

2 Conclusions

Contents

	<i>Page</i>
The reference.....	10
The companies involved	10
Lloyds TSB.....	10
Abbey National.....	11
The merger situation and related matters	12
Jurisdiction	12
The markets affected.....	13
Market definition	13
Regulation and competition policy.....	14
Overview of personal financial product markets.....	16
Personal current accounts	17
Other personal financial products.....	18
Banking services for SMEs	18
The effects of the merger	18
Our analytical approach.....	18
The merger's effects on the PCA market	19
Structural factors.....	19
The market's vulnerability to tacit collusion	19
Product homogeneity	20
Small customers	20
Transparent prices	20
Stable demand	20
Similarities among the main suppliers	21
Other factor	21
Past behaviour	21
Conclusion on tacit collusion	21
The present state of competition.....	21
Prices and service.....	21
Switching.....	24
Innovation	26
Branding and marketing	26
Profitability	26
How the market is changing	28
New entry.....	28
Advances in technology	30
New and enhanced services	31
Steps to improve switching.....	32
Trends in margins.....	33
The significance of Abbey National	33
Market share and sales growth.....	34
Other competitors to the big four	34
Abbey National as a company.....	36

The merger's effect on competition in PCAs	37
The merger's effects on the savings market	39
Structural factors.....	39
Entry	39
Switching and inertia	39
The merger's effect on competition in the savings market.....	40
The merger's effect on the mortgage market.....	40
Structural factors.....	40
Entry	40
Switching and inertia	41
The merger's effect on competition in the mortgage market.....	41
The merger's effect on other personal banking markets	41
The merger's effect on banking services for SMEs	42
The significance of Abbey National	43
Our assessment	44
The merger's overall effect on Lloyds TSB	45
Other effects of the merger.....	46
Synergies.....	46
The extent to which benefits from the merger would be passed on to consumers.....	47
The merger's effect on consumer choice	48
The merger's effect on financial exclusion.....	49
The effect of branch closures.....	49
Conclusions.....	50
Remedies.....	51
Prohibition of the merger.....	51
Divestment of businesses	52
Divestment of branches	53
Undertakings on products and prices	54
Information for customers	57
Undertakings offered by Lloyds TSB to the DGFT	57
Recommendation.....	57

The reference

2.1. On 23 February 2001 the Secretary of State for Trade and Industry (the Secretary of State), on advice from the Director General of Fair Trading (DGFT), made a reference to us under the merger provisions of the Fair Trading Act 1973 (FTA) concerning the proposed acquisition of Abbey National by Lloyds TSB (see Appendix 1.1 for our terms of reference). The Department of Trade and Industry (DTI) press notice said that the proposed merger would lead to the elimination from the market of one of the most significant branch-based competitors to the UK's four largest banks and that this might result in a substantial lessening of competition, particularly in the market for current accounts. Furthermore, the merger would remove a potential competitor in the provision of banking services to small and medium-sized companies. The Secretary of State was therefore referring the proposed merger to the CC so that it could be fully investigated.

The companies involved

Lloyds TSB

2.2. Lloyds TSB was created as a result of the 1995 merger between Lloyds Bank plc (Lloyds Bank) and TSB Group plc (TSB). Lloyds Bank had for many years been one of the

four leading clearing banks in the UK (widely referred to as the ‘big four’). Its size and the diversity of its activities have substantially increased in the last six years as a result of acquisitions, including that of TSB.

2.3. TSB itself had been formed in 1986 as the holding company of the Trustee Savings Banks and its shares were listed on the London Stock Exchange in the same year. Shortly before the merger with TSB, Lloyds Bank had acquired Cheltenham & Gloucester Building Society, now Cheltenham & Gloucester plc, thus greatly increasing its involvement in the supply of mortgages and savings products for personal customers. In March 2000 Lloyds TSB acquired Scottish Widows’ Fund and Life Assurance Society, extending the group’s life assurance and pensions business.

2.4. In the year to 31 December 2000 Lloyds TSB made a pre-tax profit of £3.9 billion and employed on average 80,000 people. Post-tax return on shareholders’ funds was 30 per cent. The group’s market capitalization at the end of April 2001 was £40 billion. In 2000 88 per cent of the group’s profits were made in the UK. Lloyds TSB has some 2,350 branches in total, including 210 owned through Cheltenham & Gloucester.

2.5. In its 2000 report and accounts, Lloyds TSB described the maximization of shareholder value over time as its governing objective. Lloyds TSB saw the biggest opportunity for growth in increasing its share of total financial assets and aimed to attract more of the business that its 16 million customers had with other financial companies. Market segmentation was of growing importance. Competition on price alone was a losing strategy, and enhancing customer value for target customers would be the primary means of delivering superior shareholder returns. The financial services industry remained highly fragmented and was ripe for further consolidation. There was ample scope for organic growth but Lloyds TSB would also continue to seek growth through acquisition.

2.6. In its Group Strategic Plan, 2000–2002, dated September 2000, a copy of which Lloyds TSB provided to us at our request, the company reaffirmed that its specific goal was to [36] total shareholder value every [36] years. [

Details omitted. See note on page iv.

] Extracts from the September 2000 document and from an update of the plan in December 2000 are set out at Appendix 5.1.

Abbey National

2.7. In 1989 Abbey National, then one of the UK’s leading building societies, was the first society to convert from mutual to public limited company (plc) status and have its shares listed on the London Stock Exchange. In the succeeding 12 years, as a result of organic growth and a series of acquisitions, Abbey National has developed from being primarily a mortgage and savings account provider into a full-service retail and wholesale bank.

2.8. In the year to 31 December 2000 Abbey National made a pre-tax profit of £2.0 billion (over 95 per cent in the UK) and employed on average over 31,000 people. Its post-tax return on shareholders’ funds was 21 per cent. The group’s market capitalization at the end of April 2001 was £17.7 billion. Abbey National has a network of some 770 branches, including 37 in supermarket outlets of Safeway plc (Safeway).

2.9. In its 2000 report and accounts the Chief Executive said that Abbey National would continue to diversify its business, build a broadly-based financial services institution, strengthen its franchises and innovate across its range of service. In June 2000 the company had

announced that it planned to increase the number of its personal bank accounts by one-third to 4 million in 2002 and to grow its share of SME accounts from 1 to 5 per cent by 2005.

The merger situation and related matters

2.10. In November 2000 it became known that Abbey National was in discussions with BoS about a possible merger. A few weeks later Lloyds TSB made approaches to Abbey National proposing that it acquire Abbey National in a friendly takeover. Abbey National rejected these approaches. It continued its talks with BoS and submitted a notification to the DGFT seeking clearance for a BoS/Abbey National merger. On 5 January 2001 Lloyds TSB submitted a notification seeking clearance for a possible takeover of Abbey National, and on 31 January it issued a statement setting out the terms of an offer, conditional on the proposed transaction being recommended by the Abbey National board and not being referred to the Competition Commission (CC). Abbey National rejected the proposed offer on the grounds that the terms were inadequate and were subject to material uncertainties.

2.11. On 5 February 2001 the Secretary of State announced that the possible merger between Abbey National and BoS would not be referred to the CC but on 23 February he referred the proposed Lloyds TSB takeover of Abbey National to us (see paragraph 2.1). Shortly afterwards Abbey National announced that, in the light of the uncertainty created by Lloyds TSB, Abbey National had terminated its merger discussions with BoS.

2.12. Subsequently, following talks between BoS and Halifax, the two companies announced on 4 May 2001 that they had agreed the terms of a recommended merger of equals between them. They intend to submit their proposals to shareholders in July 2001 and expect that, following subsequent court approval of schemes under section 425 of the Companies Act 1985, the merger will be completed by the end of September 2001.

Jurisdiction

2.13. Our terms of reference (see Appendix 1.1) require us to report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in the FTA, in that:

- (a) enterprises carried on by or under the control of Lloyds TSB will cease to be distinct from enterprises carried on by or under the control of Abbey National; and
- (b) either the value of the assets which will be taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK, or a substantial part of the UK (the share of supply test).

If so, we have to report on whether the creation of that situation may be expected to operate against the public interest. Section 63(2) of the FTA provides that ‘enterprise’ means the activities, or part of the activities, of a business. Section 65 specifies the circumstances in which two enterprises are to be regarded as ceasing to be distinct. One of the circumstances is where they are brought under common ownership or control.

2.14. As described in paragraph 2.10, Lloyds TSB notified the DGFT of the possibility that it might make an offer to acquire Abbey National, and subsequently published the terms of a conditional offer. Although that offer lapsed on the reference being made to the CC, Lloyds TSB confirmed to us that it intended to proceed with the bid if we concluded that a merger

between the two companies might not be expected to operate against the public interest. If such a bid were to succeed, it is clear that enterprises carried on by Lloyds TSB and enterprises carried on by Abbey National would come under common control and hence cease to be distinct within the meaning of the FTA.

2.15. Paragraph 3.30 records that Abbey National had total gross assets at 31 December 2000 of £204 billion. This exceeds the £70 million threshold set for the assets test. We therefore find that the assets test is satisfied and in accordance with our terms of reference (see Appendix 1.1) we exclude the share of supply test from consideration.

2.16. For the reasons set out in paragraphs 2.14 and 2.15, we conclude that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as postulated in our terms of reference. Accordingly we have to consider whether the creation of that situation may be expected to operate against the public interest. We describe first the markets which would be affected by the merger before analysing what its effects would be.

The markets affected

Market definition

2.17. We begin by defining the product and geographic markets in which Lloyds TSB and Abbey National overlap. These markets may be broadly categorized as follows:

- (a) markets for financial products sold to personal customers;
- (b) markets for financial products sold to SMEs;
- (c) markets for financial products sold to larger firms; and
- (d) wholesale banking (for example, money market and foreign exchange dealing).

Categories (c) and (d) are characterized by the presence of many global competitors and many strong buyers. In the absence of representations concerning these markets, we have no reason to believe that the merger might create competition problems in these areas and we have not considered them further.

2.18. The main types of financial product marketed to personal customers are: PCAs; deposit accounts and similar savings accounts; mortgages; other loans; credit cards; insurance (life and other); other long-term investments; and pensions. There is some substitutability among these products but most consumers appear to view them separately and there was general agreement among those giving evidence to us that each of the eight product types could be viewed as a separate economic market for the purposes of the inquiry.

2.19. We too agree that, for the purpose of analysing competition in this merger inquiry, we can treat each of the eight product types as separate markets. However, there are inter-connections between them:

- (a) Some of the product types, notably PCAs and mortgages, are seen in the industry as 'gateway' products, providing a basis on which the providers can cross-sell other financial products to customers. (There is also a link between PCAs and banking services for SMEs in this respect—see paragraph 2.185(d).)

- (b) A related point is that substantial shares of the individual product markets are held by providers with branch networks. These networks represent a major cost element which gives a strong incentive to spread sales across additional products.
- (c) There are now some products, introduced in the last few years, which straddle the boundaries between the eight product types listed above, for example accounts combining a PCA with a mortgage.
- (d) Much expenditure by banks on branding is not product specific. As with branch networks, there are advantages in companies being able to spread the costs over several product types.
- (e) Neither Lloyds TSB's nor Abbey National's internal organizations correspond to the product markets and their internal management accounts routinely reflect performance across several of them together rather than reporting on them separately.

We therefore need to take account of these linkages, in assessing the merger's effects, albeit that the primary basis of our analysis is the individual product market.

2.20. Both Lloyds TSB and Abbey National operate throughout Great Britain, while Abbey National also operates on a small scale in Northern Ireland. We received evidence that market conditions were similar throughout Great Britain for the supply of personal banking products. The position for Northern Ireland is different, at least for PCAs. There are grounds, reflecting both demand and supply side factors, for treating the Province as a separate market. On the demand side it seems unlikely that customers' banking habits are consistent with a chain of overlapping local markets connecting Northern Ireland with Great Britain. On the supply side all the four main clearing banks operating in Northern Ireland are different from the main operators in Great Britain (although two of the four are owned by banks which operate in Great Britain). We therefore treat Great Britain as a single geographic market and Northern Ireland as a separate market. Given that Lloyds TSB is not present in Northern Ireland, it was not necessary for us to investigate the merger's effects there.

2.21. There are a number of product markets serving SME customers. The products have some similarity with those sold to personal customers, but there are also differences. In particular, the SME 'relationship manager' is an important element in both current account and lending markets, and there are some special forms of financing (for example, asset-based finance) that are relevant to SME customers but not to personal customers. Given, however, the fact that Abbey National is a new entrant in the provision of bank accounts to the SME sector, we have not conducted a separate analysis for each of the SME product markets. We shall rather be assessing the effects of the merger in the context of the SME sector as a whole. As regards the geographical aspect we shall focus on Great Britain for the same reasons as set out in paragraph 2.20 in relation to the personal sector.

Regulation and competition policy

2.22. Providers of financial services are subject to regulation both as to prudential factors and the treatment of consumers. Under the Financial Services and Markets Act 2000 (FSM Act), the Financial Services Authority (FSA) will be the sole sectoral regulator of financial services, covering notably banking, insurance and mortgage lending. Its objectives are maintaining market confidence, promoting public understanding, protecting consumers and fighting financial crime. It has to have regard to a set of principles which include ensuring that regulatory requirements do not distort competition. The DGFT can refer to the CC any of the FSA's provisions or practices that he considers are anti-competitive; and the CC, following an investigation, can recommend action by the FSA if it finds that there are anti-competitive effects which are significant and unjustified.

2.23. The major banks subscribe to the Banking Code, a voluntary code of good practice for dealing with personal customers, a revised version of which came into operation in January 2001. There is also a Code of Mortgage Lending Practice. A banking code for business customers is in preparation and expected to be launched in March 2002. Following the Cruickshank report (see paragraph 2.24) the Treasury initiated a review of the effectiveness of codes in the financial services industry. There is a Financial Ombudsman Service which deals with consumers' complaints.

2.24. In November 1998 the Government set up a non-statutory review of competition in UK banking led by Mr Don Cruickshank. The main conclusions and recommendations of the Cruickshank report,¹ which was published in March 2000, were as follows:

- (a) There were competition problems in all three of the main areas considered: money transmission systems, services to personal customers and services to SMEs.
- (b) Payment systems providing wholesale money transmission should be regulated via a licensing system.
- (c) In relation to banking services for personal customers, there were some encouraging signs of new entry and increased competition. Behavioural or product regulation under the FSM Act was not required but all mergers bringing further concentration should be looked at extremely carefully. Specifically, all mergers between financial suppliers should be referred to the CC if the merging entities had material shares of the relevant market, or if they had material shares in related markets from which one might enter to compete with the other.
- (d) A complex monopoly investigation should be held into the markets for SME banking services.
- (e) Various improvements were needed in the existing framework of regulation in order to improve consumer representation and redress, and to increase transparency.

2.25. The Government broadly accepted the review's conclusions, though not some of the specific recommendations. In December 2000 it issued a consultation document setting out a proposed new regulatory regime for payment systems which would, inter alia: require price transparency in the provision of retail payment services; require that access to payment services be provided on fair and non-discriminatory terms; and require wholesale charges to be based on costs. The proposals would require new legislation and the Government intended to confer the new powers on the Office of Fair Trading (OFT) rather than a new payment systems commission as recommended by Cruickshank.

2.26. As regards personal banking products, the Government agreed that the case for regulating banking products, other than mortgages, was weak. The Government rejected Cruickshank's recommendation on merger references (see paragraph 2.24(c)) and said that the Secretary of State would continue to refer bids where he believed, drawing on the DGFT's advice, that they would have an adverse effect on competition. The Secretary of State decided not to refer the bid by Barclays PLC (Barclays) for Woolwich plc (Woolwich) in October 2000, or the possible merger between Abbey National and BoS (see paragraph 2.11).

