

**Lloyds TSB Group plc
and
Abbey National plc**

A report on the proposed merger



COMPETITION COMMISSION

Lloyds TSB Group plc and Abbey National plc

A report on the proposed merger

**Presented to Parliament by the Secretary of State for
Trade and Industry by Command of Her Majesty
July 2001**

Members of the Competition Commission as at 12 June 2001

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¹These members formed the Group which was responsible for this report under the chairmanship of Mrs D P B Kingsmill.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which she considers would not be in the public interest to disclose and which, in her opinion, would seriously and prejudicially affect certain interests.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

Contents

	<i>Page</i>
Part I—Summary and Conclusions	
<i>Chapter</i> 1	Summary..... 3
2	Conclusions 9
 Part II—Background and evidence	
3	The companies and the merger situation..... 61
4	The market..... 81
5	Views of main parties 123
6	Views of other interested parties..... 153
	List of signatories 189
 <i>Appendices</i> (The numbering of the appendices indicates the chapters to which they relate.)	
1.1	The reference and background..... 191
2.1	Issues and remedies statements 193
3.1	Proposed acquisition by Lloyds TSB of Abbey National: sequence of events 198
3.2	Lloyds TSB: group structure at 1 June 2001 201
3.3	Lloyds TSB: consolidated profit and loss accounts, 1996 to 2000 203
3.4	Lloyds TSB: consolidated balance sheets, 1996 to 2000 204
3.5	Abbey National: group structure at 30 April 2001 205
3.6	Abbey National: consolidated profit and loss accounts, 1996 to 2000 207
3.7	Abbey National: consolidated balance sheets, 1996 to 2000 208
4.1	Regional market shares and local overlaps 209
4.2	Market shares in PCAs..... 212
4.3	Further information on PCA overdraft rates and fees..... 214
4.4	Extracts from statements by the CC’s SME monopoly inquiry..... 215
5.1	Extracts from Lloyds TSB’s Strategic Plan documents..... 220
5.2	Extracts from Lloyds TSB board paper on the possible acquisition of Abbey National 227
5.3	Remedies: possible new PCA product and related features submitted by Lloyds TSB 231
5.4	Undertakings originally offered by Lloyds TSB to the OFT..... 233
	 Glossary..... 235

Part I

Summary and Conclusions

1 Summary

Introduction

1.1. The Secretary of State for Trade and Industry asked us to investigate the implications for the public interest of the proposed acquisition of Abbey National plc (Abbey National) by Lloyds TSB Group plc (Lloyds TSB) (see Appendix 1.1 for our terms of reference).

1.2. Lloyds TSB and its predecessor Lloyds Bank plc have for many years been one of the four leading clearing banks in the UK (Barclays PLC, HSBC Holdings plc, Lloyds TSB and Royal Bank of Scotland plc/National Westminster Bank plc, widely referred to as the ‘big four’). In 2000 Lloyds TSB made a pre-tax profit of £3.9 billion, achieved a post-tax return on shareholders’ funds of 30 per cent and employed 80,000 people. It has some 2,350 branches in total, including 210 owned through Cheltenham & Gloucester plc (Cheltenham & Gloucester), its subsidiary which provides mortgages and savings products.

1.3. Abbey National was in 1989 the first building society to convert from mutual to public limited company (plc) status. In the succeeding 12 years it has developed from being primarily a mortgage and savings account provider into a full-service retail and wholesale bank. In 2000 it made a pre-tax profit of £2.0 billion and a post-tax return of 21 per cent on shareholders’ funds and employed over 31,000 people. It has a network of 770 branches, including 37 in Safeway supermarket outlets.

1.4. In November 2000 it became known that Abbey National was in merger talks with Bank of Scotland (BoS). Soon afterwards Lloyds TSB approached Abbey National proposing a friendly takeover. Abbey National rejected this approach but on 31 January 2001 Lloyds TSB set out the terms of a conditional offer, which Abbey National again rejected. On 23 February 2001 the Secretary of State referred the proposed merger to us. Abbey National then terminated its merger talks with BoS, citing the uncertainty created by Lloyds TSB as the reason. Subsequently BoS and Halifax Group plc (Halifax) announced the terms of a recommended merger between them.

Findings on the public interest

1.5. The operations of Lloyds TSB and Abbey National overlap in the following categories of product market:

- (a) markets for financial products sold to personal customers, notably personal current accounts (PCAs), mortgages and savings accounts;
- (b) markets for financial products sold to small and medium-sized enterprises (SMEs), defined for this purpose as enterprises with annual turnover up to £25 million;
- (c) markets for financial products sold to larger firms; and
- (d) wholesale banking.

