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By email: statutoryauditmarket@cma.gov.uk

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Dear Sirs

Statutory Audit Market Study

Lloyds Banking Group welcomes the opportunity to contribute to the study and is supportive of the Competition and Markets Authority's aim to understand whether the statutory audit market is working effectively.

Lloyds Banking Group ('Lloyds') is a UK financial services provider with around 27 million customers. Our main business activities are retail and commercial banking, general insurance and long-term savings. Lloyds' shares are quoted on the London and New York stock exchanges and we are one of the largest companies in the FTSE 100 index.

We believe that the concentration of the audit market in the hands of the four large firms (Deloitte, EY, KPMG and PwC) is not a satisfactory situation, however any remedial actions should be set in the context of the global market and should take care to avoid unintended consequences. Auditing is an international profession and large UK companies have many stakeholders including local and, in many cases, overseas regulators. In proposing any remedies, the CMA should consider the impact on the international position of UK companies, where overseas regulators and other international stakeholders may have opinions on a company's choice of auditor. In addition, UK accounting firms provide both audit and non-audit services to a large number of global multinationals and the potential impact on this important UK industry should also be taken into account if proposing any changes. Finally, whilst recognising that increasing competition between audit firms is a very worthwhile objective, we believe that the major issue is of audit quality which we do not believe is the result of a lack of competition. These topics would benefit from being considered separately.

Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh, EH1 1YZ

The study focuses on three major themes: the incentives between audited companies, audit firms and investors; choice and switching; and the resilience of the audit market.

Themes of the study

There is significant interaction between the CMA's themes and any potential remedies:

- *Incentives:* concerns of misalignment of incentives between companies, auditors and shareholders
- *Choice and switching:* concerns that large companies have insufficient audit choice
- *Resilience of the audit market:* concerns that competition could become even more limited if any of the Big Four firms were to exit the market.

We believe that concerns about misalignment of incentives are overstated. Recent strengthening of the role of the independent audit committee, which includes setting the auditors' remuneration, approving non-audit work and reporting annually to shareholders, appear to be working well and provide a strong control over a company's relationship with its auditors for the benefit of shareholders and other stakeholders.

The CMA's concern of a lack of audit choice for large companies is consistent with our experience. Whilst Lloyds is predominantly a UK based business, the capital markets are global and as an SEC registrant, Lloyds requires an auditor that has deep expertise in both UK and US reporting requirements. Lloyds is a large business and its annual audit requires approximately 200,000 hours of audit partner and staff time; mobilising this level of resource with the appropriate expertise is a significant challenge, and for many audit firms is not achievable without significant investment. In addition, since 2016, the auditors of financial institutions have been required to provide a written report to the regulator who, we understand, value significantly the expertise and quality of auditors' work in fulfilling their supervisory role. Accordingly, the number of firms capable of auditing the Group is very small and we have had recent experience of being further restricted in our choice of new auditors due to potential conflicts of interest and temporary capacity related issues.

The very largest accounting firms have global reach, significant resources and technical expertise which equip them to audit large and complex global companies. In the UK market, there are arguably only four accounting firms that exhibit these attributes. We believe that this number is now probably too low to permit the smooth functioning of the market given the requirements of mandatory rotation. It follows that the current number of audit firms capable of large, complex audits should not be allowed to fall further as this would result in an unacceptable restriction in the choice of audit supplier. However, we envisage a number of barriers to increasing the number of large firms without unnecessary cost.

Our comments on the various potential remedies under consideration by the CMA are set out below.

Potential remedies

Increase competition between Big Four firms

We do not believe that placing greater restrictions on audit firms providing non-audit services to their audit clients, prohibiting audit firms from providing non-audit services to any other large company or public interest entity (PIE) or splitting the UK arms of major accounting firms into audit-only and non-audit services practices would have a significant effect on increasing competition between the Big Four or improving audit quality.

There are already strict UK (and US rules for SEC registrants) restricting the non-audit services that can be provided by a company's auditor and audit committees comprising solely independent directors currently play a key role in determining what services the auditor provides in addition to the statutory audit. In addition, we believe that the effect of any proposal to prohibit audit firms from providing non-audit services to all other large companies or PIEs would be to seriously restrict the company's choice of non-audit provider. We also believe that splitting UK firms into audit-only and non-audit services practices could have a negative impact on audit quality. Auditors rely heavily on the ready availability of non-audit specialists who are less likely to be available to an audit-only firm. In addition, the accounting firms place heavy emphasis on the breadth of experience that they can offer when recruiting audit partners and staff. If this were no longer available and potential employees were faced with a decision to focus solely on auditing or on advisory work, there is a risk that many high quality staff would choose the latter. There is already significant competition for audit work amongst the Big Four; the issue is a lack of choice, rather than lack of competition.

Increase competition from non-Big Four audit firms
The greater use of joint audits involving non-Big Four firms in larger, more complex audits is suggested by the CMA as an approach to encourage competition from non-Big Four audit firms. Whilst this could lead to non-Big Four firms being involved in large, complex audits and improving their technical expertise it would not address their lack of scale. We would also expect that it would result in an overall increase in audit fees for larger companies and could result in less efficient audits. If this approach is to be taken, there would need to be clarity on whether this was a stepping stone to 'gearing up' the non-Big Four audit firms with a view to reverting to a single auditor once credible competition to the Big Four had emerged, or whether it was expected to remain a permanent requirement.

More radical suggestions include breaking up the Big Four audit practices and introducing a market share cap. The break-up of the Big Four is acknowledged by the CMA to face insurmountable challenges, whilst the introduction of a cap would introduce a significant distortion into the market and could have the effect of reducing supplier choice for some companies. We do not think that the other suggestions such as providing direct support to improve the technical capability of the mid-tier firms, reducing barriers to senior staff switching firms or relaxing restrictions on audit firms' outside equity would individually have a significant impact on the ability of the non-Big Four firms to compete effectively with the Big Four.

Improve incentives for market participants
The requirements for mandatory rotation are well understood and suitably qualified firms will already be engaging with prospective targets; accordingly, we think there will be little value in publishing tender information.

Whilst further increasing the frequency of mandatory changes in auditor could change market behaviour, we believe that it could have a negative impact on audit quality. It generally takes a couple of years for an incoming audit firm to add value through the audit process and frequent changes may result in the auditor being on a 'permanent learning curve' in respect of their clients' activities and risks. In this regard, the current requirement for a mandatory audit tender after ten years and compulsory rotation after twenty years would appear to be a reasonable compromise between competition and audit quality.

In closing, we believe that the current governance rules which require the shareholders to approve the appointment of the auditors, and the audit committee to recommend its choice of auditor to the board, are working relatively well. We do not believe that there is a lack of competition between the Big Four firms; however, we are concerned about the lack of choice faced by large companies. With the introduction of mandatory rotation and the lack of credible challengers to the Big Four, companies are faced with a maximum of only three potential candidates which can be reduced even further where conflicts of interest or other issues arise.

On the separate issue of audit quality, this remains a major concern, exemplified by recent corporate collapses. In this regard, better use of regulator review and sanctions might be more likely to generate quality improvements than measures intended to increase competition, such as splitting firms into audit-only and non-audit services practices, which could have the opposite effect.

Yours sincerely

George Culmer
Chief Financial Officer