2.27. The action taken in relation to SME banking services is referred to in paragraph 2.30.

2.28. The Government has also for some time been discussing with the leading banks and the Post Office (now named Consignia plc) the provision of Universal Banking Services. In May 2001 it announced an agreement under which basic bank accounts provided by the banks

¹*Competition in UK Banking: A Report to the Chancellor of the Exchequer*, The Stationery Office, March 2000.

could be accessed through post offices (as well as bank branches) and a new card-based Post Office account would be introduced through which state benefits could be paid to recipients.

2.29. It will be clear from the above summary (and the fuller account in paragraphs 4.5 to 4.20) that there is extensive regulation of suppliers of personal financial products (as well as self-regulation), and that the Government has taken several initiatives in the last few years with a view to improving security, fairness and value for money for consumers. Nevertheless prices are not regulated, nor are many aspects of service. These matters are governed by the action of competitive market forces, subject to the operation of general competition law.

2.30. As regards competition in the markets for small business banking services, Cruickshank concluded that the situation was much more problematic than in the markets for personal customers and that an urgent complex monopoly investigation was required, bringing the possibility of structural remedies. Immediately on publication of the Cruickshank report, the Chancellor of the Exchequer and the Secretary of State made a monopoly reference to the CC under the FTA concerning the supply of banking services to SMEs (the SME monopoly inquiry). The CC is due to report on this reference later in 2001. We have taken account of that evidence put to the SME monopoly inquiry which is also relevant to our inquiry, and have kept the parties to the merger situation informed about this. We have also been told of relevant aspects of the thinking underlying the provisional conclusions of the monopoly inquiry. Nevertheless, in respect of this merger inquiry we have reached our own conclusions on the basis of the evidence before us which was relevant to our terms of reference, including that submitted to the SME monopoly inquiry.

Overview of personal financial product markets

2.31. Table 4.1 gives summary data on market shares in the markets for personal financial products which are most affected by the merger. It shows that the merger's largest effects are in the PCA, savings account and mortgage markets:

- (a) In PCAs Lloyds TSB has comfortably the biggest share at present (22 per cent), significantly ahead of the next biggest suppliers, Barclays and the Royal Bank of Scotland Group plc (RBS Group) with its subsidiaries, the Royal Bank of Scotland plc and National Westminster Bank Plc (RBS/NatWest), with 18 per cent each, while Abbey National has 5 per cent.
- (b) In both savings accounts and mortgages Abbey National is the second biggest supplier with about 13 per cent and Lloyds TSB has 9 to 10 per cent.

The principal suppliers of these products fall into two main groups: traditional banks, and building societies and former building societies.

2.32. The big four banks, each with 14 per cent or more of the PCA market, are Barclays, HSBC Bank plc (HSBC), Lloyds TSB and RBS/NatWest. All four have retail operations throughout England and Wales, and Lloyds TSB and RBS/NatWest are also among the leading banks in Scotland. None of them operates directly in Northern Ireland but the RBS Group owns Ulster Bank Limited. The other traditional clearing banks are BoS, whose retail operations are largely confined to Scotland, and National Australia Bank Limited (NAB), which operates in Scotland, Northern Ireland and the North of England through its ownership of Clydesdale Bank PLC (Clydesdale), Northern Bank Limited (Northern Bank) and Yorkshire Bank PLC (Yorkshire Bank) respectively. Three of the big four have expanded through acquisition in recent years, notably through RBS Group's takeover of NatWest in March 2000 and Barclays' takeover of Woolwich, a former building society, in October 2000, as well as the acquisitions by Lloyds TSB referred to in paragraphs 2.2 and 2.3.

2.33. Following the liberalization of financial markets in the 1980s, building societies began to diversify from savings accounts and mortgages into PCAs and other products. Most of the larger societies have since converted from mutual to plc status and/or been acquired. The three largest of the former building societies are Abbey National, Alliance & Leicester plc (Alliance & Leicester) and Halifax. Nationwide Building Society (Nationwide) is easily the biggest of the remaining mutually-owned building societies.

2.34. Other suppliers have entered the personal banking markets in recent years, partly through the exploitation of new methods of distribution opened up through technological development. Thus, for example, Egg, an Internet-based business owned by Prudential Plc (Prudential), has entered the savings and credit card markets and Standard Life Bank Limited (Standard Life) has entered the mortgage market.

2.35. There are about 14,000 bank and building society branches in the UK. The number is declining steadily and has fallen from about 17,000 in 1995. The big four banks have about 60 per cent of the total number of branches between them (see Table 4.2).

Personal current accounts

2.36. PCAs provide customers with money transmission and deposit-holding services and, through overdrafts, may act as a source of credit. Over 85 per cent of UK households are believed to have at least one current account. PCAs generate over £5 billion in income for the banks in the form of net interest and fees (see paragraph 4.28). As noted in paragraph 2.19, PCAs are also a 'gateway' through which suppliers can sell other financial products, such as credit cards, personal loans and savings accounts, as a result of the relationship established through the PCA.

2.37. PCA services are delivered through a variety of means, some of which have only been introduced in recent years: branches, automated teller machines (ATMs), telephone, Internet, digital television, wireless application protocol (WAP) phone and the Post Office. Not all PCA services can be provided through all these means—for instance, cash withdrawal or deposit requires a physical presence—and not all PCA products offer the full range of distribution methods. Because of the growth of new methods, use of branch counters is declining: Abbey National told us that use of its counters for personal banking transactions had fallen from 30 per cent of all such transactions in 1997 to 12 per cent in the first part of 2001. Lloyds TSB's strategy document of September 2000 said 'we believe that most customers will still want access to a branch, but use them less often' (see Appendix 5.1).

2.38. Table 4.5 shows trends in PCA market shares between 1995 and 2000. The combined share of the big four fell from 71 per cent in 1995 to 68.5 per cent in 1999 but then rose to 72 per cent in 2000 mainly as a result of the RBS/NatWest and Barclays/Woolwich mergers. Over the same period Abbey National's share rose from 3.8 to 5.1 per cent and Halifax's from 2.6 to 4.9 per cent. (Lloyds TSB argued that shares of new accounts in the latest year were a better indicator of banks' competitive impact than shares of the total stock of PCAs. We agree that share of new accounts, net of closures, is an indicator of recent competitive performance, but the number of accounts opened and closed in a year is a small percentage of the existing stock of accounts, so any differences between shares of net openings and shares of current stock will affect the future stock slowly. It is share of the total stock which is relevant to a bank's income from PCA business.)

2.39. Paragraphs 4.46 to 4.70 describe the barriers to entry in the PCA market, and the barriers to customers switching accounts between banks. We return to these issues in considering the effect of the merger (see paragraphs 2.80 to 2.90 and 2.122 to 2.130).

Other personal financial products

2.40. Savings accounts are deposit-holding accounts which, unlike PCAs, do not offer money transmission facilities. They are operated through branches, ATMs, post, telephone and Internet.

2.41. There are around 120 providers of savings accounts (compared with about 35 PCA providers—both figures include providers which operate under separate names but which are under common control). Table 4.13 shows market shares for the larger providers. In 2000 Halifax had the largest share with 18 per cent and Abbey National the second largest with 13 per cent. These two suppliers have lost share over the last five years, while Barclays (largely through the acquisition of Woolwich), HSBC and Nationwide have gained share.

2.42. The savings and mortgage markets have historically been closely linked since the building society movement developed in order to hold members' savings and use them to provide mortgages. Although this relationship has weakened in recent years as new suppliers have entered one or other of the markets, the two leading suppliers of mortgages are again Halifax (with 20 per cent) and Abbey National (with 13 per cent)—see Table 4.17. As in savings, both have lost share in the last five years. Barclays (again through the acquisition of Woolwich) has gained share as, to a lesser extent, has Lloyds TSB (whose share is held mainly through Cheltenham & Gloucester).

2.43. Brief details of the other personal product markets are set out in paragraphs 4.105 to 4.113.

Banking services for SMEs

2.44. Some of the banking products supplied to SMEs are similar to those supplied to individuals, for example, current accounts (including overdrafts), deposit accounts and, secured and unsecured lending. However, SME current account customers usually have access to a relationship manager to advise them on their banking business. There are also other forms of finance, such as factoring, which do not apply in personal markets. The big four banks have a greater share of the SME market than of PCAs and other personal banking markets. Measured by the proportion of SMEs for which they are the main business bank, the big four have about 85 per cent of the total, and the other traditional banks (BoS and NAB) a further 9 per cent (see Table 4.21).

The effects of the merger

Our analytical approach

2.45. As emerges from the description in paragraphs 2.31 to 2.44, the British banking markets that provide PCAs and most services to SME customers are dominated by four major suppliers (though this is much less true of other personal products). This market structure has prevailed for many years, albeit that ownership of two of the big four banks has changed (through the acquisitions of Midland Bank plc (Midland) by HSBC in 1992 and of National Westminster Bank plc (NatWest) by RBS Group in 2000) and the nature of some of them has been substantially affected by acquisitions.

2.46. We started our inquiry with no presumption as to the effects of this structure on customers. We do, however, distinguish between:

- (a) the effects of the merger on the post-merger firm, that is the enlarged Lloyds TSB; and

(b) the effects which apply also to the merged firm's rivals, in particular the other members of the big four.

2.47. In considering the significance in this case of the first category of effects, we note that there is evidence that Lloyds TSB and Abbey National compete for the same customers: their customer profiles are similar and 90 per cent of Abbey National's branches overlap with Lloyds TSB's network (see Appendix 4.1). We are not, however, dealing with markets in which products are strongly differentiated, even though there may be many differences of detail, and it appears that there is similar competition between Abbey National and the other main players. Nor is there any reason, to judge from the data on customers switching between banks, to think that competition between Lloyds TSB and Abbey National is significantly greater than would be expected from their respective market shares. The merged group would continue to face direct competition from the other three big banks and from the smaller players. Nevertheless we need to take account of the merger's effects in increasing Lloyds TSB's size and market share and how its behaviour might be expected to change as a result.

2.48. As regards the second category of effects, the issue is whether the whole market—and in particular the big four—would become less competitive than would be the case in the absence of the merger. This raises the issue of tacit collusion (see paragraphs 2.52 to 2.64).

2.49. We adopt the approach to competition just described in relation to the individual product markets in which the merging parties overlap: PCAs, savings and mortgages, other personal banking products and banking services for SMEs. We then consider the merger's overall effect on Lloyds TSB; other effects on consumers, additional to those arising in our review of the respective product markets; and the effects on efficiency and employment. Finally we draw our conclusions on the merger's overall effect on the public interest.

The merger's effects on the PCA market

Structural factors

2.50. In markets with relatively undifferentiated products, a merger's effect on concentration is an important indicator of the risk of reduced competition. The present merger would increase the combined share of the PCA market held by the big four banks from 72 to 77 per cent. The Herfindahl-Hirschman Index (HHI), a measure of industry concentration, would increase from around 1,420 to 1,650. In the guidelines of the US antitrust authorities, an HHI between 1,000 and 1,800 is regarded as denoting a moderately concentrated market; hence in these terms the merger would take the market towards the upper end of the moderately concentrated range. The guidelines also state that mergers which cause an increase of more than 100 points within the moderately concentrated category potentially raise significant competition concerns.

2.51. The market share of Lloyds TSB itself would rise from 22 to 27 per cent if the acquisition of Abbey National went ahead, considerably widening the gap between its share and those of its nearest competitors, Barclays and RBS/NatWest, both with 18 per cent.

The market's vulnerability to tacit collusion

2.52. In examining the merger's likely effects on the market as a whole (see paragraph 2.46(b)), we note that there are several features which are regarded as likely to make markets in general 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 are: product homogeneity, many small customers lacking buyer power; transparent prices; stable demand; and similarity of size and cost structure among suppliers.

The past behaviour of the main suppliers is also a relevant indicator. We consider the applicability of each of these factors, in turn, to the PCA market.

Product homogeneity

2.53. The PCA in its basic form is a package of standard services, most frequently comprising deposit-holding, various forms of money transmission and overdraft facilities. While some PCA products do not include an overdraft, there has historically been little difference in the products offered by the various banks and the three standard elements of the package are generally offered. Pricing structures, too, have been similar.

2.54. In recent years there have been signs that this situation is changing. As a result there is now some differentiation of pricing structures and some products are available which bundle PCAs with other services. However, pricing structures among the big four banks for the main PCA offering remain very similar. We consider therefore that there is still a relatively high degree of homogeneity between these banks' offerings in this market.

2.55. Strong branding can differentiate products in the consumer's mind even if the characteristics of various suppliers' products are objectively similar. Lloyds TSB argued that the brands of the leading banks were differentiated: it said that research showed, for example, that Lloyds TSB was seen as being helpful and accessible whereas Barclays had emphasized its size and HSBC its global reach. We believe branding is important in this market, but mainly because possession of a known and trusted brand is a requirement for success in the mass market. We do not believe that brand *differentiation* is such as to affect our view about the homogeneity of product offerings in this market.

Small customers

2.56. The supply of PCAs is vertically integrated in that, unlike some other financial products, PCAs are sold directly to the customer, not through intermediaries. Nor are any PCA products provided to supermarkets to their specification and sold on to customers under the supermarkets' own brand names. Consequently this is a market in which integrated suppliers sell to large numbers of individual customers, none of whom as a result has buyer power. Both Lloyds TSB and Abbey National told us that they did not, except to a very small extent, negotiate special terms for their PCA customers.

Transparent prices

2.57. All the banks publish tariffs for their PCA products. These comprise the interest rates paid on credit balances, the interest rates charged on authorized and unauthorized overdrafts and the fees charged for particular services. These tariffs are freely available in bank branches. Similarly the terms for those accounts that combine a number of features are set out in published leaflets. Since there is little individual negotiation of prices, it is very easy for suppliers to monitor each other's pricing.

Stable demand

2.58. The PCA market is mature. While up to 15 per cent of the adult population do not have a current account, growth in the overall number of accounts held is slow, at around 3 per cent a year (see Table 4.10).

Similarities among the main suppliers

2.59. The shares of the PCA market held by the big four range from 22 per cent (Lloyds TSB) to 14 per cent (HSBC). All of them also have significant shares in the other main personal product markets and in the supply of banking services to SMEs. All have substantial branch networks (see Table 4.2). As a result they have broadly similar cost structures in retail markets, with those costs being spread across broadly the same product markets.

2.60. There may be greater differences in cost structure between the traditional banks and the former and present building societies: for example, Lloyds TSB said that the former building societies had proportionately fewer rural branches and seemed able to operate effectively with a smaller network than the clearing banks. Abbey National told us that the clearing banks were burdened with old, high-cost systems.

2.61. The development of other channels for supplying banking services, notably ATMs, telephone and Internet, and the declining relative importance of branches, are changing the situation but are unlikely to do so in a fundamental way for the next few years (see paragraphs 2.113 to 2.116).

Other factor

2.62. One other factor specific to this market which may facilitate tacit collusion in pricing is the habit of cooperation which has developed among the banks in the operation of payment networks, notably the Association for Payment Clearing Services (APACS), Link Interchange Network Ltd (LINK), Mastercard and Visa. The Cruickshank report commented that, being mutually governed, the payment systems were run in the interest of the banks that owned them.

Past behaviour

2.63. As noted in paragraph 2.45, the structure of the supply side of the PCA market, with four players having the bulk of the total, has prevailed for a long time. Since the introduction of 'free' banking, initiated by Midland in the mid-1980s, there is little evidence that the big four have competed keenly on price for the bulk of customers. Lloyds TSB's internal strategy document of September 2000 (see paragraph 2.6) commented that the previous year's plan had been prepared against the background of a favourable economic environment and 'limited impact from competitors', contrasting this with the more competitive situation which the company faced in 2000 (see Appendix 5.1). The document also commented: 'Historically, customer inertia for banks has been high. With little difference between the offers of the major banks, the perceived rewards to moving bank were seen as small.'

