

Part II

Background and evidence

3 The companies and the merger situation

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Introduction

3.1. This chapter provides information on the two companies concerned in the merger situation, Lloyds TSB and Abbey National. Where appropriate, the terms 'Lloyds TSB' and 'Abbey National' are used to describe the respective groups as a whole, both as now constituted and in earlier years. The chapter begins with details of the proposed acquisition of Abbey National by Lloyds TSB which gave rise to the merger situation under investigation. This is followed by a description of each of Lloyds TSB and Abbey National, including their history, businesses, group structure, financial information at both group and business segment level, and future strategy. Finally, a summary is given of the Lloyds TSB projections of the cost savings and increments to revenue which it expects to arise in the event of the proposed acquisition taking place.

The merger situation

3.2. Lloyds TSB told us that TSB had had merger talks with Abbey National before TSB's merger with Lloyds Bank in 1995 (see paragraph 3.8) and that Lloyds TSB had discussed a merger with Abbey National in 1999. These discussions had not proceeded. Once Abbey National's discussions with BoS became public (see paragraph 3.4), Lloyds TSB had decided to renew its approach. Accordingly, in December 2000 Lloyds TSB made two approaches to Abbey National proposing an agreed takeover, both of which were rejected by Abbey National. On 5 January 2001 Lloyds TSB submitted a Merger Notice to the DGFT stating that it was 'evaluating the business case (for acquiring Abbey National) with

a view to consulting shareholders in the near future'. At that time, therefore, the situation was a merger in contemplation within section 75 of the FTA. On 31 January 2001 Lloyds TSB issued a statement confirming its intention to make an offer, subject to the proposed transaction not being referred to the CC for investigation and the Abbey National board recommending the Lloyds TSB offer. The approach from Lloyds TSB was rejected by Abbey National on 7 February 2001 on the basis that the terms of the offer were of inadequate value, had a high execution risk and were subject to regulatory uncertainties.

3.3. In accordance with the advice of the DGFT, the Secretary of State referred the proposed acquisition to the CC on 23 February 2001. The DTI press release issued at the time of the referral noted 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; that it might result in a substantial lessening of competition, particularly in the market for current accounts; and that it would also remove a potential competitor in the provision of banking services to small to medium-sized companies.

3.4. Abbey National had been in discussions with BoS since July 2000 over a possible merger of the two companies and submitted a Merger Notice to the DGFT on 19 December 2000. The Secretary of State announced on 5 February 2001 that he had decided not to refer the proposed merger between BoS and Abbey National to the CC. On 28 February 2001 Abbey National announced that, in the light of the continuing uncertainty created by Lloyds TSB, it had ended the merger talks with BoS. A timetable of events in connection with the proposed acquisition by Lloyds TSB of Abbey National and of the discussions between Abbey National and BoS is set out in Appendix 3.1.

3.5. On 4 May 2001 Halifax and BoS announced that they had agreed the terms of a merger between the two banks under a new holding company, referred to as HBOS plc. The merger would be effected by means of schemes of arrangement, for Halifax and BoS respectively, under section 425 of the Companies Act 1985. The two banks said that they expected the documentation for the merger to be dispatched to Halifax shareholders and BoS proprietors in June 2001, and that the meetings required to approve the merger would be held in July. Thereafter, the schemes of arrangement would be subject to approval by the courts. It was expected that the merger would become effective by the end of September 2001. If the merger between Halifax and BoS took place, the combined group would, in terms of total assets, be the fifth largest bank in the UK.

Lloyds TSB

History of the group

3.6. Lloyds TSB is a UK-based financial services group which provides a comprehensive range of banking and financial services in the UK and, to a much lesser extent, overseas. During 2000, Lloyds TSB earned a pre-tax profit of £3.9 billion (of which £3.4 billion (88 per cent) came from UK domestic business) and employed on average 80,000 people. It had total assets at 31 December 2000 of £218 billion. Lloyds TSB had around 16 million customers in 2000.

3.7. Lloyds TSB traces its origins to the firm of Taylors and Lloyds which opened as a private bank in Birmingham in 1765. Within the last six years the size of the bank has increased substantially with the acquisition of Cheltenham & Gloucester Building Society in August 1995, the merger with TSB in December 1995, the purchase of the minority shares in Lloyds Abbey Life plc (Lloyds Abbey Life) in 1996, the acquisition of Scottish Widows' Fund and Life Assurance Society (Scottish Widows) in March 2000 and the acquisition of Chartered Trust Group plc in September 2000.

3.8. The acquisition of Cheltenham & Gloucester for £1.8 billion greatly increased the Lloyds TSB presence in the mortgage and savings markets. TSB had been formed in 1986 as the holding company for the Trustee Savings Banks in England and Wales, Scotland, Northern Ireland and the Channel Islands, together with various common services. Shares in TSB were offered for sale in 1986 and were listed on the London Stock Exchange. The merger with Lloyds Bank took place by way of a scheme of arrangement under section 425 of the Companies Act 1985, whereby the two groups were combined under TSB Group plc, which changed its name to Lloyds TSB Group plc. The offer by TSB (after adjusting for a special dividend to TSB shareholders) valued Lloyds Bank at £10.8 billion and the equity

in the new group was split between Lloyds Bank and TSB shareholders in the ratio 71:29. The Scottish Widows acquisition, at a cost of £5.9 billion, extended Lloyds TSB's life and pensions business built around Lloyds Abbey Life, a majority stake in which had been acquired for £1.1 billion in 1988 and the outstanding 38 per cent in 1996 for £1.8 billion.

3.9. Shares in Lloyds TSB are listed in London and are traded on the over-the-counter market in New York through a sponsored American Depositary Receipt facility. Figure 3.1 shows the movement in the ordinary share price of Lloyds TSB in the ten most recent completed financial years and up to end May 2001. The movements in the FTSE All Share index and the UK Banks index are shown by way of comparison. Lloyds TSB is a significant constituent of the UK Banks price index and accordingly the index itself is affected by movements in Lloyds TSB shares. At 31 May 2001 the share price of the 25p ordinary shares of Lloyds TSB was 700p, at which price the market value of the group was £38.5 billion. Under sections 198 to 208 of the Companies Act 1985, shareholdings in public companies of 3 per cent or more have to be disclosed to the company. The only such shareholding which had been notified to Lloyds TSB at the time of preparation of its 2000 statutory report and accounts was a holding of 4 per cent by The Capital Group Companies, Inc. The Lloyds TSB strategic plan includes a target of [30] shareholder value every [30] years (see paragraph 3.29). In addition, the long-term incentive plan for directors, which was approved by shareholders at the Annual General Meeting of Lloyds TSB in April 2001, is linked to total shareholder returns relative to a group of 16 comparable UK and international companies in the banking and insurance sectors. The total returns achieved for Lloyds TSB shareholders in the five years 1996 to 2000 are shown in Table 3.1.

