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**LLOYDS
BANKING
GROUP**



For the attention of:

The Market Reference Group,
Chief Executive of the CMA,
Chairman of the CMA

Competition and Markets Authority
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Dear Sirs,

CMA inquiry into small business banking and personal current accounts

Lloyds Banking Group (LBG) welcomes the fact that the CMA now has a fresh opportunity to undertake a full, objective and evidence-based investigation of SME banking and personal current accounts (PCAs). LBG is keen that the long-standing issues in these markets are addressed, and we will support the CMA in this inquiry.

It will not surprise the CMA to hear that we do not agree with all of the conclusions in the recent reference Decision ("Decision"). However, rather than set out our detailed views on the evidence at this stage, we are writing now in a spirit of constructive and positive engagement to highlight the key questions we think the CMA needs to answer if it is to ensure that the biggest benefits accrue for customers.

The Decision makes frequent reference to the views of the four largest banks and distinguishes them from the views of other competitors, who are characterised as smaller banks and new entrants but also include other large high street banks. As your investigation progresses we believe you will find that this characterisation is inaccurate. LBG is quite different from the other large banks, particularly in our commitment to improving outcomes for customers.

It may surprise the CMA to hear that we have been calling for market-wide improvements for several years. There are definitely actions that can be taken to improve outcomes for customers and we have been trying to push specific suggestions since the ICB. One of the reasons we did not pursue the discussion on undertakings in lieu was because our suggestions were being diluted. We have had some success - for example the new Current Account Switching Service (CASS) which we devised with the ICB. However many of our recommendations have been ignored and/or have fallen between overlapping regulators; as a result, customers have not benefited as they should have done.

Whilst further improvements are possible, we also know and have been saying for some time that some previous interventions have not been effective. The FCA's recent analysis confirms this. Interventions will be more likely to succeed if the CMA can get to the bottom of a small number of assertions and critical issues, such as smaller SMEs being single banked unlike retail customers who typically have relationships with multiple providers, and if it tests any proposed interventions against robust customer insight and ideally trials them to see what actually works.

We believe it is also important to note that there are significantly overlapping exercises and processes taking place with the FCA, PSR and HMT. We agree with Which? who "strongly encourage the CMA to work together with other regulators, including the FCA, PSR and PRA, and lead a coordinated response to implement the interventions necessary..." We believe the activities of these various organisations have a critical role to play in understanding current market outcomes, and in delivering improved outcomes for customers.

We believe that getting to the bottom of often conflicting evidence requires the CMA to be able to make progress under 8 headings, which we explain in more detail in the attached note.

1. How can customer engagement and the ability to switch be enhanced quickly and sustainably?
2. Which pricing structures recover costs appropriately and what does this imply in terms of "cross-subsidies"?
3. How should "customer satisfaction" be measured and how does it affect customer behaviour?
4. Will the CMA investigation be more effective if it focuses on smaller SMEs (such as those with a turnover below £1m)?
5. What is the impact of existing industry structure and concentration on the ability of smaller and newer banks to compete?
6. Can competition be assessed without considering explicitly both the regulatory context and wider government policies, such as Basic Bank Account provision?
7. Can trials make potential market interventions more effective and efficient?
8. What impact has digital and mobile had in the last two years and what impact is it likely to have in the near future?

We appreciate that the CMA has now begun the process of evidence gathering and my team are currently working on your requests. However, I hope that by identifying these key issues at an early stage it will provide a helpful focus for your inquiry. I also hope that we will be able to engage substantively with the CMA on these issues soon.

KEY QUESTIONS TO BE ADDRESSED BY THE CMA

The CMA has a unique opportunity to assess, in a definitive way, the critical questions that have repeatedly emerged in the reference markets. The CMA can create real change for customers, and it will do so if it can get to the bottom of the eight issues that underpin the various assertions and theories that have been made about these markets.

1. HOW CAN CUSTOMER ENGAGEMENT AND THE ABILITY TO SWITCH BE ENHANCED QUICKLY AND SUSTAINABLY?

We all agree that enhancing customer engagement and, specifically, customer confidence in their ability to switch is important. Previous inquiries have made comparisons on switching with other markets that are not properly comparable, or where apparent differences in switching rates are easily explained by the relative cost and expected gains from switching. We encourage the CMA to focus less on the abstract “optimal” level of switching and more on practical things that can improve customer engagement and make it easier for SME and PCA customers to switch. We are willing to work with the CMA to identify whether some potential interventions can be considered for trial immediately (see question 7 below).

CASS is a world-class innovation and is still bedding in following a successful launch a little over a year ago. It is important, therefore, to investigate how it can be supported, improved, extended and complemented with other interventions (see below), particularly at the smaller end of the SME market.