Conclusion on tacit collusion

2.64. For these reasons, therefore, we believe that the PCA market is vulnerable to tacit collusion in pricing. This would tend to exacerbate any adverse effects on competition arising from the loss of a significant player. We now examine the evidence bearing on the strength of competition in the market at present, how the situation may be changing, the significance of Abbey National, and the merger's likely impact on competition.

The present state of competition

Prices and service

2.65. The prices of the big four banks for their standard PCA products are very similar: currently they all make no transaction charge for the main money transmission services, pay

0.1 per cent interest on credit balances and charge interest at between 18 and 19 per cent on authorized overdrafts and between 29 and 34 per cent on unauthorized overdrafts. The prices of the other traditional clearing banks, BoS and the NAB subsidiaries, Clydesdale and Yorkshire Bank, are also similar.

2.66. The former or present building societies which have entered the PCA market in the last ten years or so (Abbey National, Alliance & Leicester, Halifax and Nationwide) differentiate themselves from the big four in some areas of pricing, principally with regard to authorized overdraft rates: see Table 4.12. In round figures Abbey National, Halifax and Nationwide charge 10 per cent on authorized overdrafts and Alliance & Leicester 12 per cent. As regards interest on credit balances Abbey National and Alliance & Leicester pay rates which are not materially higher than the big four, while Nationwide pays 1 per cent. The main differentiation in this regard is currently provided by Halifax which since January 2001 has paid 4 per cent on credit balances subject to a minimum monthly amount (£1,000) being credited to the account, otherwise 4 per cent on balances of £500 and above. Lloyds TSB's September 2000 strategy document commented that most of the new entrants base their appeal on differentiating themselves from incumbents (see Appendix 5.1).

2.67. Banks which operate PCAs by telephone and/or Internet, including First Direct which is owned by HSBC, also offer better prices than the big four's standard accounts.

2.68. Fees are the other source of revenue for the banks from PCAs. The picture on fees is complex but we note the following points:

- (a) There are differences of detail among the big four as regards both the level of fees and the items on which fees are charged. The most significant of these differences is that two of the four have dropped overdraft usage fees while two (Lloyds TSB and Barclays) continue to charge £5 per month. Both have recently announced that they intend to stop levying these charges later in 2001.
- (b) Abbey National has discontinued most minor fees whereas Halifax's charging structure is similar to those of the big four. Neither charges overdraft usage fees. However, Abbey National has introduced charges for paying bills over the counter. It told us that this was to reduce queuing times for other customers and to encourage customers to use alternative payment methods, such as ATMs and deposit points, thus reducing costs to the benefit of the bank and all customers.

2.69. Paragraphs 2.65 to 2.68 refer to the standard PCA products offered. Several banks, including all the big four, now offer packaged or 'added value' accounts which give customers additional benefits in return for monthly fees. These accounts, which have been introduced within the last few years, represent a segmented approach to pricing and product design. Lloyds TSB offers three grades of packaged account, consistent with its strategy of offering enhanced value for target customers (see paragraph 2.5). Part of the added value comprises favourable terms on non-PCA products such as personal loans which are designed to increase cross-selling, albeit at reduced margins. Such products represent an increase in complexity and a reduction in transparency of pricing; these factors, as well as the perceived value of the accounts, may have the effect of deterring customers from switching to telephone or Internet PCA products. Lloyds TSB told us that about 20 per cent of its PCA customers had chosen to switch to one of the bank's added-value accounts, which were first introduced in 1997, and that the number was growing rapidly.

2.70. All the banks also offer preferential terms for youth and/or student accounts. For example, Lloyds TSB's student account offers an interest-free overdraft up to £1,500 for years 1 to 3 of study and £2,000 for years 4 and 5.

2.71. Figures collected by the Bank of England suggest that the actual average overdraft rate paid during 2000 was 10.5 per cent. The fact that this is far below the headline rates of the leading providers appears to be the result of several factors (see paragraph 4.77). The Bank of England is currently reviewing these data.

2.72. The pricing patterns described in paragraphs 2.65 to 2.70 appear to reflect a view on the part of the big banks that most customers are not price sensitive once they have opened their first account. Customers do, however, appear to be attached to the concept of 'free' banking. The banks we asked about this recognized that it might in principle be more logical to charge for transactions while paying higher rates of interest on credit balances, so that pricing would more closely reflect the costs of operating particular customers' PCAs, but argued that any bank which was the first to introduce such a policy would rapidly lose customers. Experience with packaged accounts shows that a minority of customers are prepared to pay a monthly fee for their current accounts but that is in return for other benefits, not explicitly to meet the cost of transactions.

2.73. Lloyds TSB's strategy document of September 2000 commented that, according to (then) recent market research, 'so far customers remain relatively price-insensitive for core banking services (ie current account), except for what are perceived as hidden charges, with service seemingly much more important'. [

Details omitted. See note on page iv.

]

2.74. We put it to Lloyds TSB that one interpretation of these statements was that, as part of a four-firm oligopoly, Lloyds TSB would want to avoid getting into a price war with the other three: it could afford not to respond to price initiatives by smaller players because the effect on its business was not material, given the low level of switching.

2.75. In response, Lloyds TSB said that it did not accept the concept of a 'big four' dominating the supply of PCAs: in its view there were ten or eleven significant competitors in the market. It argued, first, that some entrants' pricing was not sustainable and that it would be ruinous for Lloyds TSB to match it; and, secondly, that customers valued service as well as price. For example, customers valued such things as service quality and access to branches and ATMs more than they valued getting interest on their current account balances. Lloyds TSB had therefore invested in what it described as 'anywhere, any time' banking in preference to offering better interest rates. Competitive forces might in due course force Lloyds TSB to pay better rates on credit balances, in which case 'something else would have to give' but it did not want to lead the field in that direction.

2.76. One effect of 'free' banking is that there are cross-subsidies between different categories of customer. Information from both Lloyds TSB and Abbey National showed that, on the basis of their respective allocations of all applicable costs including overheads, only a minority of their PCA customers were profitable for the bank. [

Details omitted. See note on page iv.

]

2.77. Current pricing patterns benefit customers who have low average credit balances and high levels of transactions, and who do not use overdrafts, at the expense of those with high balances, low transactions and heavy overdraft use. If competition increases, it can be expected that cross-subsidies will be squeezed out. To the extent that the merger reduced competition, we expect that it would also slow down the elimination of cross-subsidies.

2.78. One factor which concerns us is ‘back-book pricing’ whereby established customers are left with worse terms than those offered to customers when new products are introduced. [

Details omitted. See note on page iv.

] It acknowledged that it still had about 850,000 customers with old, non-interest-bearing current accounts, and 500,000 on accounts with some per-item charging, though it said that both these numbers were falling quickly, partly as a result of customers switching to its added-value accounts. Lloyds TSB also referred to its offer of interest-free overdrafts for customers switching to it from other banks as a case where one category of new customers received preferential treatment for a limited period.

2.79. Although the ‘back book’ is less important in the PCA market than in some other personal finance markets, its existence brings out the point that incumbent suppliers with sizeable market shares have to take account of the effect of price initiatives on the profitability of their existing customer base. If a market is characterized by switching costs and/or customer inertia, suppliers can focus on new customers when competing through price, assured that cutting prices to new customers is likely to have little impact on retaining existing customers. Abbey National submitted that, in markets with switching costs, firms with low market share tended to grow (or ‘sow’) their share by competing aggressively and through price, while those with high market share tended to exploit (or ‘harvest’) theirs by preserving or increasing margins on the existing customer base. The merger, it argued, would replace a firm in sowing phase with one in harvesting phase, to the detriment of consumers and competition. [

Details omitted. See note on page iv.

] (see Appendix 5.1).

Switching

2.80. An important factor influencing competition is the ease or otherwise with which customers are able to switch their current accounts from one bank to another. If customers perceive switching as difficult and unrewarding, there is less pressure on banks to offer customers a good deal for fear of losing them.

2.81. A survey of switching in several different markets conducted for the DTI in 2000 showed that, of seven products, PCAs had easily the lowest proportion of people who switched between suppliers (6 per cent in the previous five years) and the highest proportion (79 per cent) who had not even considered switching. PCAs also had the highest proportion of customers (88 per cent) who said that they were happy to stay with their existing provider (but see paragraphs 2.88 to 2.90). There is other survey evidence which supports the view that switching of PCAs is very low (see paragraph 4.67), although the data may underestimate the extent of switching because they do not capture cases where customers open a second account, with another bank, and gradually move their business.

2.82. It is useful to distinguish two issues in this connection: first, barriers to switching, and, secondly, the low extent of switching and the reasons for it, which include but may not be limited to the presence of barriers.

2.83. The evidence we received suggests that the main barriers to switching are as follows:

(a) Consumers are concerned at the effect on their credit status: they fear that it will be harder to borrow, or to borrow at favourable rates, from a bank that has no experience of their financial behaviour.

(b) Consumers fear disruption to other aspects of their relationship with their PCA provider.

- (c) Consumers face delays and ‘hassle’ in the transfer of direct debits and other automated transactions and fear that, because of timing differences in the transfer of different transactions, they may accidentally get overdrawn and risk incurring costs.

2.84. Some of these barriers are being addressed by individual banks or by the industry as a whole (see paragraphs 2.122 to 2.130).

2.85. As regards the second issue, the actual extent of switching, Lloyds TSB put it to us that switching was low because the great majority of customers were satisfied with their existing supplier, and because the financial gains that could be made by switching PCAs, unlike mortgages for example, were small.

2.86. Abbey National, however, argued that switching was low partly because consumers’ expectations were low. It said that a two-pronged attack was necessary to improve the position: first, continued pressure was needed to improve the actual process, for example, through automation; and, secondly, those banks which were seeking to build market share, notably itself and Halifax, had to convince people that there were benefits to be gained from switching. At present Abbey National had chosen to focus on overdrafts, with its offer of an interest-free overdraft for switchers for the first 12 months and a competitive interest rate thereafter, while Halifax was focusing on its offer of 4 per cent interest on credit balances (see paragraph 2.66). Both were spending heavily on advertising to get their message across to consumers.

2.87. Survey evidence suggests that, for the small minority of customers who do switch, the reasons for doing so include dissatisfaction with the previous provider’s service (for example, because of unhelpful staff or transaction errors) but also dissatisfaction with account charges and the possibility of finding a better account elsewhere (see Table 4.11).

2.88. The evidence of customer satisfaction surveys is mixed. Lloyds TSB pointed out that, according to a survey reported by NOP in September 2000, over 60 per cent of all customers of the traditional high street banks were extremely or very satisfied with their existing provider. The Consumers’ Association (CA) told us that its surveys showed similar results to those of the banks when consumers were asked how satisfied they were but that, when asked if they would recommend their bank to others, a different picture emerged. In a survey which CA had carried out in April 2000, Lloyds TSB was among the five banks with the lowest scores for the proportion of respondents who would definitely recommend their provider to a friend (27 per cent) and the five highest for the proportion who would definitely not recommend their provider (15 per cent) (in each case the other four were NatWest, Barclays, Halifax and Clydesdale). The latter figure may be compared with only 1 or 2 per cent of customers who switch from Lloyds TSB in any year. Even allowing for the possibility that CA’s members may not be typical of the generality of customers, these findings show that the results of consumer satisfaction surveys should be regarded with a degree of reserve.

2.89. It appears to us that the reasons for the low level of switching are a mixture of objective factors, customer perceptions and habit. Customers perceive that the financial gains from switching are small, or at least too small to outweigh the perceived objections to switching. It is indeed the case that the potential financial gains are small compared with, for example, those which may be available from switching mortgages, but low expectations of financial benefit have also been fostered by the pricing policies of the big four banks (see the quotation from Lloyds TSB’s strategy document at paragraph 2.63) and by their marketing policies which concentrate mainly on service. Halifax told us that it considered the financial benefit now available from switching PCAs sufficient to motivate a sizeable proportion of customers to move. It had opened three times as many new accounts in the first four months of 2001, since the introduction of 4 per cent interest on credit balances accompanied by an advertising campaign, as in the corresponding period in 2000. It had not yet researched the reasons for the increase but thought that part of it was because, until the current campaign, many people were unaware that Halifax offered PCAs at all. Halifax’s advertising advisers told us that the

campaign was proving successful because it emphasized value in a sector where most advertising, notably that of the big four, focused on service.

2.90. One would expect the level of switching of PCAs to be low relative to many other products, partly because of the premium which customers are likely to place on trust and continuity in their PCA provider and partly because of the perceived complexity of the actual process of switching. Customer satisfaction is also a factor but it appears to us that satisfaction is a relative concept, influenced by consumers' perceptions of what alternatives exist. In any event, as noted in paragraph 2.88, the evidence on customer satisfaction is mixed. Moreover it is not axiomatic that customers must be dissatisfied before they contemplate switching to another provider: they may simply want a better deal. Allowing for these various factors, it appears to us that the incidence of switching is lower than would be expected if providers had taken more effective steps to facilitate the process (see paragraphs 2.122 to 2.130), and lower than would be the case if price-based competition were more vigorous.

Innovation

2.91. Lloyds TSB submitted that the traditional high street banks had been at the forefront of innovation in the PCA market. It provided a list of over 40 significant innovations since 1989 of which about half had emanated from the four leading banks. Lloyds TSB itself had announced a number of major initiatives and trials in Internet banking and in 1997 had been the first high street bank to create agency arrangements with the Post Office enabling personal customers to carry out certain essential banking transactions at post office counters.

2.92. Abbey National, by contrast, said that most significant innovations over the last ten years had come from outside the big four, who seldom led and often did not follow. Of a list of some 20 significant innovations in the PCA market since 1990 which Abbey National produced, only three had come from the big four. Abbey National pointed out that, even according to Lloyds TSB's list, the share of innovations attributed to the big four was well below their combined share of the PCA market.

2.93. It appears to us that a good proportion, possibly a majority, of the significant innovations of the last ten years or so in the PCA market, both commercial and technical, have come from outside the big four. We see this as one consequence of the smaller suppliers' efforts to differentiate themselves in order to attract new customers.

Branding and marketing

2.94. As noted in paragraph 2.55, possession of a known and trusted brand is a requirement for success in the supply of PCAs to the mass market. As we discuss in paragraphs 2.108 to 2.110, the need for advertising and marketing expenditure to establish such a brand name represents a barrier to entry. The nature of the advertising used tends to reflect the respective positions of the players: entrants and those seeking to grow market share tend to focus on price, while incumbents focus on service and intangible aspects without differentiating sharply between their product offerings.

Profitability

2.95. Lloyds TSB told us that its PCA business was not particularly profitable: it had made pre-tax profits of £[] million, £[] million, £[] million and £[] million in the last four years respectively from total income which had risen from £[] billion in 1997 to £[] billion in 2000. It said that the value of PCA business lay mainly in its contribution to overheads and the opportunities which it created for selling other products. The relatively low

profitability of PCAs was, it suggested, the reason why the supermarkets had not entered this market, although they had entered the markets for other personal financial products such as credit cards, loans and savings.

2.96. Abbey National made modest profits on its PCA business in 1999 and 2000 (see Table 3.12) and said that it regarded its PCA business as fundamentally profitable. It attributed this to its efficiency as a company and suggested that the position might be different for clearing banks, which were burdened with old, high-cost systems.

2.97. Barclays told us that PCAs generated less net income per customer than mortgages or personal loans, but more than credit cards.