TABLE 3.1 Lloyds TSB: shareholder returns, 1996 to 2000

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|-------------------------------|-------|-------|-------|-------|-------|
| Share price: | | | | | |
| Opening share price (£) | 3.315 | 4.305 | 7.86 | 8.53 | 7.73 |
| Closing share price (£) | 4.305 | 7.860 | 8.53 | 7.73 | 7.05 |
| Increase/decrease in year (£) | 0.990 | 3.555 | 0.67 | -0.80 | -0.68 |
| Change in year (%) | 29.9 | 82.6 | 8.5 | -9.4 | -8.8 |
| Dividends paid (p) | 12.00 | 14.30 | 18.60 | 23.60 | 27.80 |

Source: FT Business Research Centre and Lloyds TSB accounts.

3.10. The long-term credit ratings for Lloyds TSB and Lloyds TSB Bank plc (Lloyds TSB Bank) are shown in Table 3.2.

TABLE 3.2 Lloyds TSB Bank and Lloyds TSB Group plc: long-term credit ratings

| | <i>Lloyds TSB Bank plc</i> | | | | | <i>Lloyds TSB Group plc</i> |
|-----------------|----------------------------|---------------------|----------------|-----------------------------|-------------|-----------------------------|
| | <i>Senior</i> | <i>Subordinated</i> | | <i>Preferred securities</i> | | <i>Subordinated</i> |
| | | <i>Dated</i> | <i>Undated</i> | <i>Direct</i> | <i>SPV†</i> | |
| Moody's | Aaa | Aa1 | Aa1 | aaa* | Aa2* | Aa2 |
| Standard & Poor | AA | AA- | A+ | A+ | A | A+ |
| Fitch | AA+ | - | - | AA | - | - |

Source: Lloyds TSB.

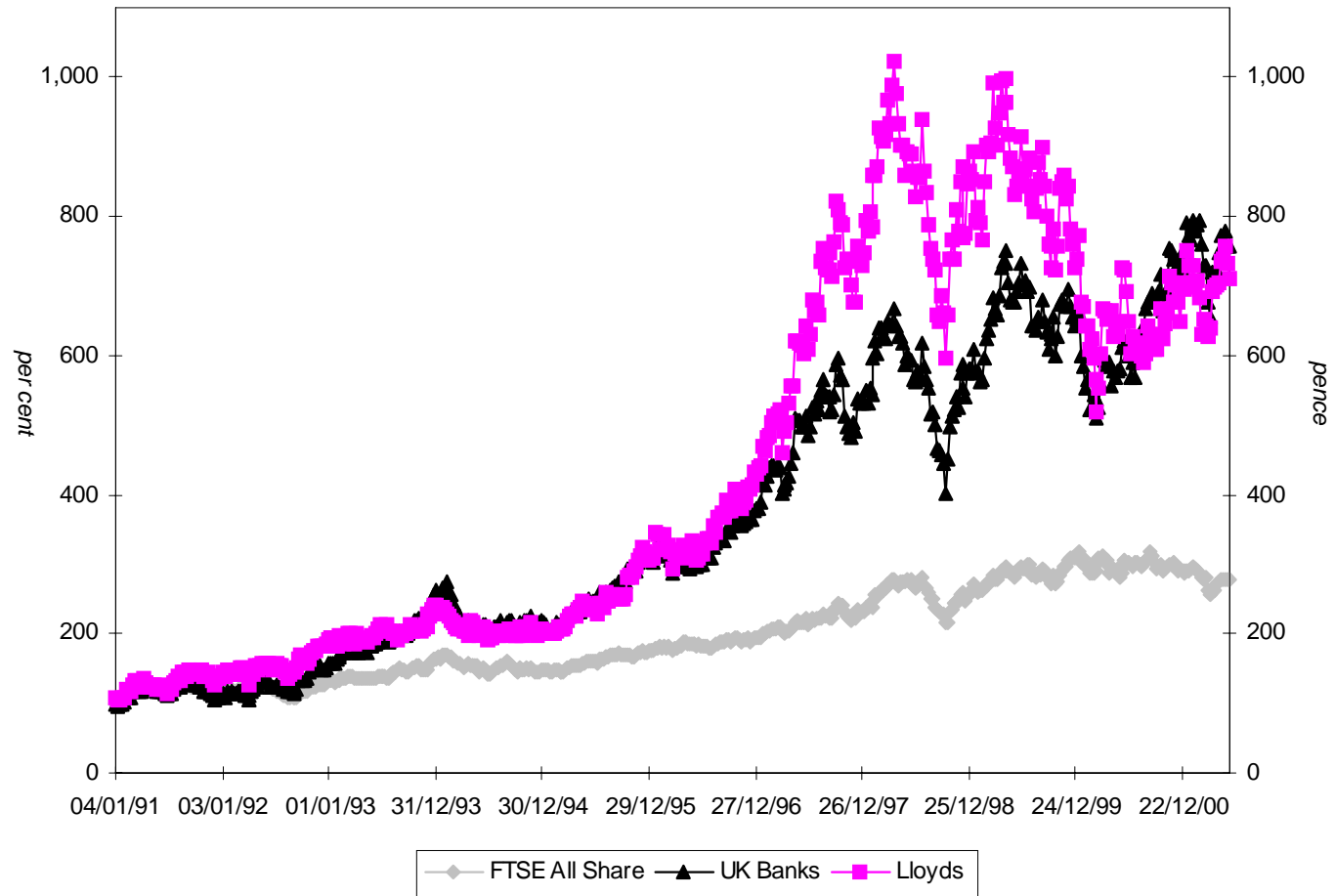
*On Moody's preference share scale.

†Special purpose vehicle.

Because Lloyds TSB Group plc is a holding company rather than a trading entity, it does not have long-term ratings except for specific issues of subordinated debt. Lloyds TSB told us that the ratings on the group's subordinated debt were one grade lower than the corresponding ratings for Lloyds TSB Bank plc because there was more risk in lending to a holding company than to an operating company.

FIGURE 3.1

Lloyds Bank plc/Lloyds TSB Group plc: share price movements from January 1991 to May 2001



Source: FT Business Research Centre.

Principal activities

3.11. Lloyds TSB has two main groups of activities: UK Retail Financial Services, and Wholesale and International Banking. UK Retail Financial Services, in turn, consists mainly of two business units: UK Retail Banking (which includes Mortgages), and Insurance and Investments. Wholesale & International Banking has responsibility for SME banking as well as Treasury, Corporate and Commercial Financial Services, Asset Finance and International Banking. A summary chart of the organization and management structure of the Lloyds TSB group is shown in Appendix 3.2.

3.12. Within UK Retail Financial Services, the business activities provide the following services and products:

(a) Retail Banking:

- (i) current accounts, savings and investment accounts, and consumer lending provided by Lloyds TSB through its retail branches and via its direct telephone and Internet banking services. At 30 April 2001 there were 2,145 branches throughout Great Britain. In addition Cheltenham & Gloucester provides retail savings and investment products through its network of 210 branches and its postal service. In the five years 1996 to 2000 the combined branch network decreased by 24 per cent mainly as a result of the closure of branches of Lloyds Bank and TSB;
 - (ii) card services, including credit and debit cards and processing services for retailers;
 - (iii) ATMs, of which Lloyds TSB operates some 4,350;
 - (iv) wealth management—including asset management, tax and estate planning, executor and trustee services—provided through 40 offices in the UK;
 - (v) e-commerce; and
 - (vi) retail stockbroking. Lloyds TSB Stockbrokers provides retail stockbroking through its Sharedeal Direct telephone service.
- (b) Mortgages:* Cheltenham & Gloucester is a specialist residential mortgage provider selling its mortgages through its own branded branches and through Lloyds TSB branches, as well as via the telephone, Internet, postal services and IFAs.
- (c) Insurance and Investments* provides three core services:

- (i) life assurance, pensions and investment products (through Scottish Widows);
- (ii) fund management for retail life, pensions and investment products, and for corporate, local authority and other institutional pension schemes (through Scottish Widows); and
- (iii) general insurance underwriting and broking (through Lloyds TSB Insurance Services Ltd, Lloyds TSB General Insurance Ltd and Ambassador Insurance Company Ltd).