Advances in behavioural economics and customer psychology suggest that traditional approaches to assessing and improving customer engagement are often problematic, and this raises a number of questions. Can the CMA use more robust techniques to understand what drives customer engagement? Can consistent, market-wide ways to improve customer engagement be found that create sustainable competitive behavioural dynamics? Are there creative alternatives to simply giving customers even more information? What impact is new digital technology having on engagement and how can this be used to drive more customer engagement?

2. WHICH PRICING STRUCTURES RECOVER COSTS APPROPRIATELY AND WHAT DOES THIS MEAN FOR “CROSS-SUBSIDIES”?

The Decision took a more holistic view of PCA pricing than in previous inquiries, and found no relationship between pricing and the size of banks. But there remains much confusion around the pricing that would occur in a “well-functioning market”.

In each of the relevant markets, banks have a wide range of fixed and variable costs, a limited number of revenue streams, and serve customers undertaking a wide range of different activities and with different needs. Economists and regulators have long recognised that trade-offs have to be made between efficient cost recovery, simple pricing structures and the existence of “cross-subsidies”, even in highly competitive markets. Similarly, questions have been raised about how different pricing structures impact on different customer segments, and whether some pricing models might deliver better customer outcomes.

We welcome an investigation of free-if-in-credit banking (FIIC), not least because this topic has been subject to frequent inaccurate and inconsistent claims. For example, it is often implied that the whole PCA market is FIIC when the reality is that a significant and increasing proportion of accounts have monthly fees. Similarly, FIIC is often criticised against partial criteria, and has never been assessed properly against other potential pricing structures.

Each pricing structure will have its pros and cons and each needs to be considered in its entirety. The CMA now has an opportunity to take this debate forward by establishing clear criteria for a robust assessment of pricing structures and cost recovery models, and much-needed factual clarity on current pricing. The CMA can set out the type of pricing structures and cost recovery models it believes are consistent with a competitive market, and which it doesn't, alongside clear criteria. This should include an objective assessment of FIIC in the context of alternatives, including the distributional consequences of FIIC and whether any other pricing structure can result in better customer outcomes.

The points above relate to the structure of pricing. To the extent that there are any historic concerns about the level of prices (which have not been articulated in the CMA's recent reports), this inquiry will need to conduct an appropriate analysis of economic profitability to establish whether this is in fact the case. And, of course, the structure of pricing is likely to be impacted if the CMA can enhance customer engagement and confidence in the ability to switch. We believe it would be valuable for the CMA to consider these effects when considering potential interventions.

3. HOW SHOULD “CUSTOMER SATISFACTION” BEST BE MEASURED AND HOW DOES IT AFFECT CUSTOMER BEHAVIOUR?

Market researchers have long known about bias in “customer satisfaction” surveys and that such surveys need to be carefully constructed if their results are to be meaningful. Recent advances in behavioural economics and customer psychology have identified new and significant concerns with traditional methods.

For example, it is commonly known that reported customer satisfaction for banks ranges from extremely high to extremely low. It depends on the question you ask, how it is framed, the context of the discussion, the consumers in question and a range of other factors. If the CMA wants to use this form of evidence, it should seek analysis and support from experienced psychologists and behavioural economists to arrive at more robust and meaningful metrics.

The Decision suggests that a relationship exists between customer satisfaction and the size or nature of the banks concerned. We do not believe the evidence supports such a relationship but, again, we would like the CMA to tackle this issue fully. If this is likely to be a “theory of harm” during the inquiry, there should be an early focus on setting up the appropriate methodological framework to create and test alternative hypotheses.

When the appropriate metric for satisfaction has been created, there is then the issue of how it correlates to competition and a hypothetical “well-functioning market”. The movement of market shares takes time and even small rates of change, in specific segments of the market, can have significant consequences. Moreover we do not believe it follows automatically that businesses with the highest satisfaction ratings should necessarily have the highest market share; John Lewis is a good example of a business that repeatedly scores highly as the most respected retailer, but it is a fraction of the size of M&S, and there is no suggestion of a competition problem here. It would be useful if the CMA could set out what type of market share movements could reasonably be expected, given (robust) measures of relative customer satisfaction.

4. WILL THE CMA INVESTIGATION BE MORE EFFECTIVE IF IT FOCUSES ON SMALLER SMES?

The recent CMA report appears to suggest that many larger business customers are being well served, and are sophisticated enough to engage in the markets effectively. This confirms our interpretation of previous evidence on SME markets, but we recognise that many smaller SMEs may be less engaged. This is one of the reasons why the focus of many of the initiatives led by the industry or by the Government tends to be on smaller businesses. For instance, CASS is available to businesses with a sales turnover of less than €2m; the new Business Banking Insight survey separately identifies smaller firms; and proposals for the sharing of credit data are likely to have most impact for smaller SMEs.