2.98. Halifax said that offering 0.1 per cent interest on credit balances in combination with high overdraft rates and high charges was very profitable. PCAs which provided a good return to customers and a competitive overdraft rate, however, such as those offered by Halifax, were not especially profitable in their own right. Nationwide also told us that its PCAs were only marginally profitable but that they would be clearly profitable if it paid only 0.1 per cent on credit balances.

2.99. A leading supermarket group told us that it did not offer a PCA because of the marginal profit, at best, that a market-leading PCA would generate. It also referred to three other factors: the need for more time for it to be seen as an established player in the financial services market; the operational complexity of PCAs; and the fact that switching remained complex, time consuming and error prone for consumers. Another leading supermarket group said that it had chosen not to introduce PCAs because the cost and service requirements were very high and history suggested that only a very small proportion of customers would change PCA provider. It recognized that this put it at a disadvantage in the cross-selling of other products, which was much easier if the customer had a PCA with the supplier concerned.

2.100. The issue of PCA profitability is complex. We would note the following aspects:

- (a) Network costs have a major influence on PCA profitability for branch-based suppliers. This is not just a matter of the quantum of the costs but also how they are accounted for, which will vary from supplier to supplier. As regards the quantum of costs, we note Lloyds TSB's statement that the former building societies benefited from smaller and more cost-effective networks than the traditional banks (see paragraph 2.60).
- (b) Both Lloyds TSB and Abbey National told us that the profit they made on individual customers varied hugely. Lloyds TSB, for example, said that in any one month around [] per cent of its PCA customers were loss making, based on PCA results alone, if all costs were taken into account (although most made a contribution towards overhead costs). The customers who were, on average, profitable were those with high balances (whether credit or overdraft). The profitability of an individual bank's PCA business therefore depends heavily on the type of customer that it has.
- (c) As we have noted (see paragraphs 2.79 and 2.89), it is likely that entrants have to offer better prices than the incumbents in order to grow their market share.

To the extent that PCAs are not very profitable, it follows from the above analysis that the reasons for this situation may differ as between providers. Abbey National's recent experience suggests that it is possible for an entrant to make profits from PCAs while offering relatively favourable prices.

2.101. The profitability of PCAs cannot in any event be seen in isolation. PCAs are the core of Lloyds TSB's retail banking business. [] of the costs of its branch network are allocated to PCAs, which are also widely seen as giving excellent opportunities for cross-selling

more profitable products such as credit cards and deposit accounts. Abbey National told us that PCAs were a rich source of information on customers' financial circumstances and behaviour, as well as allowing frequent communication with them. Lloyds TSB's strategy document of September 2000 described PCAs as 'the key relationship product' (see Appendix 5.1).

2.102. At group level Lloyds TSB has made a post-tax return on shareholders' funds of around 30 per cent in each of the last three years (see Table 3.3). Although Lloyds TSB argued that, on a realistic valuation of its capital employed, its return on capital would be much lower than this, in its 2000 report and accounts it described itself as one of the most profitable banks in the world. Since Lloyds TSB has a strong focus on retail markets, these figures substantially reflect its performance in those markets. Internal documents show that the company itself regards the profitability of its retail businesses as having been high. [*Details omitted. See note on page iv.*]

Details omitted. See note on page iv.

(See Appendix 5.1.)

How the market is changing

2.103. Lloyds TSB argued that the financial services industry as a whole was in a period of rapid and radical change. As regards PCAs it drew attention to the following factors:

- (a) new entry;
- (b) advances in technology;
- (c) the introduction of new and enhanced services; and
- (d) an increase in the rate of switching.

These changes, it said, had diminished the importance of branch networks and redefined the range of products that made up a PCA. The consequences for competition had been beneficial: barriers to entry had been lowered, and new entrants—particularly those with a low cost base—were putting added competitive pressure on the traditional banks.

2.104. We now consider in turn these various elements of change. We also examine the evidence on whether banks' margins are being affected.

New entry

2.105. Paragraphs 4.46 to 4.70 discuss barriers to entry and switching in the PCA market. The three most important factors for us to address in this context are distribution; branding and marketing; and switching.

- *Distribution*

2.106. Of the various means by which suppliers can deliver PCA services to customers, most do not present undue difficulties for prospective entrants. The important exception is a branch network. Although possession of a branch network is no longer essential for a PCA provider, currently only some 3 per cent of the market is held by providers who do not have such a network. (We discuss in paragraphs 2.113 to 2.116 the progress which non-branch-based suppliers are making.) For an entrant starting from scratch there would be significant sunk costs in establishing a network. Even though premises can be rented, investment in skilled staff and systems infrastructure would also be significant and would take time. It would be difficult for an entrant to match the branch networks of existing providers cost effectively since in the early years of establishing a presence the costs would have to be spread over fewer customers. In practice, in this mature and slow-growing market, no one has built a new national branch network in recent times.

2.107. More likely is that a player with an existing network in another market would seek to use it to enter the PCA market. This is how the former and existing building societies entered in the late 1980s and early 1990s. Supermarkets are perhaps the most likely new source of this type of entry, albeit they have little experience of the financial sector. So far they have not chosen to enter the PCA market (see paragraph 2.99 for the reasons which two of the leading supermarket groups gave us for this).

- *Branding and marketing*

2.108. We commented in paragraph 2.55 that possession of a known and trusted brand was a requirement for success in the mass PCA market. For some banking markets, such a brand need not be one already associated with financial services, as evidenced by the successful entry of some supermarket groups into other personal banking markets.

2.109. Entering the PCA market, however, is another matter. Even owners of financial service brands may find that they have to spend a disproportionate amount on advertising, and over a long period, in order to become established and acquire a significant share in the PCA market. Abbey National told us that, more than ten years after it had entered the PCA market and demutualized, many people still did not associate it with PCAs, while Halifax said that part of the success of its current advertising campaign lay in the fact that it was getting through to customers who had not previously realized that Halifax offered a PCA at all. Abbey National presented figures showing that, of total advertising spend by PCA providers in 2000, 50 per cent was by suppliers other than the big four, as compared with these suppliers' combined share of the PCA market of 28 per cent. Moreover, a much higher proportion of these suppliers' advertising related to PCAs, as opposed to general brand promotion (see Table 4.8).

2.110. We note that several existing PCA providers have launched separately-branded banks aimed at newly-developing segments of the market, for example, HSBC's First Direct, Smile, the Internet bank owned by the Co-operative Bank plc (Co-operative Bank), Abbey National's cahoot and Halifax's Intelligent Finance. These are all non-branch-based and use the telephone and/or Internet as their primary means of delivery. It may be significant that the telephone- and Internet-based entrants that have acquired the most customers are all owned by branch-based suppliers, who may have advantages over other entrants in terms of access to an existing customer base for marketing purposes and the possession of networks of ATMs and branches which can be used for transactions requiring a physical presence.

- *Switching*

2.111. We deal in paragraphs 2.122 to 2.130 with the steps being taken to improve the process of switching. The point we would mention in the present context is that the existence of

barriers to switching makes it difficult for entrants to acquire customers at a rapid rate and exacerbates the problem of diseconomies of scale in branch networks, marketing and other costs which entrants suffer in comparison with incumbents.

- *Actual entry*

2.112. The examples of recent entrants particularly mentioned to us by Lloyds TSB in the PCA market, as opposed to other personal banking products, were Citibank NA (Citibank) and Virgin. Neither of these has more than 0.1 per cent of the market, nor do other entrants which have come to our attention, such as first-e (an Internet start-up) and Fleming (now being acquired by Abbey National). Egg, the Internet-based business of Prudential, which has made a significant impact in the savings market, announced in February 2001 that it had no immediate plans to enter the PCA market, saying that it had looked at the performance of new Internet-based entrants like cahoot and Intelligent Finance and was not convinced that they had really broken into the market. Lloyds TSB accepted that there had been less entry into the PCA market than other personal banking markets but maintained that competition was nonetheless adequate.

Advances in technology

2.113. Lloyds TSB told us that some 30 per cent of PCA users were now registered for telephone banking, which had increased rapidly since the early 1990s. Internet banking had been introduced from 1997 and, between late 1999 and 2000, 12 banks had launched Internet services. The number of online banking users was expected to be nearly 5 million in 2001 and to double by 2004. Lloyds TSB was forecasting that the number of Internet transactions would grow tenfold by 2005 (though the vast majority would be enquiries).

2.114. Among telephone-based banks, First Direct, which was launched in 1989, has easily the largest market share with about 2 per cent. However, it is owned by HSBC, on which it relies for money transmission and branch access, and cannot be regarded as an independent competitor. Others, such as Citibank, are aimed at relatively affluent customers and have very small market shares.

2.115. Internet banks, of which the biggest are Smile, cahoot and Intelligent Finance, appear to have less than 1 per cent of the total PCA market between them. Although use of Internet banking will doubtless increase, possibly quite rapidly, its significance so far is relatively small. We were told that experience in the USA, which is further advanced than the UK in Internet use, is that Internet-only banks are not making much headway since customers prefer established banks which offer the Internet as part of a full range of delivery methods. Lloyds TSB's September 2000 strategy document commented that there was 'strong evidence that the online banking population currently favour multi-channel banks' (see Appendix 5.1).

2.116. The chief advantage of telephone and Internet banks is that, as a result of their lower costs, they can offer better price terms than branch-based banks. The customers who are prepared to switch to these banks are likely to have relatively high balances and hence to be among the more profitable PCA customers. Hence the impact of this type of switching may be disproportionate to the numbers of accounts involved in the competitive pressure which it puts on the branch-based banks. This is one of the factors contributing to the banks' segmentation strategies (see paragraph 2.69). But in view of the factors referred to in paragraphs 2.112 to 2.115 concerning entry, market shares and ownership, we do not consider that this type of competition is likely to be sufficient to constrain the pricing policies of the big four banks towards the bulk of their customers in the next few years.

New and enhanced services

2.117. Lloyds TSB pointed to several recent developments in PCA products which it said demonstrated the impact of competition in the market: packaged or added-value accounts; current account mortgages; immediate value for cheques; the dropping of overdraft fees; overdraft buffer zones free of interest and/or fees; and the provision of assistance and incentives for switchers.

2.118. While we agree that these are signs of growing competition between suppliers and, in some respects, increasing price sensitivity on the part of customers, in assessing their significance we would note the following:

- (a) Although packaged accounts are marketed as enhancing value for customers, and may indeed do so in many cases, it is difficult for customers to measure the value: there is likely to be uncertainty as to the extent to which the customer will use the benefits and how much those benefits would cost if the customer shopped around for the best price.
- (b) PCAs linked to other products such as mortgages and savings can help customers manage their borrowings and credit balances to best advantage and are a useful addition to the range of products available. To date, however, their uptake appears to have been modest.
- (c) Barclays told us that in 1998 it began to allow personal customers to make immediate withdrawals against cheques paid in (rather than customers having to wait several days for them to be cleared). No other bank had followed for three years.
- (d) The dropping of overdraft fees by most banks represents a clear improvement in the PCA terms offered. However, Lloyds TSB has not yet dropped overdraft fees: [*Details omitted. See note on page iv.*]

[*Details omitted. See note on page iv.*]

In April 2001, during the course of our inquiry, Lloyds TSB announced that it would drop overdraft usage fees with effect from September 2001. (Barclays has also recently announced that it will cut the interest rate on its standard PCA product from 18.8 to 15.6 per cent in September 2001.)

- (e) The introduction of buffer zones is also a clear improvement in terms but the value for customers depends on the size and terms of the facility provided. Among buffer zones free of both fee and interest, Lloyds TSB allows a maximum of £10 on its standard account but other branch-based suppliers allow up to £100.

2.119. Lloyds TSB also drew attention to improvements in service:

- (a) The number of ATMs was growing rapidly, many at convenient sites away from branches. The range of functions they provided was also expanding. Since January 2001 the major banks' ATMs were effectively an open access network.
- (b) Branch opening hours were longer and more varied in response to local demand than used to be the case. Lloyds TSB said that it had invested some £200 million in 'anywhere, any time' banking in 2000, much of it on e-commerce and call centres.

2.120. One reason why the banks are expanding their ATM networks is to provide an alternative means for customers to carry out transactions at a time when branch closures, although a sensitive issue for customers and the public at large, are continuing. To the extent that enlarging ATM networks helps the banks to justify branch closures, this is a cost-effective development for them.

2.121. The 2000 agreement by the LINK network to drop ATM charges was opposed by several banks and was reached only after considerable pressure from other banks, building societies, the media and the Government.

Steps to improve switching

2.122. Action to improve the process of switching has been taken recently, or is in hand, by banks acting both collectively and individually.

2.123. The Cruickshank report commented that it was in the banks' interests to suppress switching since customers who were locked in to a provider tolerated higher prices than those who shopped around. It recommended that standards of service be set for switching PCA supplier. The Banking Code (see paragraph 2.23) requires the outgoing bank to cooperate with the incoming bank and provide it with information on the customer's regular payments so that the transfer is made as efficiently as possible. The code does not include a timescale but there is a separate agreement that information should be provided within ten working days. Abbey National told the House of Commons Treasury Committee, which was conducting an inquiry into 'Banking and the Consumer', that in the last four months of 2000 it had found that NatWest was taking an average of 24 working days to provide account information and Lloyds TSB 18 working days. In May 2001 Intelligent Finance reported that the big four banks were taking an average of between 11 and 13 days to provide the information and that their average performance had deteriorated since the beginning of 2001 (see paragraph 4.64).

2.124. From November 2000 some banks have taken part in a pilot scheme under the auspices of APACS under which details of standing orders and direct debits are supplied electronically. APACS expects that, following the pilot, the full system should be operated by all banks by the end of 2001.

2.125. A number of banks have recently set up switcher services to do the work of arranging the transfer of regular transactions on the customer's behalf. Abbey National, whose service was established in May 2000, told us that there were frequently delays in obtaining the necessary action from originators of direct debits, such as utility companies, and that the process of transferring accounts could take as long as six weeks to complete.

2.126. Lloyds TSB has also set up a switching service of this kind. In addition Lloyds TSB announced in the course of our inquiry that from 1 July 2001 it would send a list of direct debits and standing orders to a customer's new bank within three working days of receiving the customer's authority and account details. If it failed to do so, it would pay the customer £50.

2.127. The House of Commons Treasury Committee commented in its report,¹ published in March 2001, that the major banks' efforts to ease the transfer of PCAs in the 12 months since Cruickshank's recommendation had been disappointingly slow, and called on them to do very much better in the next 12 months. Once the computerized system came into force the committee expected the banks to commit themselves to a shorter deadline than ten working days for the provision of account details: the time limit should be specified in the Banking Code and there should be penalties and/or a liability to pay compensation in the event of non-compliance.

¹*Banking and the Consumer*, The Stationery Office, March 2001.

2.128. We see an improvement in the process of switching PCAs between banks as an important development in creating the conditions for the PCA market to become more competitive. We endorse the comments of the House of Commons Treasury Committee about the disappointing progress which the banks have made in pursuing this objective and the need for improvement in this regard. Lloyds TSB's initiative (see paragraph 2.126) is a welcome step—provided it is implemented successfully—and should be followed by other banks without delay.

2.129. Besides the completion and effective implementation of the APACS project to automate the exchanges of information needed to switch accounts between banks, we believe that the banks should also take action to secure better cooperation from the originators of direct debits. Since organizations wishing to use the direct debit method of obtaining payments have to be authorized by the banks, the banks have a lever which can be used where necessary to ensure that those organizations play their part in speeding up the switching process.

2.130. Meanwhile the extent to which the switching process can be speeded up remains to be seen. Nor can the effect on customer behaviour be predicted: given the importance of perceptions, it is likely to take time before most customers perceive the process of switching to be straightforward.