3.13. The business activities of the Wholesale and International Banking division cover the following services:

- (a) SME banking:* money transmission, lending and deposits, asset finance, factoring, mortgages, insurance and investment services are provided to small businesses by a network of dedicated business managers based throughout the UK;
- (b) Treasury,* which participates in financial markets to meet the needs both of Lloyds TSB and its customers;

- (c) *Corporate and Commercial Financial Services*, which provides a range of banking and related services to major UK and multinational companies and financial institutions and (through a network of dedicated offices) to medium-sized businesses in the UK; and
- (d) *Asset Finance* provides (through Lloyds UDT Finance Ltd) leasing, hire purchase and loan products to the corporate and personal sectors direct, through intermediaries and through a number of joint ventures. Products include motor vehicle finance and asset finance for SMEs.

Financial information

Lloyds TSB group

3.14. A summary of the consolidated financial results of the Lloyds TSB group for the five years to 31 December 2000 is shown in Table 3.3. Details of the profit and loss accounts and balance sheets are given in Appendices 3.3 and 3.4.

TABLE 3.3 Lloyds TSB: consolidated financial results, 1996 to 2000

| | <i>£ million</i> | | | | |
|--|------------------|---------|---------|---------|---------|
| | 1996 | 1997 | 1998 | 1999 | 2000 |
| Total income | 6,749 | 7,230 | 7,078 | 7,872 | 8,469 |
| Trading surplus | 2,895 | 3,554 | 3,606 | 4,499 | 4,517 |
| Pre-tax profit | 2,505 | 3,162 | 3,015 | 3,621 | 3,886 |
| Post-tax profit attributable to shareholders | 1,575 | 2,335 | 2,120 | 2,514 | 2,724 |
| Retained profit | 883 | 1,410 | 916 | 1,063 | 1,041 |
| Shareholders' funds | 5,074 | 6,254 | 7,475 | 8,693 | 9,737 |
| Subordinated liabilities (loan capital) | 3,919 | 4,209 | 4,021 | 6,493 | 7,510 |
| Total assets | 147,367 | 158,106 | 167,997 | 176,091 | 217,982 |
| <i>Key financial ratios</i> | <i>per cent</i> | | | | |
| Post-tax return on mean shareholders' funds* | 33.9 | 41.2 | 30.9 | 31.1 | 29.6 |
| Cost:income ratio*† | 57.1 | 50.8 | 49.1 | 42.8 | 46.7 |
| Group net interest margin*‡ | 3.2 | 3.6 | 3.8 | 3.8 | 3.49 |
| Group interest spread* | 2.5 | 2.9 | 2.9 | 3.1 | 2.95 |

Source: Lloyds TSB accounts, as reported year by year.

*See glossary for the basis of calculation of the financial ratios shown above.

†The cost:income ratios in 2000 of Halifax and Alliance & Leicester were 46.0 per cent and 58.8 per cent respectively. The ratio for Nationwide, a building society, in the year to 4 April 2000 was 58.9 per cent.

‡The net interest margins of the other major UK banks in 1999 and 2000 were:

| | 1999 | 2000 |
|-------------------------|------|------|
| | % | % |
| Barclays | 3.40 | 3.11 |
| HSBC | 2.72 | 2.67 |
| RBS/NatWest (pro forma) | 3.00 | 3.00 |

During the five years to 31 December 2000, total income increased by 25.5 per cent, while total assets increased by 47.9 per cent. Pre-tax profits rose by 55.1 per cent and shareholders' funds by 91.9 per cent. The post-tax return on average shareholders' funds in the most recent three years was around 30 per cent, having fallen from 41.2 per cent in 1997. As indicated, the figures in Table 3.3 are those published on a year-by-year basis. They do not, therefore, take account of prior-year adjustments resulting from changes in the basis of presentation.

3.15. Cheltenham & Gloucester and TSB were added to the Lloyds TSB group in the course of 1995, and so do not affect comparisons between years in Table 3.3. In December 1996 the outstanding 38 per cent of Lloyds Abbey Life (see paragraph 3.8) was acquired for £1.8 billion. In April 1997 the consumer finance business of the Brazilian associate of the Lloyds TSB group was acquired for £173 million. In September 1998, the New Zealand banking arm of BoS—Countrywide—was acquired for £252 million

settled by the issue of loan notes. In September 2000 the group acquired Chartered Trust Group plc and ACL Autolease Holdings Ltd from Standard Chartered plc for a cash consideration of £614 million. The Scottish Widows acquisition had been announced in June 1999, but completion did not take place until March 2000. The results of the acquisition were consolidated in the Lloyds TSB group results from March 2000. The total consideration paid was £5,947 million of which £4,077 million represented the fair value of the assets acquired and £1,870 million was goodwill. The pre-tax result from Scottish Widows included in the Lloyds TSB results for 2000 in Table 3.3 was a loss of £23 million.

3.16. The group net interest margin rose from 3.21 per cent in 1996 to 3.86 per cent in 1999 before falling to 3.49 per cent in 2000. However, a major element in the reduction between 1999 and 2000 was non-recurring finance charges in connection with the acquisition of Scottish Widows. Excluding these charges, the group net interest margin in 2000 was 3.67 per cent. The net interest margin differs considerably between businesses and in recent years has been higher on domestic business than on international business. In 2000 the net interest margin on domestic business was 3.58 per cent compared with 3.02 per cent on international business; in 1999 the equivalent figures were 3.98 per cent and 3.18 per cent respectively.

3.17. The Lloyds TSB medium-term incentive plan for executive directors in 2000 (approved by shareholders in April 2000) included as one of the targets a reduction in the cost:income ratio to 37 per cent by 2002. The cost:income ratio had fallen from 57.1 per cent in 1995 to 42.8 per cent in 1999, but it then rose to 46.7 per cent in 2000. In its 2000 financial review, Lloyds TSB noted that the group had incurred £188 million of exceptional restructuring costs in the year, while e-commerce investment costs totalled approximately £150 million. A core element of Lloyds TSB's strategy was to increase investment to underpin its competitiveness and revenue growth opportunities. Whilst the group's cost:income ratio was expected to improve further over time, Lloyds TSB no longer considered that it was appropriate to be constrained by a separate cost:income ratio target.

3.18. As shown in Appendix 3.2, the Lloyds TSB group is managed on a divisional basis by five executive directors, each of whom is responsible for a group of businesses. Management accounts are prepared for each division and for business units within the divisions. Of the divisions shown in Appendix 3.2, three are engaged, either in whole or in part, in the provision of UK retail financial services: UK Retail Banking, Insurance and Investments and Group IT and Operations. We regard UK retail financial services as the main focus of our inquiry but, because that segment is made up of elements spread across the divisions indicated, there is limited in-depth information on UK retail financial services as a specific entity.

