs to reflect the changing use of branches (e.g. for other retail banking products) and to rebrand many of them following the TSB divestment. The high fixed costs of under-utilised branches has also led to the branch closures by a number of larger PCA providers;¹²⁹
 - (ii) as the CMA recognises, entrants can focus on particular segments of the market (e.g. large cities or customers who do not require a branch) without establishing an extensive branch network.¹³⁰ The absence of a branch network is clearly not a barrier to these providers' business models; and

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PCA Update, paragraph 2.11

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<http://www.tsb.co.uk/investors/our-business/>

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PCA Update, paragraph 2.21

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PCA Update, Summary paragraph 18

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PCA Update, paragraph 2.77

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<http://www.bloomberg.com/news/2014-07-23/metro-bank-s-hill-compares-to-apple-in-deposit-push.html>

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See for example <http://www.barclays.com/news/2014/01/barclays--comment-on-media-speculation-regarding-branches.html>, <http://www.rbs.com/news/2014/05/closing-branches--one-of-the-hardest-decisions-that-we-ever-have.html> and <http://www.bbc.co.uk/news/business-23753042>

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PCA Update, paragraph 2.53

- (iii) medium-size providers with smaller branch networks can also compete effectively, as evidenced by the growth of Santander and others. Moreover, small and medium-sized providers have actively decided not to service PCAs through extensive national branch networks. For example, Co-op and Santander were ultimately not interested in acquiring the Verde and Rainbow branch networks, and a number of Post Office outlets offer bureau de change facilities but not PCA servicing. Moreover, PCA providers can expand their branch networks if they choose to do so - Metro plans to have 200 branches by 2020 and the Post Office has doubled its branch network to 239.¹³¹ In this connection, the Post Office, Tesco and Co-op have extensive potential branch networks via their stores, which generate significant non-banking footfall; and
- (e) **The relevance of cross-subsidies.** The CMA claims that PCAs may be cross-subsidised with other retail banking products, citing a single Credit Suisse report and the submission of one PCA provider (a more extensive inquiry into this question may not support this contention). The CMA considers that this might represent a barrier to entry and expansion.¹³² LBG would observe that the costs of providing PCAs are largely fixed (e.g. payments infrastructure, branches, ATMs, IT systems, staffing, customer support and marketing) and most are shared across different retail banking products. It is very difficult to allocate these common costs to conduct a meaningful profitability analysis. However, although the requirement to provide BBAs will inevitably result in cross-subsidies between categories of PCA customers (as explained above), LBG does not agree that PCAs as a whole are loss-making or cross-subsidised with other banking products. Moreover, LBG does not consider that PCAs are sold at a loss to generate follow-on sales of other products, and notes the CMA's finding that cross-selling is less effective than it was in 2011.¹³³

4. MARKET OUTCOMES FOR PCA CUSTOMERS

No link between bank size and customer outcomes

- 4.1 The CMA's findings on customer outcomes are not robust and are inconsistent with a wide range of independent evidence. The CMA's analysis is of limited use as it has made comparisons on the basis of individual PCA revenue streams (e.g. overdrafts), instead of considering PCA offerings as a whole. Any comparison of customer outcomes should be based on a holistic assessment of the price, quality, range and service offered by different providers, by controlling for price and other relevant variables. Moreover, the CMA should be cautious in making generalisations about the market as a whole without considering the performance of individual providers.
 - (a) **Customer satisfaction** - the CMA asserts that "*satisfaction with the established PCA providers is... lower than with smaller and newer competitors*",¹³⁴ on the basis of Which? ratings for a single year. However, other evidence demonstrates that LBG has significantly fewer complaints per 10,000 accounts than Santander.¹³⁵ On an industry level, only 3 per cent of PCA holders are unhappy with their existing bank,¹³⁶ only 1 in 1750 packaged account customers complained to the FOS in 2013/14,¹³⁷ with the FOS noting that there has

¹³¹ PCA Update, paragraph 2.62
¹³² PCA Update, paragraphs 2.66-2.67
¹³³ PCA Update, paragraph 2.73
¹³⁴ PCA Update, paragraph 6.31
¹³⁵ PCA Update, Figure 2.6B
¹³⁶ PCA Update, paragraph 6.29
¹³⁷ Derived from PCA Update, paragraph 6.24

been "*encouraging improvement in the way some banks investigate and deal with these complaints*",¹³⁸ and the number of complaints to the FCA is on a significant downward trend;¹³⁹

- (b) **Revenues per account and credit interest rates** – the CMA has not identified any clear relationship between size and revenues per account,¹⁴⁰ and has correctly identified Lloyds as providing market-leading credit interest on its Club Lloyds account;¹⁴¹
- (c) **Overdraft charges** – the CMA has found no obvious relationship between size and overdraft charges. Indeed, the CMA's analysis reveals that five of the seven highest cost accounts for unarranged overdrafts are provided by small or mid-sized banks;¹⁴² and
- (d) **Switching** - customers' main reason for not switching is satisfaction with their current provider and confidence and awareness of the switching process is high and increasing, as explained above.