Trends in margins

2.131. If, as Lloyds TSB argued, personal banking markets have been undergoing radical change as a result of rapidly-increasing competition in the last three to four years, some effect should be visible in banks' margins. We have noted the following points in this regard:

(a) Lloyds TSB's net interest margin shows no clear trend over the period 1996 to 2000 (see Table 3.3). While these figures relate to the group as a whole, we noted in paragraph 2.102 that Lloyds TSB is substantially focused on UK retail markets.

(b) There is no clear trend in the net interest margins of the other members of the big four, or indeed Abbey National, although most showed a modest fall in 2000 compared with 1999.

(c) [

Details omitted. See note on page iv.
] (see Appendix 5.1).

(d) Specifically on PCAs, Lloyds TSB experienced only a slight decline in margin between 1997 and 2000. [

Details omitted. See note on page iv.

]

2.132. These points suggest to us that any effect of intensifying competition in compressing margins is recent and that Lloyds TSB expects PCAs to be relatively unaffected. Lloyds TSB described the recent trend in its profitability as 'flat'.

The significance of Abbey National

2.133. Lloyds TSB submitted that Abbey National's role in the competitive process had not been of such significance that its removal could be expected to operate against the public interest. Its market share of 5 per cent was slightly more than Halifax and other former and existing building societies. Its share of new accounts in 2000 was less than those of Halifax, Alliance & Leicester and Nationwide. Lloyds TSB commented that Abbey National was not a

‘maverick’ player, nor was it a price leader in interest paid on credit balances or overdraft rates. Lloyds TSB said that Abbey National had been concentrating on growing other parts of its business, for example in wholesale banking, and had lost focus on the PCA market. The merger would make no difference to competition in that market.

2.134. We consider these and other relevant aspects in assessing the importance of Abbey National to competition in the PCA market.

Market share and sales growth

2.135. The information we collected from PCA providers indicated that Abbey National’s share of the market was indeed around 5 per cent in 2000, in line with the estimate available to market participants from the surveys carried out by NOP’s Financial Research Survey (FRS). (Abbey National itself claimed a share of 6.8 per cent, based on work by another market research company.)

2.136. A 5 per cent share achieved by the twelfth year after entry into the market does not prima facie appear impressive. We have commented, however, that there are significant barriers to entry and growth. Table 4.5, which shows market share over the period 1995 to 2000, illustrates the slow pace of change in this market. As conceded by Lloyds TSB, Abbey National had in 2000 the highest share of any supplier outside the big four, along with Halifax.

2.137. Abbey National’s share was almost static between 1998 and 2000. [
Details omitted. See note on page iv.

]

Other competitors to the big four

- *Halifax*

2.138. Halifax, which entered the PCA market in 1991, three years later than Abbey National, had effectively equalled Abbey National’s share of the market by 2000. Lloyds TSB said that it regarded Halifax as the stronger competitor of the two: it had won more new business than Abbey National in 2000; its recent advertising campaign and PCA offer had significantly increased its share of switches from Lloyds TSB; and its pricing and marketing had been more innovative than Abbey National’s, with the result that it had a better-differentiated brand.

2.139. We agree that Halifax is currently proving a vigorous competitor in the PCA market. It told us that it had opened three times as many new accounts in the first four months of 2001, the period in which its advertising campaign based on the offer of 4 per cent interest on credit balances had been running, compared with the same period a year earlier. It would be a mistake to put too much weight on short-term factors, however. Halifax has several features in common with Abbey National. Both are former building societies better known for mortgages and savings than PCAs. They have similar market capitalization (though Halifax’s has risen since the HBOS plc (HBOS) merger announcement), similar sizes of branch network and similar shares of the PCA market. Lloyds TSB argued that market performance was more important than structural similarities. We would make two comments: first, Halifax’s market performance over the last few years has not been markedly different from Abbey National’s; and, secondly, structural factors are also relevant because they affect an organization’s potential as a competitor. We are therefore not convinced by Lloyds TSB’s submission that, in the PCA market, while Halifax is a strong competitor, Abbey National is a weak one whose loss would be insignificant.

- *Other competitors*

2.140. As another former building society, Alliance & Leicester also has similarities with Abbey National and Halifax. However, it is substantially smaller, with a market capitalization of £4 billion and a network of around 300 branches. Its pre-tax profits grew steadily up to 1999 but then fell by 10 per cent. In the PCA market its share, which was not far behind Abbey National's in 1995, has remained broadly unchanged at around 3.4 per cent. Lloyds TSB pointed out that Alliance & Leicester customers had the benefit of access to 17,500 post offices for cheque and cash handling; this has not, however, enabled the company to grow its market share.

2.141. Nationwide, the only one of the remaining building societies with a significant presence in the PCA market, has a national network of some 680 branches. Taking account also of agency agreements, it has a total of nearly 900 outlets, more than Abbey National. Its market share appears to be growing and is currently around 3 per cent. As a building society, Nationwide has a distinct brand proposition, derived from its mutual status, based on value for its members. It may prove in time to be a significant competitor if it can sustain its growth.

2.142. The other players with more than 2 per cent of the market each are NAB, with 3.7 per cent, and BoS with 2.1 per cent. BoS and the NAB subsidiaries are traditional clearing banks with a sizeable presence in their respective geographical areas. As long-standing incumbents they have more in common with the big four banks, as is indicated by the price terms of their standard PCA products, and their market shares have tended to fall in recent years.

2.143. BoS has made some incursion into personal banking markets in England and Wales through telephone banking and through joint ventures, for example with Sainsbury, but with very few branches outside Scotland it lacks the necessary infrastructure to make a material impact on the PCA market in Great Britain as a whole. We discuss the implications of its planned merger with Halifax in paragraphs 2.147 to 2.149.

2.144. NAB has publicly stated its wish to expand by acquisition in the UK and there have been frequent press reports linking it with a variety of other players, including Abbey National and Alliance & Leicester. While acquisition of another PCA supplier might make NAB a more significant force in the market, that is no more than a possibility and cannot affect our assessment.

2.145. Lloyds TSB submitted that the Post Office provided certain banking services through 17,500 outlets on an agency basis to customers of participating banks, including Lloyds TSB itself, Barclays and Alliance & Leicester. The introduction of a new computer system in spring 2001 would enable the Post Office to handle a wider range of banking products. As a result, Lloyds TSB said, the Post Office hoped to negotiate further agency agreements and ultimately to replace many bank branches, particularly in rural areas. In this way the Post Office would facilitate competition between banks.

2.146. We note that the Post Office hopes to play a wider role in banking markets. These ambitions may be assisted by the agreement on the provision of Universal Banking Services reached in May 2001 under which all the leading banks will make their basic bank accounts accessible through post offices (see paragraph 2.28). The development of the Post Office's involvement in banking may in due course have an appreciable effect on the market, enabling PCA providers without extensive branch networks of their own to compete more effectively. We believe, however, that it will be some years before the impact of this development can be assessed. Given the conservative attitudes displayed by most consumers in this market, and the fact that the Post Office's recent initiatives are directed at low-income customers, we do not consider that the wider role planned by the Post Office will have a material effect on PCA competition in the timescale within which we consider we must assess the expected effects of the merger.

- *HBOS plc*

2.147. Commenting on the planned merger between Halifax and BoS to create HBOS, which was announced in the course of our inquiry, Lloyds TSB said that the merger would allow the two parties to compete even more effectively than they could separately and across a broader range of products and geographical areas. In terms of total assets, the merger would create the fifth largest bank in the UK. Lloyds TSB argued that if, contrary to its submission, the CC saw a particular value in there being a ‘fifth force’, HBOS fulfilled such a role and would attain economies of scale. In the PCA market the merged group would surpass Abbey National in number of branches, geographical coverage and market share. With the cost savings expected from the merger, HBOS would be able to fund continuing aggressive competition. Moreover it would have to grow its sales strongly in order to achieve the £350 million of revenue benefits from the merger which the two parties had committed themselves to achieving.

2.148. It is possible that the HBOS merger will not proceed because the key actions needed to approve it remain to be taken (see paragraph 2.12) and the deal will have to be scrutinized by the competition authorities. We therefore have to consider the prospects for the PCA market both with and without that merger.

2.149. We have given our views in paragraphs 2.138 and 2.139 and paragraphs 2.142 and 2.143 respectively on the importance of Halifax and BoS as independent competitors. If we assume that the HBOS merger proceeds, there are still major uncertainties over the execution of the merger—how quickly and effectively the two companies can be integrated and how performance might be affected during this process—and over the policies of the new entity. Spokesmen for the new grouping have made statements to the effect that it will be a pro-competition champion across the major retail banking markets (see paragraph 4.30), but it remains to be seen how behaviour in the PCA market would be affected, bearing in mind that both the BoS and Halifax brands are expected to continue. HBOS would be under pressure from the City to show that the synergies from this merger of equals were benefiting shareholders and it is not clear to us that the group would devote a significant part of them to fund an even more competitive stance in PCAs than Halifax is already taking. Indeed it is possible that the enlarged customer base of HBOS would encourage it to attach more weight to the enhancement of margins than to growth of market share. On the other hand, if the BoS brand were to be deployed in a more aggressive way in Scotland, there could be a significant impact. While there is a potential for HBOS to be a force for increased competition in PCAs greater than is currently represented by Halifax and BoS separately, the uncertainties are such that we have not placed weight on this factor.

Abbey National as a company

2.150. As shown in Table 3.10, Abbey National has a good record of growth in both income and pre-tax profit in recent years; indeed it has grown faster than Lloyds TSB in these respects (see paragraphs 3.14 and 3.44). Post-tax return on shareholders’ funds has been consistently in the range 18 to 22 per cent. The cost:income ratio in 2000 was 44 per cent, around the same as the equivalent figures for Halifax and Lloyds TSB and far below those of Alliance & Leicester and Nationwide. This is a solid financial performance.

2.151. Abbey National has significant shares in several personal banking markets, enabling it to spread the costs of its branch network over a range of different activities. It has succeeded in diversifying its business in other ways too, notably in wholesale banking. As a result, by 2000 more than half the company’s pre-tax profits came from activities other than the original mortgages and savings businesses.

2.152. In its internal documents concerning the bid (see extracts at Appendix 5.2), Lloyds TSB commented that Abbey National possessed a distinct set of assets: trusted brands; a massive customer base (15 million); integrated distribution through branches, ATMs, telephone, digital television and independent financial advisers (IFAs); financial strength; and proven products (among which it highlighted mortgages, savings, life assurance, treasury and consumer finance).

2.153. Lloyds TSB argued that Abbey National was not, in any distinctive or special sense, a significant or a 'maverick' player. This is relevant to our analysis of the merger's effects on the market as a whole (see paragraph 2.46(b)).

2.154. Abbey National submitted that it had been responsible for many innovations in banking. In PCAs, for example, it had in 1996 been one of the first banks to offer a basic bank account without an overdraft (the Instant Plus Account, a product designed for people who would otherwise be at risk of financial exclusion), and in 2000 it had been the first bank in the world to offer a PCA product with access through both digital television and the Internet. It is currently experimenting with a combination of bank branches and coffee shops and has begun to franchise some of its branches to individual managers.

2.155. We consider that Abbey National has been a reasonably innovative player in the provision of PCAs. As important, however, is its status as a relatively recent entrant seeking to grow its sales (see paragraph 2.79). For these reasons, we believe that Abbey National represents a significant force for competition, although one whose importance has to be assessed by reference to other factors too, such as market share.

The merger's effect on competition in PCAs

2.156. Pulling together the various elements reviewed in paragraphs 2.50 to 2.155, 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. As we noted in paragraph 2.64, this is a market that is vulnerable to tacit collusion in pricing.
- (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, offering better price terms than branch-based banks, have made some progress, they remain niche players. Many of the customers who want to use these services are also looking for a provider with a branch network. Hence 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.

2.157. In these circumstances we consider that well-established rivals to the traditional banks are important for competition. The efforts which are being made to increase customers'

willingness to shop around and switch (see paragraphs 2.122 to 2.130) will have little impact unless there is a choice of providers offering different propositions, especially in respect of price. Particular importance attaches to branch-based suppliers which have shown the capability and staying power to win a significant share of the market despite the barriers to growth which we have discussed.

2.158. Abbey National is one of the two most successful suppliers in this category, along with Halifax. Although its market share has grown only slightly in the last three years, it offers a distinct alternative to the big four banks, it has been reasonably innovative, and it has to compete actively in order to maintain its position. As a result, it already acts as a constraint on the big four. Given its financial performance, we consider that Abbey National is capable of maintaining its independence, and we believe that it has the potential to achieve renewed growth. 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.

2.159. We hold this view regardless of whether the merger between BoS and Halifax goes ahead. Given the constraints on competition to which we have referred, the effect on competition of the loss of Abbey National would be significant with or without the emergence of HBOS.

2.160. We consider that the recent trends towards strengthening competition in the PCA market, while encouraging for the future, in today's conditions remain vulnerable to being set back, or their favourable impact on customers diluted or delayed, by possible developments on the supply side. We think two conditions in particular need to obtain if setbacks are to be avoided and progress sustained: first, that any consolidation in the industry is not such as materially to reduce competitive pressure on the big four; and secondly, that the industry collectively pursues vigorously the drive to simplify and expedite the process of account switching by customers. Our second point is mainly outside the scope of our inquiry, but we have expressed our views in paragraphs 2.122 to 2.130. On the first point, we consider that the proposed merger between Abbey National and Lloyds TSB could be expected materially to reduce competitive pressure on the big four. (We do, of course, recognize that any other future proposed mergers in the sector would be reviewed by the competition authorities on their own merits.)

2.161. For the reasons set out in paragraphs 2.156 to 2.160, 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 (see paragraphs 2.231 to 2.236), would reduce incentives to compete in both the ways postulated in paragraph 2.46:

- (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 therefore expect that the merger would lead to a reduction in competition in the PCA market compared with the situation that would otherwise exist.

2.162. We believe this reduction in competition would have adverse effects in the form of 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.

The merger's effects on the savings market

Structural factors

2.163. The range of savings accounts available in the British market is arguably more varied than the range of PCAs (see paragraph 4.83) but the variations tend to be based on standard themes—for example, notice periods, fixed or variable interest rates—and products are not strongly differentiated between suppliers. Accordingly, concentration is again an important indicator of competition. As shown in Table 4.13, the merger would increase Lloyds TSB's market share from 10 to 23 per cent, making it the largest supplier, some way ahead of Halifax with 18 per cent. The HHI would rise from about 900 to 1,160, and hence move into the lower end of the moderately concentrated range, as categorized in the guidelines of the US antitrust authorities (see paragraph 2.50 for the equivalent effect in the PCA market).

2.164. The merger would increase the four-firm concentration ratio from 52 to 62 per cent. Besides Lloyds TSB and Halifax, Barclays and Nationwide, each with around 10.5 per cent, make up the four leading firms. It will be seen from Table 4.13 that the four-firm concentration ratio has fallen from 56 per cent in 1995 to 52 per cent in 2000. In the same period the four-firm ratio in PCAs, already much higher at 71 per cent in 1995, rose slightly to 72 per cent in 2000 as a result of acquisitions affecting the big four banks.

Entry

2.165. We noted that there are far more suppliers of savings products than PCAs (see paragraph 2.41). Although some of the barriers to entry which affect the PCA market are also relevant here, entry into the savings market is less difficult:

- (a) Although all the main suppliers possess a branch network, it appears to be easier for non-branch-based suppliers to grow sales than it is in the PCA market.
- (b) Savings providers have less need for money transmission skills, infrastructure and access to payment schemes.

2.166. As a result there has been significant new entry in the last ten years from three categories of players: insurance companies, supermarket groups and foreign banks. The first two categories have well-known brands, while the third appear not to be targeting the mass market.