Categories (c) and (d) are characterized by the presence of global competitors and strong buyers. We have no reason to believe that the merger might create competition problems in these areas.

1.6. PCAs are the core product in personal banking. They also serve as a ‘gateway’ through which suppliers can sell other financial products, such as credit cards and personal loans, as a result of the relationship established through the PCA. The merger would increase the PCA share of Lloyds TSB, already the market leader, from 22 to 27 per cent and would raise the combined share of the big four banks from 72 to 77 per cent.

1.7. We considered the merger’s effects not only on Lloyds TSB but also on the merged firm’s rivals, particularly the other members of the big four. There are several features of the PCA market—homogeneity of products, many small customers lacking buyer power, transparent prices, stable demand, similarity of size and cost structure among the main suppliers, and suppliers’ past behaviour—which make the market vulnerable to tacit collusion in pricing, that is, parallel pricing by rival firms, without any overt agreement between them, in ways which serve their common commercial interest. These features would tend to exacerbate any adverse effects on competition arising from the loss of a significant player.

1.8. We see the PCA market as one in which change has been slow over many years but where there are now signs of more rapid development and some strengthening of competition. Nevertheless the constraints on the development of competition are considerable:

- (a) The entrenched position of the big four remains strong. What little market share they have lost through erosion by entrants has been recouped as a result of business acquisitions.
- (b) Customers tend to see switching between banks as a difficult and unrewarding process, and the rate of switching is very low. Action is being taken to ease the process but there is little sign yet of an actual increase in switching.
- (c) Although telephone and Internet-based banks have made some progress, they remain niche players. The great majority of customers continue to bank with multi-service providers which include a national branch network in their range of distribution.
- (d) Branch-based players which have entered in the last ten years, springing from the building society movement, have grown market share only slowly despite their more favourable terms and sustained marketing campaigns.
- (e) Other entry by operators not related to the incumbent banks has been very limited.

In these circumstances well-established rivals to the traditional banks are important for competition.

1.9. Abbey National, along with Halifax, is one of the two most successful branch-based suppliers which have shown the capability and staying power to win a significant share of the PCA market despite the barriers to growth. It offers a distinct alternative to the big four banks, it has been reasonably innovative, and it has to compete actively to maintain its position. Given its financial performance, we consider that Abbey National is capable of maintaining its independence. There is also a possibility of its merging with another player to form an enlarged group which would maintain or increase competitive pressure on the big four. Either way, we consider that it is an important force for competition in the PCA market. We hold this view regardless of whether the merger between BoS and Halifax goes ahead.

1.10. In today's conditions the recent trends towards strengthening competition in the PCA market remain vulnerable to being set back, or their favourable impact on customers diluted or

delayed, by possible developments on the supply side. We consider that the removal of Abbey National as a competitor through its acquisition by Lloyds TSB, with the consequent dismantling of its branch network, would reduce incentives to compete:

- (a) in respect of Lloyds TSB individually, by increasing its customer base and thereby encouraging it to attach more weight to the enhancement of margins than to the growth of market share; and
- (b) in respect of the big four banks collectively, by removing one of the two main sources of actual and potential competition.

We expect this reduction in competition to lead to higher prices (that is, higher fees and overdraft rates, and lower interest on credit balances) and a loss of innovation, compared with the situation that could be expected in the absence of the merger.

1.11. Steps are being taken to improve the process of switching PCAs between banks. This is important in creating conditions for the market to become more competitive but, so far, progress by the banks has been disappointingly slow. The current project to automate the necessary exchanges of information must be completed and effectively implemented without delay and the process must be speeded up. We believe the banks should also take action to secure better cooperation from originators of direct debits.

1.12. As regards the mortgages and savings accounts markets, although the merger would significantly increase concentration on the supply side, the evidence we received indicated that these markets are competitive. We are satisfied that the merger would not be damaging to competition or to consumers of these products. Nor do we have concerns about the effects on the other personal product markets where Lloyds TSB and Abbey National overlap.

1.13. The market for the supply of banking services to SMEs is highly concentrated and is dominated by the traditional banks, especially the big four which together have about 85 per cent of the total (Lloyds TSB itself has around 16 per cent). There are high barriers to entry, and there has been little change in suppliers' market shares. The structure and levels of prices charged by the traditional banks are similar. The market raises significant competition concerns.