3.19. Each of the business units within the Lloyds TSB group maintains its own management accounts which show the unit's own direct revenues, costs and provisions, as well as its lending and deposits. In addition, where the business unit uses services from other business units or cost centres, it pays an internal transfer price for those services (for instance, transmission services and use of the branch network) or bears an allocation of central costs such as human resources, IT, and the corporate head office (based on allocation principles applied on a consistent basis across all businesses). The results of a particular business or product will, therefore, be significantly affected by the basis on which costs are allocated to activities.

3.20. In preparing management accounts, the Lloyds TSB group aims to transfer any exposure to interest rate risk from the business units to a specialist central unit referred to as Group Balance Sheet Management (GBSM), where it can be managed centrally on a portfolio basis. GBSM sits alongside, but is separate from, the Treasury function (within Wholesale and International Banking) where it is a cost centre operated on a profit-neutral basis. For management accounting purposes, all customer deposits are placed with GBSM and all customer assets are funded by GBSM, with the transfer rates applied broadly corresponding to the pricing characteristics of the relevant assets and liabilities. As a result, there is no linkage within a particular unit (for instance, Cheltenham & Gloucester) between customer assets and customer liabilities. Interest income figures included in management accounts for a business unit represent net (not gross) interest—that is, they are net of the internal cost of funds. Transfer rates for funds are set on the basis of an internal policy which Lloyds TSB told us was intended to be fair between businesses, simple to implement and profit neutral.

3.21. Certain businesses may require capital to be held in their own right, particularly if they constitute a separate bank (such as Cheltenham & Gloucester) or a separate legal entity. For management

accounting purposes, earnings on endowed capital (share capital plus retained profits) by such businesses are removed through a combination of an interest charge on free capital and a funding cost of fixed assets. Lloyds TSB told us that in this way all business units were placed on a comparable basis, irrespective of statutory or regulatory heritage.

Major business segments

3.22. The pre-tax profits of the major business segments of Lloyds TSB for the four years 1997 to 2000 are shown in Table 3.4. The table also shows, by way of footnote, the combined results of those businesses regarded by Lloyds TSB as constituting UK retail financial services.

TABLE 3.4 Lloyds TSB: pre-tax profit of major business segments, 1997 to 2000

| | £ million | | | |
|------------------------------------|---|------|------|------|
| | 1997 | 1998 | 1999 | 2000 |
| Personal Banking* | (Figures omitted. See note on page iv.) | | | |
| Lloyds UDT personal loans | | | | |
| Clubs, charities etc | | | | |
| SME business: | | | | |
| Retail merchant acquiring* | | | | |
| SME other | | | | |
| UK corporate | | | | |
| Insurance and Investments* | | | | |
| International Banking (Domestic)*† | | | | |
| Other‡ | | | | |
| UK subtotal | | | | |
| Non-UK | | | | |
| Total | | | | |
| Adjustments and rounding | | | | |
| Pre-tax profit per Table 3.3 | | | | |

Source: Lloyds TSB.

1997 1998 1999 2000

*Total UK retail financial services [Figures omitted. See note on page iv.]

†From 2000 a new segment—Wealth Management—was introduced which included Private Banking and International Banking (Domestic). Private Banking had previously been reported as part of Insurance and Investments.

‡Includes Treasury, central group items, pensions mis-selling provisions and imputation assessments.

Selected customer and product groups

3.23. Table 3.5 shows the pre-tax profit for personal banking in Table 3.4 attributed to major product groups in the period from 1997 to 2000.

TABLE 3.5 Lloyds TSB: pre-tax profit of major products in personal banking

| | £ million | | | |
|--|-----------|------|------|------|
| | 1997 | 1998 | 1999 | 2000 |
| Accounts in credit | (| |) | |
| Overdrafts | | | | |
| Commercial and other | | | | |
| Subtotal PCAs* | | | | |
| Deposit accounts | | | | |
| Personal loans | | | | |
| Credit cards | | | | |
| Cheltenham & Gloucester mortgages | | | | |
| Cheltenham & Gloucester savings accounts | | | | |
| Other | | | | |
| Total UK personal banking | | | | |
| Rounding etc | | | | |
| Total personal banking per Table 3.4 | | | | |

Figures omitted. See note on page iv.

Source: Lloyds TSB.

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

3.24. Lloyds TSB told us that it had recently started to carry out work on the profitability of different types of personal customer with a view to managing relationships more effectively. [*Details omitted. See note on page iv.*]

Details omitted. See note on page iv.

3.25. Lloyds TSB said that the PCA was not a profitable product for the group. On a fully-absorbed cost basis, in any one month, around [30] per cent of PCA customers had unprofitable PCAs, though this figure fell to [20] per cent when all of their holdings of Lloyds TSB products (not just their PCAs) were taken into account. On a marginal cost basis (a basis that did not allocate indirect or overhead costs to customers), in any one month, around [30] per cent of PCA customers made a positive contribution on PCA business alone and [30] per cent on a total product basis. The distribution of profitability over

PCA customers was highly skewed. The group's analysis of the pre-tax position by decile for PCA customers in February 2001, on a fully absorbed cost basis, taking account of holdings of all products, is shown in Table 3.6.

TABLE 3.6 **Lloyds TSB: pre-tax profitability of PCA customers (all products) by decile, February 2001**

| <i>£ million</i> | | |
|------------------------------|--|--------------------|
| <i>Pre-tax profit/(loss)</i> | | |
| <i>Decile</i> | <i>For decile</i> | <i>Cumulative*</i> |
| 0 | <div style="font-size: 4em; vertical-align: middle;">(</div> <div style="text-align: center;"> <p><i>Figures omitted. See note on page iv.</i></p> </div> <div style="font-size: 4em; vertical-align: middle;">)</div> | |
| 1 | | |
| 2 | | |
| 3 | | |
| 4 | | |
| 5 | | |
| 6 | | |
| 7 | | |
| 8 | | |
| 9 | | |

Source: Lloyds TSB.

*Subject to rounding differences.

Customer accounts were allocated to a decile on the basis of their fully-absorbed cost product/account profit score. The score was compiled from a combination of the result from all products/accounts owned by the PCA customer (not just the current account) and the result from all products/accounts associated with the customer (for example, where he/she was a party to a joint account). In order to calculate a profit for a decile and to reconcile the total of the decile profits to the management accounts, it was necessary to avoid double counting joint account profit that would otherwise occur as a result of the method of allocating customers to deciles. In calculating the profit for a decile, a joint account profit was allocated only to the main party, with the other party being treated as secondary. Main and secondary parties were not evenly distributed across deciles and this could lead to minor inconsistencies.

3.26. Lloyds TSB said that customer profitability was driven by several factors of which number and type of product held and the average balance maintained were primary factors. Secondary factors included transaction levels and product opening and closing patterns. Low PCA profitability was not explained by high transaction costs since there was a positive relationship between average transaction costs and average customer profitability, nor by bad debt risk as the average level of provisions increased with customer profitability. More profitable customers tended to hold added-value accounts, with [30] per cent of Gold accounts and [30] per cent of Select accounts being held by the most profitable [30] per cent of customers. Lloyds TSB also said that customers would move between profitability deciles over time as their product holdings changed.