Switching and inertia

2.167. The switching barriers listed in paragraph 2.83 in respect of PCAs are much less relevant to savings products. Nevertheless the Cruickshank report found that there was considerable inertia: the average savings account was held for ten years and two-thirds of survey respondents had not actively considered any other supplier when selecting their main savings account.

2.168. There has been a tendency for the attractiveness of interest rates on particular accounts to fall off over time, while new products with better rates are offered to attract new customers (back-book pricing: see the discussion of this subject in the context of PCAs in paragraph 2.78). [

Details omitted. See note on page iv.

] Elsewhere, however, the document noted that '[*Details omitted. See*
note on page iv.] the propensity of switching to alternative providers continues

to accelerate' (see Appendix 5.1). Lloyds TSB told us in April 2001 that its overall savings margin declined substantially throughout 2000. For the previous two years Lloyds TSB branch staff had been asked to identify customers with poor-paying accounts and encourage them to upgrade. Nearly 90 per cent of the balances on Lloyds TSB accounts, it said, would not now be improved by upgrading to another Lloyds TSB account. [

Details omitted. See note on page iv.

]

2.169. The Banking Code now requires that interest rates on superseded accounts be kept at the same level as those on similar accounts that are actively promoted to new customers, or that customers be transferred to the new account (see paragraph 4.89).

The merger's effect on competition in the savings market

2.170. The consensus of those giving evidence to us was that the savings market was competitive and that the merger would not have adverse effects on consumers. There is no shortage of choice for savers who are prepared to shop around, whether through branches or otherwise, and we do not believe that the disappearance of Abbey National as an independent provider would have adverse effects on competition or on consumers.

2.171. We have some concerns about back-book pricing but we do not think that this is likely to be affected by the merger. In the first instance it is a matter for action via the Banking Code.

The merger's effect on the mortgage market

Structural factors

2.172. As with PCAs and savings products, most mortgages are relatively standard products and it is therefore relevant to examine the merger's effect on concentration. Table 4.17 shows that the merger would increase Lloyds TSB's share of the mortgage market from 9.4 to 22.6 per cent. As in savings, Lloyds TSB would become the leading supplier ahead of Halifax, on 20 per cent. The HHI would increase from around 860 to 1,110, a similar effect to that seen in the savings market (see paragraph 2.163). The four-firm concentration ratio, again embracing Barclays and Nationwide as well as Lloyds TSB and Halifax, would increase from 51 to 58 per cent, having fallen from 55 per cent in 1995.

Entry

2.173. The analysis of entry in the mortgage market is similar to that in the savings market. Again there are over 100 suppliers and entry appears not to be difficult for those with an established brand. One additional factor in the mortgage market is the role played by intermediaries such as IFAs and estate agents, who now account for about 40 per cent of new mortgage business. Their role no doubt helps newcomers to enter the market by offering favourable rates. This may be especially relevant to suppliers which do not have to carry the costs of a branch network but need help in acquiring customers.

2.174. The principal recent entrants into the mortgage market have been insurance companies and Sainsbury. The most successful in the last two years appears to have been Standard Life.

Switching and inertia

2.175. Consumers potentially incur valuation and legal fees in switching to a new mortgage provider. Because mortgage payments tend to be an important expense for consumers, however, the saving that can be made by switching to a provider offering a lower rate of interest can be substantial and the rate of switching of mortgages is higher than for some other personal banking products. About one-third of all gross mortgage lending is now accounted for by remortgaging of existing properties.

2.176. Nevertheless, back-book pricing has been a feature of the mortgage market, with lenders offering special terms only to new borrowers and frequently paying switchers' valuation and legal fees.

2.177. [

Details omitted. See note on page iv.

] Lloyds

TSB told us in April 2001 that the decline in margins had been quicker and steeper than expected the previous September. As a result of the move started by HSBC and continued by Nationwide, Halifax and Abbey National, most of the big players had now repriced their back book as well as offering keen rates for new borrowers. As a result the average mortgage margin was now down to about 1 per cent.

The merger's effect on competition in the mortgage market

2.178. The evidence we received indicates that there is now considerable competition for new customers in the mortgage market. While back-book pricing is still an issue, customers are becoming increasingly ready to switch provider in order to obtain better terms. There are many suppliers and low barriers to entry. In present and foreseeable circumstances we are satisfied that the merger will not be damaging to competition or to consumers.

The merger's effect on other personal banking markets

2.179. The remaining personal banking markets where Lloyds TSB and Abbey National overlap are other loans, credit cards, insurance, other long-term investments and pensions.

2.180. The market for other loans includes unsecured loans and loans secured on personal assets other than property, principally vehicles. Depending on the measure used, Lloyds TSB has 12 to 13 per cent and Abbey National 6 to 8 per cent of this market. The market is not concentrated and the share held by the big four collectively is around one-third. There appear to be no particular entry barriers.

2.181. In the credit card market Lloyds TSB has a share of around 10 per cent but Abbey National's is less than 2 per cent. During our inquiry Abbey National sold its credit card business to MBNA Corporation (MBNA), a US-owned bank which has entered the market in the last few years (see paragraph 4.110). MBNA will continue to market an Abbey National branded card, paying fees to Abbey National based on the issuance and usage of these cards. New entrants have been more successful in this market than in other personal banking markets and the share held by the big four banks has fallen from 73 to 61 per cent over the last five years.

2.182. In the remaining personal banking markets where the merger parties overlap their combined shares are less than 12 per cent.

2.183. Taking account of the factors referred to in paragraphs 2.179 to 2.182, and the absence of representations to us about the merger's impact in these areas, we consider that the merger would have no harmful effects on these markets.

The merger's effect on banking services for SMEs

2.184. Lloyds TSB, which offers a full range of banking products to SMEs, has about 20 per cent of the supply of services to small enterprises (with turnover up to £1 million a year), rather less for other SMEs: we estimate that its share of total income from SME banking in 1999 was about 16 per cent. Abbey National offers only a restricted range of products (see paragraph 2.189), focusing primarily on smaller enterprises, and has less than 1 per cent of the market. Consequently the merger makes little difference to the current concentration of supply in this market.

2.185. The various factors affecting entry into the PCA market are all relevant in some degree in the SME market too (see paragraphs 2.105 to 2.111). The following aspects which are specific to the latter market are worth noting:

- (a) Many SMEs which handle a lot of cash need frequent and easy access to a local branch.
- (b) Lending to SMEs, particularly through overdrafts, requires specialized skills which an entrant would have to obtain, for example, by recruiting relationship managers from incumbent suppliers.
- (c) Information for credit scoring of SMEs is not readily available, putting entrants at risk of acquiring the most risky customers (ie those rejected by other banks).
- (d) Around two-thirds of new SMEs open their first business account at the bank where the principals have their personal account.

2.186. There are also significant barriers to switching. While some of the reasons for the low level of switching in the PCA market are arguably less relevant to SMEs (for example, dislike of hassle), others are greater:

- (a) Product comparisons are more difficult because of the greater complexity of the products and the element of negotiation that affects prices to SMEs.
- (b) Loss of credit status and disruption to a range of banking facilities are likely to be more important factors for SMEs.

The actual level of switching by SMEs appears nonetheless to be somewhat higher than for PCA customers, although at 3 to 5 per cent it is still low relative to many other markets (see paragraph 4.126).

2.187. There has been very little entry into the core elements of the SME market, where the principal products are current accounts and general purpose loans (see paragraph 4.129). Moreover there has been very little change in market shares in recent years, apart from a decline in NatWest's share before its acquisition by RBS Group (see Table 4.21).

2.188. Most of the traditional banks, including Lloyds TSB, do not generally pay interest on credit balances in SME current accounts but do levy standing charges and per-item charges on transactions. Overdraft rates are usually negotiated. Table 4.22 shows the main price terms offered in 2000.

The significance of Abbey National

2.189. At present Abbey National markets the following products to SMEs:

- (a) a current account offered only to sole traders and two-person partnerships—this account does not include an overdraft facility or branch access (transactions are made via ATMs, post, telephone and Internet);
- (b) a short-term deposit account;
- (c) factoring and invoice discounting services; and
- (d) a variety of asset financing products.

The last two are provided through First National Bank plc (First National), a finance house which Abbey National acquired in 1995. Abbey National introduced current and deposit accounts in 1997.

2.190. Lloyds TSB submitted that Abbey National was a small, niche operator. Since it did not offer an overdraft facility, which Lloyds TSB described as the cornerstone of a relationship-based offer to SMEs, Abbey National could not be considered an effective current competitor in the liquidity management part of the SME market (current accounts and short-term deposit accounts).

2.191. Lloyds TSB further submitted that the merger would have no impact on *potential* competition in the SME market. Several other firms were equally able to enter the market, including Alliance & Leicester, BoS and Halifax, and the Post Office was seeking to renegotiate its contract with Alliance & Leicester so that other banks could also use post offices for small business transactions. Following the announcement of BoS's planned merger with Halifax, Lloyds TSB pointed out that, based on the merging parties' own statements, it appeared that a new competitive force in SME banking might develop from the combination of BoS's existing skills and Halifax's brand and geographic penetration.

2.192. Abbey National, by contrast, argued that it was one of only two players (the other being Halifax) with the brand strength and branch network to provide a competitive alternative to the traditional banks on a national level. It had initially limited itself to a remote offering in order to avoid overburdening its branch counters. Nevertheless branches had been crucial to its entry because 80 per cent of its business banking customers had been introduced via the branch network.

2.193. As regards the competition which it already provides, Abbey National submitted that its current account product was distinct from those of the traditional banks in offering:

- (a) no standing charges;
- (b) no charge for normal transactions for customers with monthly transaction numbers under specified limits, and lower transaction charges than the clearing banks for other customers; and
- (c) interest on credit balances.

Abbey National estimated that a typical SME customer would save £400 to £800 a year from banking with it rather than one of the big four. In 2000 the number of its business current account customers had risen by three-quarters. It estimated that, even with its present, limited offer, it was gaining a [3%] to [5%] per cent share of all new SME business (Lloyds TSB put the figure at 3 per cent). It claimed that it was already having some impact on pricing by the big

four in that they had partially followed Abbey National in offering free banking for an introductory period to SMEs transferring to them.

2.194. Lloyds TSB said that its policy in offering concessionary terms to some switchers had not changed in recent years. In the December 2000 update of its strategic plan Lloyds TSB noted that ‘the high value markets of Wealth Management and Business Banking are ... being targeted by mortgage banks like Alliance & Leicester and Abbey National (for SME business). There is a risk that they will use price to establish a position in these sectors’ (see Appendix 5.1). Questioned about this statement, Lloyds TSB said that Halifax should also have been referred to in that context, since it too was clearly a prospective competitor. Lloyds TSB added that the only reason Abbey National and Alliance & Leicester were the two names mentioned in the document was that there had been stories in the press about them in the run-up to the document’s preparation.

2.195. As regards the future, Abbey National said that in June 2000 it had publicly stated its intention to achieve a 5 per cent share of business banking customers within five years. It recognized that it would need to make greater use of the branch network to achieve this: since use of counters for personal banking transactions had fallen sharply since 1997 (see paragraph 2.37), this would now be possible. It was well advanced in developing systems to allow it to offer a current account to limited liability companies. Those systems would be operational from September 2001, from which time Abbey National would also offer overdraft facilities to SME customers.

Our assessment

2.196. The SME market is highly concentrated and is dominated by the traditional banks (especially the big four). 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. It is clear from the Cruickshank report and the published statements from the subsequent SME monopoly inquiry (see Appendix 4.4) that there are significant competition concerns about this market. In these circumstances new entry by vigorous and efficient suppliers is of great importance.

2.197. Abbey National is only a small player in the market at present. It does, however, have several of the attributes needed to expand successfully—an established brand name, a national network of branches and a substantial presence in personal and some business banking markets—and it has established a foothold in the SME market. It reports that its existing business banking operations are profitable (see paragraph 3.48) and it has publicly stated its ambitions to increase its share of this market. It is therefore well placed to provide competition to the incumbents.

2.198. Among the other smaller players and possible entrants, only Halifax has comparable potential. If it succeeds in its planned merger with BoS, we believe that the new entity, HBOS, through the combination of Halifax’s brand and distribution attributes and BoS’s experience in business banking, has the potential to become a strong and effective competitor. Without the BoS merger we consider that Halifax is worse placed than Abbey National to compete effectively because it has not yet introduced a current account for business customers or made a comparable acquisition to Abbey National’s purchase of First National. Alliance & Leicester, like Abbey National, has a foothold in the SME market and may be able to build on this but its potential is less than Abbey National’s because it is a much smaller company and has a much smaller branch network. Nationwide is also seeking to enter the market but as a mutual organization its name is associated more with personal customers. We do not think that, leaving aside Alliance & Leicester, banks which might seek to offer SME services via post offices will have a material impact on the market in the foreseeable future.

2.199. We noted in the context of the PCA market that there are major uncertainties surrounding the HBOS merger (see paragraph 2.149). Moreover the dominance of the big four banks in the SME market is such that, even if that merger proceeds and HBOS becomes a strong competitor in the SME market in England and Wales, the competition from Abbey National would in our view still be important.

2.200. For these reasons we consider that the merger 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.

The merger's overall effect on Lloyds TSB

2.201. In order to complete the task of assessing the merger's effects on the post-merger firm (see paragraph 2.46(a)), we need to consider whether there are additional effects on Lloyds TSB beyond those which are specific to particular markets and that arise because of links between markets. As noted in paragraph 2.19, such links may further strengthen Lloyds TSB's position.

2.202. In its internal papers on the planned bid (see Appendix 5.2), Lloyds TSB stated that 'the combination of the two businesses would be virtually unassailable in UK retail financial services with 25 million customers and market leading positions in all personal financial services products'. Asked about this statement in a hearing, Lloyds TSB said that it had lost its number one position in some of its markets following RBS Group's acquisition of NatWest, and the merger would help to recover those leadership positions. Moreover, in a world of declining margins, the efficiencies available through the merger would enhance Lloyds TSB's competitiveness.

2.203. We have considered whether the merger, by increasing Lloyds TSB's size and profitability, would increase the likelihood of Lloyds TSB being able and willing to deter and repel entrants by offering more favourable terms to new customers, which the new entrants could not profitably match, thus increasing the difficulty of entrants' acquiring customers. However most banks already offer favourable terms to new customers, notably students and other young people, and we doubt that further action by Lloyds TSB alone would have much impact on the opportunities for new entrants.

2.204. One other issue which arises at this point is the merger's effect on cross-selling. Lloyds TSB has projected that it would be able to increase annual revenues by £450 million by the fourth year after the merger, leading to an increase of £250 million a year in pre-tax profits: much of this is projected to come from increased sales to Abbey National customers.

2.205. The merger's effect on cross-selling could be harmful for consumers if two conditions were satisfied:

- (a) that Lloyds TSB could, as it expects, achieve a higher level of cross-sales than Abbey National itself would achieve; and
- (b) the additional products cross-sold by Lloyds TSB were worse value for money than those which the customers concerned would otherwise have bought, whether from Abbey National or otherwise.

2.206. On the first point, Lloyds TSB claimed that it achieved a higher level of cross-selling than the average for UK banks, and a higher level than Abbey National. It said that its customers had an average of 2.3 Lloyds TSB products whereas, according to information

published by Abbey National, its equivalent figure was 1.75, although Lloyds TSB did not know the basis of the calculation of this figure.

2.207. In our view, comparisons between the cross-selling performance of different banks are not very meaningful because they are likely to reflect differences in the respective product ranges (and possibly different methods of calculation). If Abbey National were to remain independent it is likely that its cross-selling rate would increase as it continued to expand its product range. We do not think there is any strong reason to believe that cross-selling to Abbey National customers would be materially greater if the merger proceeded. We have not therefore found it necessary to examine whether the condition at (b) in paragraph 2.205 applies.