Overdraft control and pricing has improved

- 4.2 The CMA considers that customers are not being served well, primarily due to the difficulty in comparing charging structures across providers, which the CMA considers has increased over the last two years.
- 4.3 LBG would observe that the industry has now implemented the transparency initiatives agreed with the OFT, the shift from unarranged overdraft income to arranged overdraft income is continuing,¹⁴³ and overdraft fees have fallen, with the average unpaid item charge across the industry falling from £34 in 2007 to £10 in 2011.¹⁴⁴ Only 30 per cent of customers use overdrafts, so the terms and pricing of overdrafts are inapplicable to most customers. Moreover, many of the customers who use overdrafts have chosen packaged PCAs, which provide them with an interest and fee free overdraft for some or all of their borrowing
- 4.4 As the CMA accepts, individual providers' charging structures may have become simpler to understand, with fee capping, buffers, grace periods and discretionary criteria being valued by customers and operating to reduce charges. LBG has sought to simplify its charges and has provided customers with a choice of PCAs to enable them to reduce their overdraft charges. Customers have responded to this, with customers who use overdrafts being much more likely to pay for a packaged account with an interest and fee free overdraft than have a standard account.
- 4.5 LBG considers that well-informed customers can take advantage of the diversity of charging structures available in the market, and that appropriate initiatives (such as MiData or improving the Money Advice Service comparison tool) will assist them in doing so. Moreover, the harmonization of charging structures would limit competition and be detrimental to customers, particularly as the CMA has not taken a view on the best charging structure for customers.¹⁴⁵
- 4.6 LBG has also enhanced customers' abilities to monitor and control their spending through the use of mobile banking, new tools (e.g. Money Manager) and text alerts. LBG also seeks to proactively

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FOS Annual Report, page 58

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PCA Update, paragraph 6.20

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PCA Update, paragraph 2.29a

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PCA Update, paragraph 2.29b

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PCA Update, paragraph 2.29c and Figure 2.5

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PCA Update, paragraph 6.35

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LBG Response to CMA Questionnaire, May 2014, page 7

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PCA Update, paragraph 3.9

contact customers in financial difficulty to help them with fees and/or selecting the most appropriate product for their circumstances, although its ability to do so is constrained by the fact that [Confidential] per cent of its customers have non-marketing indicators on their account which limits LBG's ability to contact customers to offer them other, more appropriate products. As the CMA has identified, other providers have made similar efforts.

Existing initiatives will result in further improvements for customers

- 4.7 The CMA's analysis does not place sufficient weight on the likely impact of the numerous (structural and behavioural) changes that are already taking place, which are changing the competitive landscape and which LBG believes will mitigate or address the CMA's concerns. In this regard, historic evidence may not be a reliable indicator of future developments as the pace of change is likely to be even more rapid going forward, reflecting the cumulative impact of a variety of measures which are changing the PCA market including:
- (a) regulatory initiatives including CASS, enhancements to BBAs, interchange regulation and MiData;
 - (b) entry and expansion by Atom, Metro, Virgin Money, TSB, Tesco, the Post Office and others;
 - (c) the competitive development of innovative products, including Club Lloyds, Santander 123 and TSB Classic Plus; and
 - (d) the impact of technology and innovation, including significant increases in the usage and functionality of digital banking, and the disruptive emergence of alternative payments providers such as PayPal, Amazon, Apple and Google.

ANNEX 3

COMMENTS ON THE CMA'S DRAFT TERMS OF REFERENCE (ANNEX B OF THE CMA'S CONSULTATION DOCUMENT)

LBG considers that the draft terms of reference should be amended as indicated below, for the reasons set out in this Annex.

Amended terms of reference

"For the purposes of this reference:

- 'retail banking services' means:
 - in respect of personal current account customers, provision of an account (including Basic Bank Accounts and packaged bank accounts) marketed to individuals rather than businesses, which provides the facility to hold deposits, to receive and make payments by cheque and/or debit card, to use automated teller machine facilities and to make regular payments by direct debit and/or standing order but does not include:
 - an account in which money is held on deposit in a currency other than the official currency of the United Kingdom; or
 - an account in which credit funds are held and offset against mortgage debt or a loan (other than an overdraft facility);
 - in respect of small and medium-sized enterprises, provision of ~~services, including but not limited to~~ general purpose loans and liquidity management services, including business current accounts and overdrafts.