Strategy and future prospects

3.27. The governing objective of Lloyds TSB, as highlighted in its 2000 report and accounts, is to maximize shareholder value over time. Lloyds TSB said that it had been working for years to be more than just a bank and in doing so it had built one of the UK's most diversified financial service companies. Not only was the market for financial services much bigger than the banking market, it was also growing much faster. Lloyds TSB wanted to continue to grow its share of banking business in the UK, but the biggest opportunity for growth lay in increasing its share of total financial transactions. The aim of the group was to attract more of the business that its 16 million customers had with other financial companies.

3.28. Market segmentation had assumed even greater importance. Lloyds TSB believed that over time competition on price alone was a losing strategy. The key to success was to find new, different and better ways of servicing each customer group. Ultimately, enhancing customer value for target customers was the primary means of delivering superior shareholder returns. Because the financial services industry remained highly fragmented it was ripe for further consolidation. It was not a question of whether

restructuring was necessary, but how it would be achieved. The acquisition of Scottish Widows and the Chartered Trust companies (see paragraph 3.15) were examples of participation by Lloyds TSB in the continuing industry consolidation. There was plenty of scope for organic growth, but Lloyds TSB would also continue to seek growth through acquisition.¹

3.29. The Lloyds TSB group's internal strategic plan for 2000 to 2002, which the board considered on 14 September 2000, reaffirmed the objective of [£] shareholder value every [5] years, [

Details omitted. See note on page iv.

].

Abbey National

History of the group

3.30. Abbey National is the fifth largest banking group incorporated in the UK in terms of total assets. During 2000 the group earned a pre-tax profit of approximately £2.0 billion and employed on average over 31,000 people. It had total assets at 31 December 2000 of £204 billion. Non-UK business represented less than 5 per cent of total assets and profit before tax in 2000. Abbey National had 15 million customers in 2000, compared with 8 million in 1989.

3.31. Abbey National Building Society was formed from the merger in 1944 of two long-standing building societies. In 1989 it converted from mutual status, the first building society to do so, with shares in the resulting public limited company being issued to former members of the building society and listed on the London Stock Exchange. Over the succeeding 12 years, the business of the bank has widened from being primarily a provider of mortgage and savings accounts to a full-service retail and wholesale bank. Over half the profits of Abbey National now come from markets other than mortgages and savings. In the period since demutualization in 1989, Abbey National has made a number of acquisitions, some of the more significant of which are shown in Table 3.7.

TABLE 3.7 **Abbey National: significant acquisitions, 1989 to 2001**

| <i>Date</i> | <i>Business acquired</i> | <i>Purchase price £m</i> |
|---------------|---|------------------------------|
| January 1992 | Scottish Mutual | 288 |
| November 1994 | Household Mortgage Corporation | 56 |
| August 1995 | First National Finance Corporation plc | 285 |
| July 1996 | Wagon Finance Ltd | 108 |
| August 1996 | National & Provincial Building Society (N&P) | 1,363 |
| July 1997 | Cater Allen Holdings Plc | 193 |
| August 1997 | Eole Finance (a specialist French consumer credit business) | 38 |
| May 1998 | State Securities Ltd | 19 |
| July 1998 | Fleet Management Services Ltd | 11 |
| December 1998 | Three point-of-sale finance businesses trading under the Lombard name | 347 |
| April 2000 | Porterbrook Ltd* | 773 |
| August 2000 | Highway Vehicle Management Ltd* | 171 |
| November 2000 | The legal claims financing business of Investec Bank | 66 |
| May 2001 | The aircraft leasing business of ING | 26 |

Source: Abbey National.

*Purchase price includes debt financing.

¹Paragraphs 3.27 and 3.28 are based on the account of the group's strategy in the Chairman's statement in the report and accounts for 2000.

The proposed acquisition by Abbey National of Scottish Provident Institution (Scottish Provident) for £1.8 billion was announced in September 2000 and is due for completion in July 2001, subject to court and policy-holder approval. In May 2001 Abbey National announced the purchase of the Fleming Premier Banking business from J P Morgan Chase for £106 million, though the transaction has not yet been completed.

3.32. Shares in Abbey National are listed on both the London and New York Stock Exchanges. The listing in the USA is through a listing of American Depositary Shares. Figure 3.2 shows the movement in the ordinary share price of Abbey National in the ten most recent completed financial years and up to end May 2001. The movements in the FTSE All Share index and the UK Banks index are shown by way of comparison. Abbey National is a significant constituent of the UK Banks price index and accordingly the index itself is affected by movements in Abbey National shares. At 31 May 2001 the share price of the 10p ordinary shares in Abbey National was £12.14, at which price the equity market value of the group was £17.3 billion. At the time of preparation of its 2000 statutory report and accounts, no shareholdings of 3 per cent or more (see paragraph 3.9) had been notified to Abbey National. The returns achieved by Abbey National shareholders (dividends and changes in share price) in each of the five years 1996 to 2000 is shown in Table 3.8.

TABLE 3.8 **Abbey National: shareholder returns, 1996 to 2000**

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|-------------------------------|-------|-------|-------|--------|-------|
| Share price: | | | | | |
| Opening share price (£) | 6.36 | 7.65 | 10.49 | 12.87 | 9.87 |
| Closing share price (£) | 7.65 | 10.49 | 12.87 | 9.87 | 12.17 |
| Increase/decrease in year (£) | 1.29 | 2.84 | 2.38 | -3.00 | 2.30 |
| Change in year (%) | 20.30 | 37.10 | 22.70 | -23.30 | 23.30 |
| Dividends paid (p) | 23.20 | 27.60 | 32.25 | 36.95 | 42.00 |

Source: FT Business Research Centre and Abbey National accounts.

3.33. The debt of Abbey National and of some of its subsidiaries is rated by the main agencies. Details of the current ratings are shown in Table 3.9.

TABLE 3.9 **Abbey National: credit ratings of group companies**

| | <i>Abbey National plc</i> | <i>Abbey National Trading Services plc</i> | <i>Abbey National North America</i> |
|-----------------|-------------------------------|--|---|
| | <i>Long term</i> | <i>Short term</i> | <i>Short term</i> |
| Moody's | AA | P-1 | P-1 |
| Standard & Poor | AA | - | - |
| Fitch | AA | F1+ | F1+ |