2.208. As we discuss in paragraph 2.220, we would expect Lloyds TSB to want to use the synergy benefits of the merger to enhance profits rather than to compete more intensively. The merger would relieve its current market share concerns and thus allow the group to focus primarily on the preservation or enhancement of margins on its existing business.

Other effects of the merger

2.209. We now consider certain other effects of the merger which cut across the market-by-market issues: the synergies to which the merger would give rise; the extent to which consumers would benefit from these; the effect on consumer choice; the effect on financial exclusion; and the effect of branch closures.

Synergies

2.210. Lloyds TSB estimates that the merger would enable it to achieve an increase in annual pre-tax profits of £950 million, of which £900 million would be achieved in the fourth year following the acquisition. Of the £900 million, £650 million would come from cost reductions and £250 million from increases in sales (see paragraph 2.204).

2.211. The cost reductions are expected to arise from the combination of businesses and central functions, and from the integration of retail banking networks and systems (see paragraph 3.51). Since Lloyds TSB had to make its estimates without the benefit of discussions with Abbey National management, it necessarily had to take a top-down approach, allocating Abbey National's costs to various activities and making assumptions as to what proportion of those costs might be saved as a result of the merger. The calculations were approved by Lloyds TSB's auditors.

2.212. We note that the projected savings within the combined group from the acquisition of Abbey National represent a lower proportion of the cost base than was the case for the TSB acquisition (see paragraphs 3.54 and 3.55). However, both Lloyds TSB and Abbey National had considerably lower cost to income ratios in 2000 than Lloyds TSB had in 1995, so the scope for further downward pressure on costs generally may now be more restricted. Moreover, the cost reduction achieved by 1999 following the TSB acquisition included the effect of a credit for pension costs of £108 million, a factor which will not necessarily be repeated, at least on the same scale, were the Abbey National acquisition to proceed. The cost savings now projected therefore appear to be challenging. Lloyds TSB's auditors described the projections as realistic but full (see paragraph 3.55).

2.213. A major element of the cost savings would come from reductions in employment. Lloyds TSB has publicly stated that it expects about 9,000 jobs to be lost as a result of the merger. Lloyds TSB submitted that the 9,000 job losses should be seen in the context of a combined workforce of around 100,000 and an annual staff turnover rate within Lloyds TSB alone of around 7,000. It was confident that the great majority of the job losses could be

achieved without recourse to compulsory redundancies, even though it could not guarantee that there would be none.

2.214. Asked about the likely geographical distribution of the job losses, Lloyds TSB said that, in the absence of detailed discussions with Abbey National management, it was not in a position to say where the losses would arise. Apart from job losses in branches, which would not be geographically concentrated, it was likely that reductions would be made in the workforce at some of Abbey National's call centres and processing centres such as those at Bradford and Milton Keynes.

2.215. As regards revenue synergies, Lloyds TSB expects to achieve these by extending its existing delivery channels and product range to Abbey National customers and deploying its customer management capabilities. We discussed in paragraphs 2.206 and 2.207 Lloyds TSB's claim that it achieves a higher level of cross-selling than Abbey National.

2.216. Even though there must be some doubt about the level of cost savings which would result from the merger, we expect that they would be substantial. They would represent efficiency gains inasmuch as Lloyds TSB would be able to improve the ratio between its costs and its income. Whether these efficiencies would benefit the public interest, however, depends on the extent to which they would be passed on to customers: see paragraphs 2.218 to 2.221.

2.217. We note that, in estimating the revenue synergies, Lloyds TSB assumed that very few Abbey National customers would be lost to competitors following the merger. This expectation was based on Lloyds TSB's experience following the 1995 merger with TSB. The assumption clearly indicates that Lloyds TSB expects that there will still be a low level of switching of customers between banks in the next few years.

The extent to which benefits from the merger would be passed on to consumers

2.218. Lloyds TSB's internal papers dealing with the planned bid for Abbey National (see Appendix 5.2) make clear that the benefits of the cost savings and revenue increases were expected to accrue to shareholders: part would pass to Abbey National shareholders by way of a premium for control of the company and the rest would go to increase the profits of the merged group. Lloyds TSB confirmed to us at a hearing that it had not identified any element of the synergy benefits as passing to consumers, though subsequently, in the context of remedies, it put forward proposals which envisaged between £[] million and £[] million being passed to customers in the form of price reductions (see paragraph 2.265). The internal papers show that Lloyds TSB envisaged that there would be benefits to customers through:

- (a) improved service as a result of access to a more extensive network of branches and ATMs; Abbey National customers would also benefit from the agreement under which certain services were provided to Lloyds TSB customers by the Post Office;
- (b) an extended product range combining the best products from both companies; and
- (c) the benefits of the enlarged group's combined investment in telephone banking and Internet services.

2.219. Asked about the assumption that the financial benefits from the merger would accrue to shareholders alone, Lloyds TSB said that since, in its submission, the markets affected by the merger were competitive, it would be obliged to pass on to customers the benefits of increased efficiency in lower prices. [*Details omitted. See note on page iv.*]

2.220. To the extent that the markets are competitive, Lloyds TSB would be obliged to cut prices and margins regardless of the merger. The synergies it gained from the merger would simply put it in a better position to make those cuts without damaging profitability. But in our view Lloyds TSB's current profitability is such that it does not need the merger synergies in order to be able to cut prices: the September 2000 strategy document (see Appendix 5.1) stated that 'we still expect to make acceptable returns from [the retail banking] sector in the medium term. [

Details omitted. See note on page iv.

] We therefore do not believe that consumers would benefit from the merger synergies in terms of lower prices than they would otherwise pay.

2.221. We are not convinced that the benefits for customers which Lloyds TSB identified as arising from the merger (see paragraph 2.218) would be significant. If Abbey National customers attached importance to having access to a bigger branch network than Abbey National's, they could have chosen one of the big four banks. ATMs are now largely an open-access network regardless of ownership. Abbey National has a comprehensive set of distribution channels except for the Post Office. Moreover there is nothing to prevent Abbey National customers from buying Lloyds TSB products now (subject, where applicable, to creditworthiness).

The merger's effect on consumer choice

2.222. Superficially the merger would reduce by one the number of separate providers of banking services available for consumers to choose from. In the PCA market it would remove one of only three competitors to the big four—the others being Halifax and Nationwide—which offer a broad range of personal banking services through a national branch network. To the extent that many consumers still prefer to deal with branch-based suppliers, and some evidently value the convenience of buying several products from a single supplier, the reduction in choice is material. It would also remove one of the two alternative suppliers in the SME market with a national branch network. We are less concerned, however, about the loss of choice in competitive markets than in uncompetitive ones, namely the supply of PCAs and services to SMEs.

2.223. The significance of the loss of choice also depends partly on the distinctiveness of Abbey National's product and service proposition. We noted in paragraphs 2.65 to 2.68 that the standard PCA terms of the big four banks are similar and that Abbey National's offer is different from theirs as regard overdraft rates and fees. We commented in paragraph 2.155 that Abbey National had also been a reasonably innovative player in the PCA market. Elsewhere, its account for certain types of small business has provided a distinctive offering in the SME market (see paragraph 2.193).

2.224. Lloyds TSB told us that, since it had not had access to Abbey National's books, it was not in a position to say whether it would retain individual products: it would decide this after the merger, taking into account whether products were producing an economic return.

2.225. Lloyds TSB might or might not, therefore, choose to continue those elements of Abbey National's product portfolio which have provided worthwhile choice for consumers. [

Details omitted. See note on page iv.

] This is the sort of behaviour which is more likely to be found in a relatively recent entrant seeking to grow sales than in an incumbent with a large, established customer base.) In any event the continued availability of Abbey

National's products, separately branded within Lloyds TSB's overall portfolio, would not be equivalent to their availability from an independent player, since it could be expected that Lloyds TSB would promote them less in order to minimize the harm done to the rest of its sales.

2.226. Quality of service is an important aspect of the banks' offering in all product markets. Poor service quality is among the principal reasons which customers give for switching banks (see Table 4.11). We received representations from several people who had experienced poor service from Lloyds TSB, some of whom had switched to Abbey National (see paragraph 6.201). We do not suggest that these communications are evidence of widespread discontent with Lloyds TSB's service—indeed we received other letters from people speaking well of Lloyds TSB—nor are we in a position to compare quality of service as between Lloyds TSB and Abbey National. However, these letters serve to illustrate that some consumers value the ability to choose between banks on grounds of service quality. The choice of banks with a national branch network is, as noted above, already quite small.

2.227. For these reasons we believe that the merger would have an adverse effect on consumer choice. We find this effect to be material in relation to the PCA and SME markets where, as we have said, the merger would also have adverse effects on competition.

The merger's effect on financial exclusion

2.228. Lloyds TSB submitted that it had a relatively high proportion of low-income customers because of the TSB inheritance and that it was therefore well attuned to the particular needs of such customers. It said it had introduced a basic bank account (offering no overdraft) which, unlike Abbey National's Instant Plus Account, met the PAT 14 standards drawn up by the Government as part of its policy of improving access to financial services.

2.229. We note, however, that Lloyds TSB's basic bank account was introduced only towards the end of 2000 and as a result of the Government's policy of reducing social exclusion. So far, Lloyds TSB has accepted only 25,000 customers for its basic account. Abbey National offered its Instant Plus Account on its own initiative from 1996 and, as noted in paragraph 2.225, has over 600,000 customers on this account. Abbey National told us that this product failed to meet the PAT 14 standards partly because a minimum opening balance of £100 and a minimum monthly credit of £250 were required. It did not believe that these requirements were onerous: most people living on social security benefits, for example, would receive over £250 a month in benefits.

2.230. We therefore believe that Abbey National has played a useful part in reducing financial exclusion. As we noted in paragraph 2.225, there could be no certainty that Lloyds TSB would continue the Instant Plus Account, given the losses it incurs. We reach no adverse finding in respect of the merger's effect on financial exclusion as such but see the matter as a significant consideration within our assessment of the merger's effect on consumer choice.

The effect of branch closures

2.231. Lloyds TSB calculated that some 90 per cent of Abbey National's branch network overlapped with its own in the sense that, in the area within the M25, the Abbey National branch was within 0.25 miles of a Lloyds TSB branch, and elsewhere it was within one mile. Lloyds TSB has publicly stated that it would 'co-locate' some 600 branches if the merger went ahead, compared with the total of some 730 branches in Abbey National's network.

2.232. Lloyds TSB told us it was confident that it could close 600 branches without harming customer service. Although some customers would have to travel a little further to

their nearest branch, others would have the opposite experience. Following the merger with TSB, Lloyds TSB had embarked on a similar, though smaller, programme of co-locations. Very few customers had been lost, it said, and a high level of customer satisfaction had been maintained. Moreover Abbey National customers would have access to the much larger Lloyds TSB branch network, as well as the ability to carry out banking transactions at 17,500 post offices.

2.233. Convenience of branch location is the single most important reason given by customers for their choice of bank: it was given as a reason by 27 per cent of respondents to a recent survey (see Table 4.7). It can therefore be expected that some customers who chose Abbey National because its local branch was convenient for them would suffer some reduction in convenience if that branch was closed and co-located with a nearby Lloyds TSB branch (and similarly for Lloyds TSB customers if it were the Lloyds TSB branch that was closed).

2.234. On the one hand, it would be in Lloyds TSB's interests to minimize any loss of customers as a result of branch closures, and since there are branches of other banks in almost all the areas affected, it could not afford to ignore this factor. On the other hand, given the low level of switching by PCA customers, Lloyds TSB would in our view be able to cause a degree of inconvenience to customers without running the risk of losing significant numbers of them. We therefore believe Lloyds TSB could be expected to close branches, despite some inconvenience for customers, if it was cost effective to do so.

2.235. We also do not believe it likely that Lloyds TSB could close 600 branches without causing a reduction in service quality for some customers, if only temporarily.

2.236. In view of Lloyds TSB's experience in managing the integration of the Lloyds Bank and TSB networks, and the other countervailing factors which it mentioned (see paragraph 2.232), however, we do not think there is sufficient evidence to justify an adverse finding in respect of the effect of branch closures on convenience and service quality. That said, the prospect that 80 per cent of Abbey National's network (or its equivalent, given the possibility that in some places the Lloyds TSB branch would be the one to close) would be closed emphasizes to us that Abbey National would be dismantled as a separate, branch-based operation if the merger went ahead. It is unlikely that a comparable network would be created in future.

Conclusions

2.237. We have found that the merger would reduce competition in the PCA market and that adverse consequences for consumers could be expected to result (see paragraphs 2.161 and 2.162).

2.238. We are satisfied that the merger would not materially affect competition in any other individual market for personal financial products in which both Lloyds TSB and Abbey National operate (see paragraphs 2.170, 2.178 and 2.183).

2.239. In relation to the market for the supply of banking services to SMEs, we find that the merger would reduce competition, with adverse consequences for the consumers of those services (see paragraph 2.200).

2.240. As regards other effects of the merger:

(a) We have found that the merger's overall impact on Lloyds TSB in terms of competition would not give rise to adverse effects going beyond the reduction of competition in the PCA and SME markets (see paragraphs 2.201 to 2.208).

- (b)* The merger would lead to efficiency gains (paragraph 2.216) but we have found that these would not be passed on to consumers in the form of reduced prices (see paragraph 2.220). We do not consider that the other benefits which Lloyds TSB claimed the merger would generate for consumers would be significant (see paragraph 2.221).
- (c)* We believe the merger would have an adverse effect on consumer choice and that this would be material in relation to the PCA and SME markets (see paragraph 2.227). We have not reached a separate adverse finding in relation to the merger's effect on financial exclusion but we see the possible impact in that regard as an aspect of the effect on consumer choice (see paragraph 2.230).
- (d)* We consider that, while the planned closure by Lloyds TSB of 600 branches following the merger might cause some reduction in convenience and service quality, the evidence is not sufficient to justify our reaching an adverse finding on that aspect of the merger (see paragraph 2.236).

2.241. For the reasons set out in paragraphs 2.237 to 2.240, we conclude that the merger may be expected to operate against the public interest with the specific adverse effects, in respect of both the PCA and SME markets, that prices would be higher, and customer choice and innovation would be reduced, compared with the situation that could be expected to arise in the absence of the merger.

Remedies

2.242. Where we have found that a merger situation operates or may be expected to operate against the public interest, we are required by section 72(2) of the FTA to consider what action, if any, should be taken for the purpose of remedying or preventing the adverse effects which we have identified and may, if we think fit, include recommendations as to such action.

2.243. We included a number of possible types of remedy in our issues statement, published in April 2001 (see Appendix 2.1), and invited comments. In early May we published a second statement giving interested parties a further opportunity to comment on the types of remedy we had identified or to put forward other possibilities (also set out in Appendix 2.1). We covered the subject in both sets of hearings that we held with Lloyds TSB and Abbey National. Before the second hearings, Lloyds TSB put forward for our consideration some specific proposals under one of the headings we had set out (see paragraphs 2.262 to 2.264) and a shortened version of these was provided to Abbey National so that it was able to give us its comments on them. We have taken full account of the representations of both main parties, as well as those received from others in response to our published consultation documents.

Prohibition of the merger

2.244. In relation to the possibility of our recommending that the merger be prohibited, we highlighted in particular three aspects with the parties:

- (a)* Abbey National's actual and potential importance as an independent competitor in the various markets where its operations overlapped with those of Lloyds TSB;
- (b)* Abbey National's potential importance as a competitor in those markets in the event of the company's acquisition by someone other than one of the big four; and
- (c)* Abbey National's importance as operator of a national network of branches which would disappear if it were acquired by Lloyds TSB.

The parties' views on these aspects and our own analysis are set out in the part of this chapter which deals with the merger's effects.