LBG’s experience is that the larger end of the SME market has significantly different competition characteristics compared to smaller firms. Larger firms typically buy

bespoke propositions and are usually sophisticated buyers. On the other hand, the overlap between small business customers and the PCA market is well documented. The CMA, therefore, may wish to consider whether focusing on the smaller end of the SME market could enable a more holistic (and simplified) analysis, and enable more immediate interventions (such as a coordinated effort to raise awareness of CASS). A key issue is the suggestion that small business customers are always more likely to open BCAs with their PCA provider. Our internal evidence does not support this conclusion but, having been raised, this issue warrants careful investigation as it has implications for the wider question of customer engagement.

A related key issue is how fast digital technology, currently revolutionising the PCA market, will affect the small SME market. We would also observe that, unlike retail customers, most smaller SMEs do not typically have relationships with multiple providers. It may be relatively easier to increase retail customer engagement and switching because they already have several relationships with providers offering current accounts. The CMA should consider the importance of this when designing and trialling remedies to drive further engagement and shopping around by SME customers.

5. WHAT IS THE IMPACT OF EXISTING INDUSTRY STRUCTURE AND CONCENTRATION ON THE ABILITY OF SMALLER AND NEWER BANKS TO COMPETE?

LBG accepts that market-wide action can continue to improve these markets for customers. If the CMA's preliminary concerns about customer engagement and switching are substantiated, any such interventions are likely to involve industry-wide changes in pricing and information disclosure, and in finding improvements and extensions to CASS.

There have been suggestions in past inquiries that supply-side changes to industry structure can improve customer outcomes. We believe that competitive dynamics are driven by customer engagement and switching (with the focus, therefore, being on demand-side issues). There are more banks available to UK customers than supermarkets. The challenge is not one of the extent of choice available, but of how best to ensure that customers can and do exercise that choice. We do not understand why having more banks will improve customer engagement and switching, and previous inquiries have not adequately addressed this issue. Moreover, experience from the recent State aid divestments demonstrates that structural divestment is expensive, disruptive for customers and disproportionate to the concerns raised.

The concentration narrative began before the recent spate of entry and expansion, and we urge a forward-looking approach which considers the longer-term impacts of the changes that are already underway. For example, historically, in the retail grocery market, it was concluded that discounters were in a different market from the big grocers – a conclusion that would now appear questionable.

New entry and expansion is taking place, which is good for customers, and is something LBG welcomes. This is supported by CASS - an initiative we led the industry in developing. We have also supported other developments such as simplifying regulatory applications. However, there have been two specific assertions about barriers to entry where we believe more evidence is required and where concerns can be resolved if they are identified.

- Is access to payment systems a real barrier to entry or expansion? We have heard this claim before, but have yet to see evidence that this is a barrier, other than claims by new entrants. We support the Payment Systems Regulator's efforts to get to the bottom of these claims. If we are wrong and problems are identified then we would support interventions to deliver cheaper and direct access to payment systems.
- To what extent are bank branch networks likely to represent a barrier to entry or expansion in the future? Many new entrants either don't see opening branches as a barrier to entry (Metro) or necessary to compete (Atom and Tesco). Opening bank branches is no more costly than opening other retail outlets and these costs can also be recovered if market entry is unsuccessful. We urge the CMA to undertake a detailed assessment of the cost to open branches, the degree to which they represent sunk costs and how recent entrants have considered this decision. We also believe that the digital pressures in banking are no different than for other retailers and a number of banks have already announced significant plans to reduce their existing branch networks. The role of branches is changing and they are being used less to service PCAs and more for other products such as mortgages. There are likely to be many branch closures in the coming years. If, after a proper review of the evidence, the CMA still thinks that better branch access is required for smaller banks we are willing to explore the feasibility of existing banks offering agency servicing arrangements for business and personal current accounts to new entrants.

6. CAN COMPETITION BE ASSESSED WITHOUT CONSIDERING EXPLICITLY BOTH THE REGULATORY CONTEXT AND WIDER GOVERNMENT POLICIES, SUCH AS BASIC BANK ACCOUNT PROVISION?

Banking markets are already some of the most regulated markets in the UK, and this regulation has increased substantially in recent years. The impact of this regulation (and wider policy interventions by government) is significant and should be considered explicitly in the inquiry.