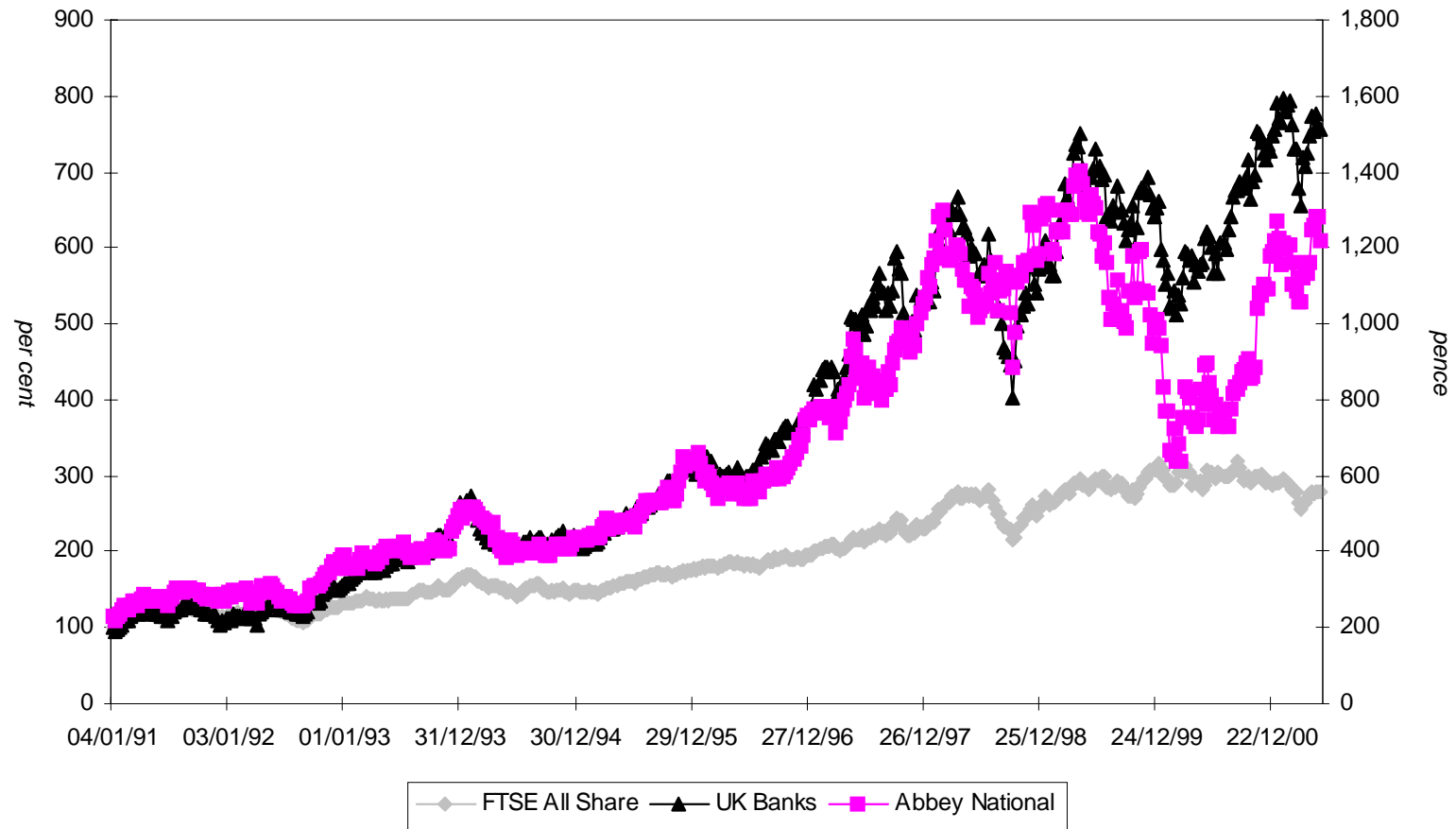
Source: Abbey National.

Principal activities

3.34. In May 2000 Abbey National introduced a new management structure creating four operating divisions within the group, each of which is the responsibility of an executive director. These are Retail Banking, Wholesale Banking, Business to Business and Business to Consumer. There are a further four executive directors of Abbey National, each of whom is responsible for a number of central activities, some of which provide services to the operating divisions. The central functions are: Finance; Group Technology and Infrastructure (IT); Corporate Development and Human Resources; Risk and Company Secretariat. In recent years Abbey National has outsourced a number of functions to enable it to focus on its core activities, sold (or assigned in the case of leases) and leased back substantially all the group's freehold and leasehold properties, transferred its card business to a partner and entered into franchising arrangements for the provision of retail banking facilities. A summary of the organization and management structure of the Abbey National group is shown in Appendix 3.5.

FIGURE 3.2

Abbey National plc: share price movements from January 1991 to May 2001



Source: FT Business Research Centre.

3.35. The Retail Banking division includes Abbey National's UK retail banking network, Abbey National Life plc (Abbey National Life) and Abbey National General Insurance Services Ltd (ANGI). The UK Retail Bank, the group's largest business, manages the design, pricing, sales, marketing and distribution of the majority of the group's retail products. At 30 April 2001 the distribution network consisted of 732 traditional branches, four of which incorporated Costa Coffee shops. In addition, there were 37 in-store branches in Safeway supermarkets, and some 4,580 ATMs. The main products of the business are residential mortgages, retail savings accounts and personal banking services. Over the last five years the total number of branches has increased by 87, but the N&P acquisition in 1996 involved an accretion of 335 branches, many of which have subsequently been closed or amalgamated with existing Abbey National branches. Abbey National told us that N&P did not offer branch-based current account products and that the branches that were closed would otherwise have required significant sums of capital expenditure to bring them up to an acceptable standard. Customer space had increased threefold from that available to the public at the time of the N&P acquisition.

3.36. Abbey National Life is an active participant in the three principal segments of the UK life insurance industry: protection (term insurance), investment and savings, and pensions. Abbey National Life products are sold exclusively through the retail distribution network, with Abbey National acting as an appointed representative under the Financial Services Act 1986. A financial planning service is offered to customers in almost all the group's branches.

3.37. ANGI provides a range of non-life-insurance products including property (buildings and contents), motor, payment protection and travel insurance. Insurance related to residential mortgages is the primary type of policy sold and is offered to customers through the branch network and over the telephone, often at the same time that a mortgage is being taken out.

3.38. The Wholesale Banking division of the group is conducted by Abbey National Treasury Services plc (ANTS), an authorized bank, which also provides the treasury function for the group. ANTS participates in a range of international markets which include wholesale lending, asset financing, asset-backed investments, risk management and financial products, and securities financing.

3.39. The Business to Business division comprises Scottish Mutual, Scottish Mutual International, First National and Continental Europe. Scottish Mutual distributes its products solely through IFAs in the UK. The range of products includes personal pensions, conventional and unit-linked protection plans, regular investment plans, single-premium products (such as investment bonds and with-profits bonds) and products linked to mortgages and healthcare products (through Pegasus). Abbey National told us that, on completion of the acquisition of Scottish Provident (see paragraph 3.31), it intended to retain the Scottish Provident brand and to combine the Scottish Provident activities with Abbey National's existing life insurance operations.

3.40. First National comprises four activities:

- (a) consumer finance, which consists of the provision of unsecured personal loans under the First National Bank brand and the provision of secured loans under the First National Mortgage Company brand;
- (b) motor finance in the form of hire purchase and conditional sale loans to consumers and also loans to the supporting dealers;
- (c) business finance in the areas of commercial mortgages, SME business banking, small ticket leasing, vehicle contract hire and factoring; and
- (d) retail finance by the provision of unsecured loans under the First National Tricity Finance brand.

All First National activities listed above, with the exception of small fleet leasing, vehicle contract hire, retail finance and SME business banking, are distributed through intermediaries. The business banking activities are branded as Abbey National (Business & Professional Banking).

3.41. The Continental European business comprises operations in France and Italy which are managed locally. The principal activity of these operations is the provision of mortgage finance.