1.14. Abbey National has entered this market in the last few years. It currently offers a restricted range of products and has less than 1 per cent of total supply. It does, however, have several of the attributes needed to compete successfully—an established brand name, a national network of branches and a presence in personal and some business banking markets—and it has established a foothold in the SME market. It is therefore well placed to provide competition to the incumbents and it has publicly stated its ambitions to increase its market share. Among the other smaller players and possible entrants, only Halifax has comparable potential: if it succeeds in its planned merger with BoS, the new entity could become a strong and effective competitor in the provision of services to SMEs; without the BoS merger we consider that Halifax is worse placed than Abbey National to compete effectively in this market.

1.15. We consider therefore that the acquisition of Abbey National by Lloyds TSB would reduce competition in the supply of banking services to SMEs, where there is a particular need for *increased* competition, because it would eliminate one of the very few players outside the big four which are able to contest this market. We believe that the merger would cause prices for SME banking services to be higher, and innovation lower, than would be expected in the absence of the merger.

1.16. The merger would lead to efficiency gains but we believe these would not be passed on to consumers in the form of reduced prices. The merger would, moreover, have an adverse effect on consumer choice which would be material in relation to the PCA and SME markets. The planned closure by Lloyds TSB of some 600 branches following the merger would be

likely to cause some reduction in convenience and service quality but there are countervailing factors and the evidence is not sufficient to justify an adverse finding in relation to the effect of branch closures on convenience and service quality.

Remedies

1.17. As well as outright prohibition of the merger, we considered several possible types of remedy for the adverse effects which we identified:

- (a) We reviewed the possibility that Lloyds TSB might be required to divest Cheltenham & Gloucester or Cahoot, Abbey National's stand-alone Internet bank. Cheltenham & Gloucester operates to a very small extent in the PCA market and not at all in the SME market, and anyone acquiring it would do so primarily for its mortgages and savings businesses. We think it unlikely, given the absence of PCA and SME customers, that the Cheltenham & Gloucester branch network would be seen as an attractive platform for entry or expansion into those markets. Cahoot has only about 0.1 per cent of the PCA market: its divestment would be wholly inadequate as a remedy for the loss of Abbey National, particularly as it would not affect the reduction in branch-based competition which would result from the merger. We concluded that there are no Lloyds TSB or Abbey National businesses which could be divested in order to remedy the adverse effects of the merger.
- (b) We considered the possible divestment of branches. Any such divestment would have to include the customer base if it was to affect competition. Both Lloyds TSB and Abbey National saw considerable difficulties about such action though Lloyds TSB was prepared to contemplate it on a modest scale. However, in order to address adequately the adverse effects of the merger, the number of branches to be divested would have to be substantial. The process would be difficult, slow, and unpredictable. Even if it could be done, there could be no guarantee that the transferred customers would stay and it would be uncertain whether the acquirer would provide effective competition to compensate for the loss of Abbey National. We concluded that divestment of branches and customers would not be a suitable remedy.
- (c) We considered the possibility of requiring Lloyds TSB to give undertakings regarding the terms of individual products to be offered by the merged group, and Lloyds TSB put forward specific proposals on these lines. However, we see difficulties both of principle and practice:
 - (i) Undertakings of this type would represent an interference in the operation of market forces. In our view such regulatory intervention is second best to the play of competitive forces which allows markets to develop in ways which reflect consumers' observed preferences.
 - (ii) We see considerable difficulties in the drawing up and monitoring of suitable undertakings.

We therefore do not consider that proposals on these lines would be an appropriate or effective remedy.

- (d) We contemplated steps to improve the awareness of customers of the enlarged group concerning the terms of the products they were buying and how they compared with those from competing suppliers. Such a remedy would itself be a weak step, however, and would be useful only alongside other action which safeguarded the competitiveness of the market. Since we have not identified remedies which would achieve that end, an information-based remedy would not be effective.

1.18. We have therefore concluded that the possible remedies short of prohibiting the merger would not adequately address the adverse effects. The importance of Abbey National is that it has developed a successful business model which is based on a national network of branches. Its PCA and SME businesses are built on that foundation and cannot be separated from it. It may become possible in due course for non-branch-based suppliers to compete effectively and win a substantial share of the PCA and SME markets but we do not expect that to happen for a considerable period.

1.19. Having reviewed all possibilities, and considering the nature and extent of the adverse effects that we identified, we have concluded that prohibiting the merger is the only remedy capable of fully addressing those adverse effects. Accordingly, we recommend that the merger be prohibited.