A good example is Basic Bank Accounts (BBAs). These accounts, which are mandated by HMT, form a significant part of the PCA market and have a material impact on competition. They provide customers with a free account that has (increasingly) almost all of the functionality of a normal PCA, but where provision is not required by all current account providers. We understand and support the need for the industry to provide affordable access to banking for the whole of society, but it is vital that there is a coherent approach from the various agencies involved and across the different policies being pursued. The current policy frameworks for BBAs create a clear and direct distortion between providers and between products, and discourage innovation. Since existing BBAs are loss-making products for banks, it would be useful to clarify how it is possible to consider "cross-subsidies" or cost reflective pricing without an explicit recognition of how banks should recover BBA costs. The CMA could investigate less distortionary cost recovery mechanisms such as a levy on all bank customers. Early guidance on whether such solutions are likely to be acceptable would be extremely helpful. A view on which banks should be obliged to provide BBAs would also be useful.

Another critical regulatory impact is the reduction in interchange fee income. With this reduced income stream how will banks recover costs in the future? Will this mean the end of FIIC? More generally, other regulations and policies are likely to impact on pricing going forward and should therefore be examined by the CMA.

In the case of SME finance, there are a significant number of initiatives currently being developed and implemented with policy objectives that may not be specifically about competition but where there may be some benefits in that respect. An example is Government legislation to mandate the provision and sharing of wider credit information. The impact of this was described by the CMA in its Decision as having the realistic potential to change circumstances in the short term. At the very least, the prospective impact of such initiatives needs to be taken fully into account but you may wish to influence the shape of such proposals to ensure they have the most appropriate impact, particularly at the smaller end of the market. Given our

involvement in the work to implement these proposals, we will be very happy to engage with you and the staff team at key points of discussion and decision.

Finally, last month, the FCA began a review of the effectiveness of the recently launched CASS, alongside a study of the costs and benefits of an account number portability (ANP) alternative system "as a way of increasing competition in banking." The aim of the study is to assess how CASS has affected levels of switching, customer satisfaction and provider behaviour and consider the relative costs and benefits of ANP. There is clearly a large degree of overlap both in scope and timing of the FCA and CMA inquiries. We would, therefore, welcome a co-ordinated approach in this area.

7. CAN TRIALS MAKE MARKET INTERVENTIONS MORE EFFECTIVE AND EFFICIENT?

Previous market interventions have not always had the desired or intended effects, for example, the OFT's illustrative charging scenarios and annual statements. The FCA's analysis and evidence in response to the CMA's consultation confirms this view. The success of any market interventions will be enhanced by trialling in advance. We understand the FCA is of the same view. Early trialling of appropriate interventions could be used as a way of both deepening understanding and creating rapid and real changes in these markets. We are currently working with the FCA on similar trials in general insurance and have offered to trial remedies with the OFT in previous studies. LBG remains willing to support such an approach and to participate in it.

Several candidates for early trials and interventions exist. Examples include enhancing the scope and impact of CASS (including additional advertising spend), gearing annual statements to different customer needs, incentivising new or existing comparison websites to switch more customers, working with government to accelerate and trial MiData developments, rapidly increasing the number of customers that receive text alerts, alternative forms of pricing in areas like overdrafts, and actively promoting information to small businesses about alternative forms of lending. We believe that trials of some of these issues, conducted early in the inquiry, could help both with evidence on theories of harm, and to inform any remedies discussion. We would be very happy to provide more information and thinking on these if that were useful.

8. WHAT IMPACT HAS DIGITAL AND MOBILE HAD IN THE LAST TWO YEARS AND WHAT IMPACT IS IT LIKELY TO HAVE IN THE NEAR FUTURE?

It is clear to everyone in the industry that significant changes are being brought about in consumer behaviour by developments in digital and mobile technology. Recent analysis by the FCA confirms this for retail customers.

There has also been significant investment in new innovations both at industry level (for example PayM that allows people to pay friends and family instantly using just their mobile phone number) and by individual providers to improve customer service and offer better prices and rewards for customers.

The CMA Phase 1 team identified these changes as a key issue but did not have the opportunity to evaluate their impact fully. The CMA should prioritise identifying their impact to date on consumer behaviour, building on the FCA's work, then examine:

- the speed and extent of digital and mobile take up across retail consumers, in the next two years, to understand how these behavioural changes may spread, and the impact if they do;
- what the impact has been on SME customers' behaviour where mobile related developments were adopted later than in retail but where the rate of take up appears to be faster;
- how quickly SME mobile and digital usage will grow and spread and how it will bring behavioural change amongst SME customers;
- what other opportunities digital and mobile technologies are creating to increase retail and SME customer engagement and switching, and what plans are in development amongst current account providers, price comparison sites and app developers. Could they also be used to trial interventions which would previously have been impossible or prohibitively costly and time consuming to trial?