3.42. The Business to Consumer division comprises the offshore retail financial services of Abbey National, the offshore retail banking business of Cater Allen, City Deal Services (an execution-only stockbroker) and two businesses launched in 2000—Inscape and cahoot. Inscape is a wealth management business targeted at individuals with at least £50,000 liquid assets to invest. The cahoot business is Abbey National's separately branded e-commerce financial services provider, which operates through PCs, telephones (including WAP-enabled mobile phones) and digital televisions. The products of cahoot include PCAs.

3.43. A final part of the Abbey National group is Group Infrastructure, comprising Central Service Financial Holdings (which contains the earnings on the difference between the group's statutory capital and the target regulated capital allocated to segments) and the earnings of certain small non-core businesses.

Financial information

Abbey National group

3.44. A summary of the consolidated financial results of the Abbey National group is shown in Table 3.10. Details of the profit and loss accounts and balance sheets are given in Appendices 3.6 and 3.7.

TABLE 3.10 Abbey National: consolidated financial results, 1996 to 2000

| | <i>£ million</i> | | | | |
|--|------------------|---------|---------|---------|---------|
| | 1996 | 1997 | 1998 | 1999 | 2000 |
| Total income | 2,349 | 2,613 | 3,111 | 3,750 | 4,294 |
| Pre-tax profit | 1,167 | 1,279 | 1,520 | 1,783 | 1,975 |
| Post-tax profit attributable to shareholders | 767 | 954 | 1,058 | 1,261 | 1,365 |
| Retained profit | 327 | 407 | 398 | 638 | 522 |
| Shareholders' funds (including non-equity) | 4,393 | 4,878 | 5,407 | 6,078 | 6,830 |
| Subordinated liabilities (loan capital) | 2,374 | 2,463 | 3,333 | 4,641 | 5,871 |
| Total assets | 124,011 | 150,808 | 177,779 | 180,744 | 204,391 |
| <i>Key financial ratios</i> | <i>per cent</i> | | | | |
| Post-tax return on mean shareholders' funds* | 18.4 | 20.6 | 20.6 | 22.0 | 21.1 |
| Cost:income ratio* | 44.2 | 45.7 | 43.3 | 43.1 | 44.1 |
| Group net interest margin* | 1.76 | 1.68 | 1.61 | 1.75 | 1.61 |
| Group interest spread* | 2.08 | 1.99 | 2.10 | 1.55 | 1.42 |

Source: CC from Abbey National accounts, as reported year by year.

*See glossary for the basis of calculation of the financial ratios shown above.

During the five years to 31 December 2000, total income increased by 82.8 per cent, while total assets increased by 64.8 per cent. Pre-tax profits increased by 69.2 per cent and shareholders' funds by 55.5 per cent. The post-tax return on mean shareholders' funds rose from 18.4 per cent in 1996 to 22.0 per cent in 1999, before falling slightly to 21.1 per cent in 2000. As indicated, the figures in Table 3.10 are those published by Abbey National on a year-by-year basis. They do not, therefore, take account of prior-year adjustments resulting from changes in accounting presentation. The results in Table 3.10 also reflect the acquisitions that Abbey National has made in recent years (see paragraph 3.31) as well as internally-generated growth.

3.45. The group net interest margin has fluctuated around 1.7 per cent, while the group interest spread narrowed from 2.08 per cent in 1996 to 1.42 in 2000. These ratios reflect the change in composition of Abbey National's business as well as changes in conditions in financial markets.

Major business segments

3.46. As noted in paragraph 3.34, Abbey National introduced a new management structure with effect from May 2000. The segmental analysis for 1999 and 2000 shown in the 2000 statutory accounts is set out in Table 3.11.

TABLE 3.11 **Abbey National: segmental analysis of group financial results, 1999 and 2000**

| | <i>£ million</i> | | | | | |
|---|---------------------------|------------------------------|-------------------------------------|-------------------------------------|---------------------------------|--------------|
| | <i>Retail Banking</i> | <i>Wholesale Banking</i> | <i>Business to Business</i> | <i>Business to Consumer</i> | <i>Group Infrastructure</i> | <i>Total</i> |
| <i>2000</i> | | | | | | |
| Net interest income | 1,578 | 441 | 593 | 76 | -8 | 2,680 |
| Other income and charges | <u>810</u> | <u>423</u> | <u>180</u> | <u>56</u> | <u>145</u> | <u>1,614</u> |
| Total income | 2,388 | 864 | 773 | 132 | 137 | 4,294 |
| Operating expenses | -944 | -155 | -326 | -177 | -213 | -1,815 |
| Depreciation on operating lease assets | - | -100 | -78 | - | - | -178 |
| Debt provisions | -150 | - | -120 | -2 | -1 | -273 |
| Provisions for contingencies | -11 | - | 5 | -3 | -12 | -21 |
| Written-off fixed asset investments | - | -34 | - | 2 | - | -32 |
| Pre-tax profit/loss | <u>1,283</u> | <u>575</u> | <u>254</u> | <u>-48</u> | <u>-89</u> | <u>1,975</u> |
| Total assets | 69,097 | 102,495 | 26,722 | 5,517 | 560 | 204,391 |
| Net assets | 2,674 | 2,510 | 1,231 | 129 | 286 | 6,830 |
| Employees (number) | 18,141 | 702 | 6,750 | 1,465 | 4,210 | 31,268 |
| <i>1999</i> | | | | | | |
| Net interest income | 1,624 | 393 | 593 | 62 | -11 | 2,661 |
| Other income and charges* | <u>670</u> | <u>169</u> | <u>133</u> | <u>46</u> | <u>129</u> | <u>1,147</u> |
| Total income | 2,294 | 562 | 726 | 108 | 118 | 3,808 |
| Operating expenses | -885 | -115 | -301 | -107 | -186 | -1,594 |
| Depreciation on operating lease assets* | - | -2 | -50 | - | - | -52 |
| Debt provisions | -167 | - | -136 | - | - | -303 |
| Provisions for contingencies | -15 | - | -5 | - | -3 | -23 |
| Written-off fixed asset investments | - | -26 | - | - | - | -26 |
| | <u>1,227</u> | <u>419</u> | <u>234</u> | <u>1</u> | <u>-71</u> | <u>1,810</u> |
| Exceptional Y2K and EMU costs | <u>-16</u> | <u>-2</u> | <u>-7</u> | <u>-1</u> | <u>-1</u> | <u>-27</u> |
| Pre-tax profit/loss | <u>1,211</u> | <u>417</u> | <u>227</u> | <u>-</u> | <u>-72</u> | <u>1,783</u> |
| Total assets | 68,943 | 81,741 | 25,087 | 4,491 | 482 | 180,744 |
| Net assets | 2,740 | 2,087 | 1,442 | 107 | -298 | 6,078 |
| Employees (number) | 18,005 | 561 | 6,693 | 1,141 | 2,809 | 29,209 |

Source: Abbey National.

*Other income and charges and depreciation on operating lease assets in 1999 are shown after taking account of a change in presentation of depreciation on operating lease assets which was made in 2000.

Selected product groups

3.47. The pre-tax results of the Retail Banking division for 1997 to 2000 allocated to product groups are shown in Table 3.12.