'small and medium-sized enterprise' means a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) not exceeding £25 million, but does not include a business that is part of a group with annual sales revenues (exclusive of VAT and other turnover-related taxes) exceeding £25 million."

BBAs and packaged accounts should be within the scope of any market investigation

As explained in Annex 2, BBAs are a key feature of the PCA market. Similarly, there are 10 million active packaged accounts (15 per cent of all active PCAs).¹⁴⁶ LBG considers that the terms of reference should explicitly include these types of PCA, which will need to be within the scope of any market investigation.

The definition of "retail banking services" to SMEs should be clarified and focused

LBG considers that the existing definition of "retail banking services" to SMEs is unclear, and potentially includes a range of services which have formed no part of the CMA/PCA market study, such as long term deposits, asset based finance, insurance and merchant acquiring. It would be helpful to clarify that any market investigation would only consider those services in relation to which the CMA has found reasonable grounds to suspect competition issues, namely general purpose loans and liquidity management services.

¹⁴⁶

PCA Update, Annex A, Table 1

Businesses part of a group with turnover of over £25 million do not have SME banking needs

LBG considers that the definition of SME should exclude businesses with turnover of under £25 million but who form part of a group with turnover of over £25 million. In LBG's experience, such businesses typically have corporate banking needs and have different behaviour to SMEs.

Any market investigation should consider the impact of the range of SME lending options

The CMA has found that a wide range of lending products are available to SMEs. We consider that these products exert a strong and increasing competitive constraint on general purpose loans and overdrafts. For example:

- as many SMEs have asset finance or hire purchase arrangements as have bank loans;
- many smaller SMEs use consumer finance products - 37 per cent of SMEs that make use of a bank overdraft, bank loan, commercial mortgage or credit card hold one or more of these in the personal name of one of their owners or directors; and
- the CMA has found that SMEs are increasingly using invoice and asset finance, while alternative finance platforms such as peer-to-peer lending are "growing strongly".

We consider that any market investigation will need to more thoroughly consider the impact of these forms of finance.

ANNEX 4

**RESPONSE TO CMA'S "KEY QUESTIONS" FOR CONSULTATION LISTED AT 1.8 OF THE CMA'S
CONSULTATION DOCUMENT**

Paragraph and chapter references are to the CMA's Consultation Document.

- 1. Do you consider that the CMA's analysis of the suspected features of concern in the market for PCAs is correct (see paragraph 3.6)?**

Please refer to Annex 2 above.

- 2. Do you consider that the CMA's provisional analysis with respect to the exercise of its discretion to refer the PCA market is correct (see Chapter 4)?**

LBG does not consider that the CMA's provisional analysis is sufficiently robust, comprehensive or accurate and therefore considers that the case for a detailed and costly Phase 2 investigation has not been made out.

- 3. Do you consider that the CMA's analysis of the suspected features of concern in the SME banking sector is correct (see paragraph 3.3)?**

Please refer to Annex 1 above.

- 4. Do you consider that the CMA's provisional analysis with respect to the exercise of its discretion to refer SME banking is correct (see Chapter 4)?**

LBG does not consider that the CMA's provisional analysis is sufficiently robust, comprehensive or accurate and therefore considers that the case for a detailed and costly Phase 2 investigation has not been made out.

- 5. Do you consider that the features which the CMA has identified that may prevent, restrict or distort competition, are capable of being effectively and comprehensively remedied by UILs (undertakings in lieu of an MIR) given by the banks (see the features in paragraphs 3.3 and 3.6)?**

Please refer to the response to question 6 below.

- 6. Do you have any views on the CMA's provisional analysis regarding proposals for possible UILs being offered in principle by the four largest UK retail banks in relation to SME banking, particularly on the appropriateness, effectiveness and deliverability of such UILs (see paragraphs 4.58 to 4.71 and Annex A)?**

LBG considers that the UILs offered in principle by the banks could have effectively delivered significant positive change to the benefit of customers in the SME market within an achievable timeframe. However, given the CMA's provisional decision that it is not minded to accept UILs, LBG has informed the CMA that it does not intend to further progress their proposals. LBG will continue to seek to improve the outcomes for all of its customers both unilaterally and, where appropriate, multilaterally, as any Phase 2 investigation progresses.

7. Do you consider that a potential solution to any competition concerns identified may need to consider alterations to the structure of the markets in addition to (or in place of) remedies focused on increasing customer engagement?

LBG considers that alterations to the structure of the markets are unlikely to be necessary, effective or proportionate remedies to the features the CMA has provisionally identified, particularly in light of the time, cost and complexity involved in implementing the TSB and Williams & Glyn divestment remedies in this sector.