Divestment of businesses

2.245. We have considered whether there are discrete businesses, either in Lloyds TSB or Abbey National, the divestment of which would remove or at least substantially mitigate the adverse effects identified. We reviewed two specific possibilities: Cheltenham & Gloucester and cahoot.

2.246. The principal activities of Cheltenham & Gloucester are the supply of mortgages and savings accounts: it operates to a very small extent in the PCA market and not all in the SME market. We have found the mortgages and savings markets to be competitive and have made no adverse findings in respect of them. The divestment of Cheltenham & Gloucester is therefore not necessary to remedy any adverse effects in those markets. Since our concerns in respect of PCAs and SMEs surround the loss of a branch-based competitor, however, we considered whether the divestment of Cheltenham & Gloucester would provide a ready-made branch network which might enable a new player to enter the PCA and SME markets, or an existing player (outside the big four) to expand in them.

2.247. Lloyds TSB commented that Cheltenham & Gloucester's branch network was well located, though with some bias towards the South and West of England. It might be of interest to another player, such as NAB, that was seeking to get into branch-based competition and in that context Lloyds TSB was prepared to consider the divestment of Cheltenham & Gloucester as a remedy, whether in itself or possibly as part of a package that also included some Lloyds TSB and Abbey National branches. It maintained that the Cheltenham & Gloucester branches and their staff were capable, with some investment and development, of managing all types of financial services products, including PCAs. Indeed the offering of PCAs was currently being piloted in one or two branches.

2.248. We do not think, however, that divestment of the Cheltenham & Gloucester branches would in itself achieve a great deal. Anyone interested in using the branches to supply PCAs and products for SMEs would need suitable IT systems, staff trained to handle those products and, above all, customers. A party acquiring Cheltenham & Gloucester would do so primarily for its existing businesses in mortgages and savings accounts. We think it unlikely, given the absence of PCA and SME customers, that the Cheltenham & Gloucester network would be seen as an attractive platform for entry or expansion into those markets. We do not see this as an effective remedy for the adverse effects which we have identified, whether on its own or as part of a package of branch divestments.

2.249. Cahoot is Abbey National's stand-alone Internet bank. It has some [\approx] PCA customers, which represents about 0.1 per cent of the PCA market. It may in due course become a significant competitive force but we do not believe it will be in the foreseeable future. As a remedy for the loss of an independent Abbey National the divestment of cahoot would be wholly inadequate, particularly as it would not mitigate the reduction in branch-based competition which would result from the merger.

2.250. We did not identify any other Lloyds TSB or Abbey National businesses whose divestment would address the adverse effects, nor did Lloyds TSB (or anyone else) draw any to our attention. We therefore concluded that there are no Lloyds TSB or Abbey National businesses which could be divested in order to remedy the adverse effects we identified.

Divestment of branches

2.251. We included in our issues statement, on the usual hypothetical basis, the possibility that branches be divested to competing providers of retail financial services in localities where Lloyds TSB and Abbey National together had a high share of total branches. In the event, as indicated earlier in this chapter, we have concluded that the adverse effects of the merger would flow from a weakening of competition and loss of choice in the PCA and SME markets at national level and we have not, therefore, focused attention on local issues. We have nevertheless considered whether divestment of branches might remedy the adverse effects which we foresee at national level.

2.252. As we noted in the context of Cheltenham & Gloucester, divestment of the premises alone would achieve little. Share of customer accounts is the real issue, therefore in order to have an impact on competition in the market, branches would have to be divested complete with their customer base.

2.253. Lloyds TSB told us in a written submission that this would be possible in principle under provisions in the FSM Act which were expected to come into force late in 2001 or early in 2002. This would nevertheless be a complex exercise, it said, where the interests of customers needed to be borne in mind. Lloyds TSB said that there were three issues to consider in this respect:

- (a) Divestment of customers was difficult to reconcile with the promotion of customer choice. Lloyds TSB could offer transferring customers an amount (say £100) to compensate them but they would necessarily be free to reject that offer or to transfer back to the merged group later.
- (b) Divestment of Lloyds TSB or Abbey National branches and customers on any significant scale would cause significant damage to the brands and customer relations.
- (c) Such divestment on any significant scale would make the merger commercially unviable.

Lloyds TSB said that it would therefore be unwilling to contemplate any extensive divestment undertaking.

2.254. Questioned about this possibility at a hearing with us, Lloyds TSB said that the new provisions in the FSM Act would involve applying to the courts for permission to transfer customers. A parallel process already existed in relation to the transfer of customers between insurance companies: it involved advertising and advising customers, but the process normally took no more than six months. Lloyds TSB said that it would much prefer to encourage customers to move of their own volition but the FSM Act would allow a fall-back process whereby a move could be enforced.

2.255. Lloyds TSB said that it was prepared to contemplate the divestment of branches, say up to 50, in order to meet a problem of local concentration, although even that would not be easy. The divestment of several hundred branches would have horrendous reputation implications for Lloyds TSB and the operational implications would be extremely difficult. Lloyds TSB said it was very unlikely that it would be prepared to do this as a remedy for adverse effects of the merger at a national level.

2.256. Abbey National said that the identification of the customers to be transferred would be problematic since Abbey National PCA customers were not assigned to a particular branch and might use several. It argued, more generally, that in order to compensate for the loss of Abbey National any divestment package would need to be structured so that the purchaser had a comprehensive national branch network; choice was preserved at local level; and the

purchaser was present in the key high street locations for SMEs. The precise number and location of branches that would need to be divested would depend on the acquirer's existing network but the number required would be very substantial.

2.257. Abbey National further argued that even if such a remedy could be structured and a suitable buyer found, it would be unlikely to create an effective substitute for Abbey National at least in the short to medium term:

- (a) Abbey National was more than the sum of its assets. To compensate for its loss, any remedy would need to ensure that the purchaser would have a cohesive and viable business able to provide effective competition to the big four. In practice, however, banking mergers carried substantial execution risks and these were multiplied where only part of a business was merged.
- (b) It took time to integrate a branch network. Lloyds TSB itself envisaged taking more than two years to merge the Lloyds TSB and Abbey National networks. There were formidable IT issues.
- (c) The purchaser would need to harmonize product offerings. This was likely to require the acquired customers to move to the purchaser's existing products. In effect this would be a mass switch, raising all the practical issues associated with PCA switching.

2.258. In Abbey National's submission the divestment of branches together with the customer base would cause other formidable difficulties. Although the FSM Act would introduce a new procedure designed to simplify transfers of banking businesses, the procedure was unlikely to be available until the end of 2001. It was not yet clear how long the process would take. The compulsory transfer of accounts was likely to be unpopular with customers and challenges must be anticipated. A court would not sanction a scheme unless it felt that it was appropriate to do so and this might cast doubt on the 'deliverability' of any undertakings to divest branches using this route. Whether or not ultimately successful, these challenges would be likely to add significant delay, cost and uncertainty to the process. Even if a transfer of customers was effected, it would be impossible to ensure that they did not transfer out again.

2.259. We consider that, in order to address adequately the adverse effects we have found which concern the operation of the PCA and SME markets at national level, the number of branches and their customers that would need to be divested would be substantial, running to several hundred branches. In order to achieve effective competition in both the PCA and SME markets, they would have to be sold to a single buyer who was in a position to provide such competition.

2.260. We believe, taking account of the views of both Lloyds TSB and Abbey National, that the actual process would be difficult, slow and unpredictable: the provisions of the FSM Act to which Lloyds TSB referred will not be in force for many months after we report and a process of compulsorily transferring customers would take up to a further six months. Even if the operation could be performed satisfactorily, there could be no guarantee that the transferred customers would stay and it would be uncertain whether the acquirer of the branches and customers would provide effective competition such as to compensate for the loss of Abbey National. We conclude that divestment of branches and customers would not be a suitable remedy.

Undertakings on products and prices

2.261. A further type of remedy included in our issues statement was 'undertakings relating to the terms of individual products offered by the enlarged group, for example PCAs, services for SMEs, for a period of years following the merger' (see paragraph 26(d) of Appendix 2.1).

2.262. In response, Lloyds TSB reiterated its belief that the merger could not be expected to operate against the public interest but said remedies in relation to products and pricing might deserve consideration if we were concerned that the merger would:

- (a) enable Lloyds TSB to impose less favourable terms on customers than would otherwise be the case; or
- (b) weaken the competitive pressure on Lloyds TSB or the big four banks as to the terms and conditions offered for PCAs; or
- (c) enable Lloyds TSB to retain all the benefits of the merger without passing any of them on to customers.

2.263. In such circumstances, Lloyds TSB argued, it would be appropriate and practicable to secure that, as a condition to clearance of the merger, Lloyds TSB:

- (a) gave guarantees to maintain the relative attractiveness of existing Abbey National branch-based mortgage, savings, loans and overdraft products, and any specified SME product, for a period of two years following the merger; and
- (b) for three years after the merger offered a new PCA product, with specified features, which would:
 - (i) secure that an appreciable proportion of the merger benefits were immediately passed on to customers;
 - (ii) change the competitive dynamics of the PCA market;
 - (iii) further intensify competitive pressure in that market; and
 - (iv) introduce an account with a more cost-reflective price structure.

Lloyds TSB said that it would also be prepared to cut the interest rate which it charged on PCA overdrafts. It would undertake to inform all PCA customers within six months of the merger which of its PCA products was most appropriate for them, thus addressing any concern that it would seek to benefit from customer inertia.

2.264. The full statement of Lloyds TSB's proposals in this regard is set out in paragraph 5.69 and Appendix 5.3.

2.265. Lloyds TSB told us that it believed the annual cost to it of implementing these proposals would be in the range £[] million to £[] million, depending on the uptake of the new product. This would be additional to the decline in margins which it expected to result from general market pressures. Lloyds TSB compared the cost, which would begin to take effect immediately, with the projected synergy benefits from the merger of £500 million a year by year three. (We note that the benefits are expected to be £900 million by year four and £950 million a year when all the effects had worked through.)

2.266. We have carefully considered whether these or similar proposals would remedy the adverse effects which we have identified. However, they raise difficulties of both principle and practicality.

2.267. As regards issues of principle, undertakings on these lines would represent a significant interference in the operation of market forces. This is a particular problem in a merger situation inasmuch as the undertakings would apply to only one supplier in the market. Since Lloyds TSB would be by some margin the biggest supplier of PCAs, it is to be expected that other suppliers would have to respond, but the nature of their response is unpredictable. It

seems likely to us that the overall result would be less attractive terms for customers than would be produced by the operation of the market in the absence of the merger.

2.268. In so far as the Lloyds TSB proposals envisage preserving the value of particular Abbey National products, they would not compensate for loss of product innovation and development which could be expected if Abbey National were to continue independently of the big four. Since we have found that the market is becoming more competitive and would, absent the merger, be likely to continue doing so, it could be expected that Abbey National would improve the price competitiveness of its offering.

2.269. In so far as Lloyds TSB's proposals envisage the introduction of a new product, they would represent a change in the market initiated by regulation, not a competitive response. In our view such regulatory intervention is second-best to the vigorous play of competitive forces which allows markets to develop in ways which reflect consumers' observed preferences.

2.270. Moreover, although Lloyds TSB claimed that the reduction in profit of £[§<] million to £[§<] million which it would incur as a result of its proposals was incremental to any decline in margins which would result from other market developments, it appears to us that the effect would be to bring forward downward pressure on prices which Lloyds TSB accepts would happen anyway. On this basis, in order for the effect of the offer to continue to be incremental, the terms would have to be improved at intervals, say annually. Lloyds TSB agreed that it was possible that, as the market became more competitive, it might have to take an initiative on these lines anyway.

2.271. As regards practicality, we believe that it would be extremely difficult to draw up undertakings, whether concerning existing or new products, which would guarantee that the products achieved specified objectives in terms of value for customers. The undertakings would comprise commitments going beyond what we would expect Lloyds TSB to do otherwise, and which would reduce its profits. It is therefore to be expected that Lloyds TSB would look for ways of minimizing the loss of profit involved. Although the main characteristics of PCAs are straightforward, there are many detailed aspects of their terms and conditions which are in principle open to variation and which could affect their attractiveness to customers.

2.272. Even if the value of the products could be safeguarded by highly detailed specification, it might be possible for Lloyds TSB to find other ways of recouping the cost, for example by introducing or increasing charges for particular transactions or products which were not actually part of the products' specifications, or by reducing service quality. (We note that Lloyds TSB argued to the SME monopoly inquiry that, in an uncompetitive market, price-controlled suppliers could be expected to reduce quality of service to prevent the price control from eroding their margins.)

2.273. Undertakings on the lines envisaged by Lloyds TSB would have to be agreed with the OFT in order to ensure that they met the required objectives. Given the detail involved, covering existing Abbey National products as well as new and existing Lloyds TSB products, this process would be both long and uncertain. The OFT would also have to undertake a complex monitoring operation throughout the period concerned. Such monitoring would have to cover not only the specification of the products but also their marketing, which Lloyds TSB recognized to be important (see paragraph 2.263). Moreover with developments in the marketplace both the monitoring and the assessment of the undertakings would become progressively more difficult and in time, we suspect, less effective.

2.274. For the reasons set out in paragraphs 2.267 to 2.273 we do not consider that proposals on the lines put forward by Lloyds TSB would be an appropriate or effective remedy for the adverse effects we have identified.

Information for customers

2.275. The final type of remedy set out in our issues statement was the possibility that steps be taken to improve customers' awareness of the terms of the products they were buying from the enlarged group and how they compared with those available from competing suppliers (see paragraph 26(e) of Appendix 2.1). It appeared to us that action on these lines would reduce the risk that customers of the enlarged group, through inertia, would continue to buy products from it even if their terms were less attractive than those of competing products. A remedy of this kind would in itself, however, be a weak step and would be useful only alongside other action which safeguarded the competitiveness of the market. Since we have not been able to find other remedies which would achieve that end, we do not see an information-based remedy as effective in the context of the adverse effects we have identified.

Undertakings offered by Lloyds TSB to the DGFT

2.276. Lloyds TSB said that it remained ready to implement the undertakings which it had offered to the DGFT in the hope of heading off a reference to us (see Appendix 5.4).

2.277. Taking the four points in turn:

- (a) Lloyds TSB has already announced that it will implement the proposals on switching from 1 July 2001. We comment on this in paragraph 2.128.
- (b) We have dealt in paragraph 2.275 with the possibility of a remedy designed to increase transparency of product terms and to facilitate comparisons with terms offered by competitors.
- (c) We believe it unlikely that Lloyds TSB would seek to introduce ATM charges for some time to come, regardless of whether it gave a formal undertaking to that effect.
- (d) We have discussed the possible divestment of cahoot (see paragraph 2.249).

We have also taken into account Lloyds TSB's proposal to extend its Post Office arrangements to Abbey National personal customers (see paragraph 2.221). As regards Lloyds TSB's proposal to extend its commitment not to close 'the last bank in town' to all Abbey National branches, Lloyds TSB told us that there were only four locations where an Abbey National branch was currently in this position.

Recommendation

2.278. As set out in paragraphs 2.245 to 2.277, we have concluded that the various possible remedies short of prohibiting the merger would not adequately address the adverse effects. These effects mainly concern the PCA and SME markets. We have noted the importance of the links between the different product markets in personal banking, however, and there are further links between those markets and the provision of banking services to SMEs (see paragraph 2.19). In particular, all but 3 per cent of the PCA market, and virtually the whole of the SME market, is in the hands of branch-based suppliers, who spread the costs of their branch networks over a range of different products. 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, as a result of the evidence we received, we do not expect that to happen for a considerable period.

2.279. 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. We consider that this remedy is both necessary and proportionate to the adverse effects. Accordingly we recommend that the merger be prohibited.