TABLE 3.12 Abbey National: pre-tax results of Retail Banking division, 1997 to 2000, by product group

Details omitted. See note on page iv.

Source: Abbey National.

Details omitted. See note on page iv.

Details omitted. See note on page iv.

] The analyses of results shown above are prepared on the basis of a full allocation of costs to activities. This involves apportionment of a substantial level of costs which are common to several businesses—for instance, the cost of the branch network and money transmission services. Accordingly, the results shown by business are sensitive to the underlying assumptions made for cost allocation purposes. Abbey National told us that in 2000 approximately [30] per cent of the operating costs of the Retail Banking division were allocated to PCA banking products, by applying activity profiles to general ledger costs and then identifying which particular activities were associated with each product group. Abbey National said that it was aware that the main clearing banks [*Details omitted. See note on page iv.*].

3.48. Abbey National told us that it serviced its SME customers mainly through five business units administered by First National (part of the Business to Business division). The group was unable to provide data on the profitability of the SME products as there was no separation in the accounting data between SME and non-SME business activity. However, it provided a ‘best endeavours’ estimate of the extent of the SME activity included in the total figures for 1999, which consisted of summary profit and loss data for the five businesses concerned and a percentage estimate of the level of SME activity within each of the businesses. This showed aggregate revenue for SME activity of £[30] million and operating expenses of £[30] million. After allowing for bad debt charges of £[30] million the pre-tax profit on SME activities was £[30] million. The process by which Abbey National intends to expand its services to SMEs was outlined in a board paper and involves:

Details omitted. See note on page iv.

The plan projected growth of the existing SME activity to generate a pre-tax profit of £[30] million to £[30] million by 2005.

Strategy and future prospects

3.49. Abbey National has set out as its purpose to achieve above-average growth in shareholder value over the long term by meeting stakeholder needs. In 1998 it set out a number of strategic objectives as follows:

- (a) to strengthen Abbey National's market position in UK personal financial services;
- (b) to win and hold competitive advantage through superior customer service;
- (c) to continue to diversify profit streams away from its traditional mortgage and savings activities;
- (d) to remain a low-cost operator;
- (e) to maintain strong management of risks;
- (f) to promote brand strength; and
- (g) to develop synergies between its mutually-supporting businesses.

In June 2000, Abbey National announced that it planned to increase the number of PCAs by one-third to 4 million by 2002 and to grow its share of the SME market from 1 to 5 per cent by 2005. The review of the Chief Executive included in the 2000 report and accounts stressed that Abbey National would keep diversifying its business, build a leading, broadly-based financial services institution, strengthen its franchises and innovate across its range of services.

Lloyds TSB's projection for the combined groups

3.50. In its news release on 31 January 2001 giving details of the proposed offer for Abbey National, Lloyds TSB said it estimated that a combination with Abbey National would lead in due course to an additional annual contribution to profit before tax from revenue and cost synergies of £950 million a year. Additional profit before tax of £900 million was expected to be achieved by the fourth year following the transaction (2005), of which £250 million was expected from increased revenues (net of various costs) in the year and £650 million from reduced costs in the year. These figures were estimated by Lloyds TSB without the benefit of discussions with Abbey National management; the statements of estimated revenue benefits and cost savings were reported on by PricewaterhouseCoopers (auditors to Lloyds TSB) and by Merrill Lynch International and J P Morgan plc under the Takeover Code. Abbey National's comments on the Lloyds TSB estimates are set out in paragraph 5.116.

Reduced costs

3.51. Lloyds TSB estimated that by 2005 the annual reduction in costs as a result of the merger would be £650 million at 2005 prices. The cost savings are expected by Lloyds TSB to arise from the combination of central functions (£165 million), the integration of retail banking networks and systems (£250 million) and a further £235 million from the combination of other businesses. A top-down approach was used by Lloyds TSB which involved allocating Abbey National's costs to various activities and then making assumptions as to what proportion of those costs might be saved by a merger. The cost savings for the various categories were expected to be achieved over different timescales. The overall one-off costs of achieving the projected cost savings were estimated by Lloyds TSB at £1.1 billion, spread over the period in which the cost savings were expected to be achieved.

3.52. Lloyds TSB estimated that the transaction would result in losses over four years of approximately 9,000 jobs from a combined group with over 100,000 staff. It was envisaged that this would be achieved with minimal compulsory redundancies: Lloyds TSB's normal staff turnover was approximately 9 per cent per year (around 7,000 employees). 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 might arise. Apart from job losses at 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.

3.53. Lloyds TSB told us that there would not be any branch closures as a result of the merger for at least two years, and that after 2003 a co-location programme of Lloyds TSB and Abbey National branches was planned. There were more than 600 potential co-location sites in a combined network, giving rise to the possibility of closure of a similar number of branches.

3.54. At the time of the merger between Lloyds Bank and TSB in 1995, Lloyds TSB committed itself to achieving cost savings rising to around £350 million a year in 1999. The target figure for cost savings was subsequently raised to £400 million to take account of the savings from the full integration of Lloyds Abbey Life. Lloyds TSB told us that this target for cost savings was set in absolute terms. For the target to be met, the operating costs reported for 1999 would have needed to be £400 million below those reported on a pro forma basis for the 12 months to 31 December 1995. In the 1999 accounts the combined pro forma operating costs for 1995 were stated as £3,850 million, or £3,644 million when adjusted to take account of subsequent acquisitions and disposals. Lloyds TSB costs reported for 1999 were £3,227 million, some £417 million below the adjusted cost base. The company told us that, if the effect of cost inflation (at, say, 2 per cent a year) on the combined base operating costs for 1995 had been taken into account, the cost savings achieved in 1999 would have amounted to more than £700 million in 1999 prices. We note that this was some 17 per cent of the actual combined costs for 1995 when rolled forward to 1999 prices (or over 50 per cent of the rolled forward costs of TSB on its own).

3.55. The cost savings projected for 2005 of £650 million in 2005 prices, were Abbey National to be acquired by Lloyds TSB, compared with operating costs reported by Abbey National in 2000 of £1,815 million. In order to make a comparison with the cost savings achieved following the merger with TSB of 17 per cent of the combined cost base, we rolled forward these Abbey National operating costs to 2005 prices (using the same rate of cost inflation used by Lloyds TSB of 3 per cent) and calculated that the projected cost savings of £650 million represented 10 per cent of the combined cost base (31 per cent of the rolled-forward operating costs of Abbey National on its own). These are significantly lower targets in percentage terms than those set by Lloyds TSB at the time of the acquisition of TSB. We note that the potential for cost saving generally in both Lloyds TSB and Abbey National may be less than that which existed in the Lloyds Bank/TSB merger in 1995. In 1995 the cost:income ratio of the newly-combined Lloyds TSB group (excluding a restructuring provision) was 59.9 per cent, whereas by 2000 it had fallen to 44.4 per cent (excluding exceptional restructuring costs), and that of Abbey National in 2000 was 44.1 per cent. Cost:income ratios for a banking group are in part dependent on its mix of business and can vary over time as the mix changes. For the same reason comparisons between the cost:income ratios of different banks have to be viewed with caution. The cost savings achieved by 1999 of £417 million (see paragraph 3.54) included the effect of a credit for pension costs of £108 million, a factor which would not necessarily be repeated, at least to the same extent, were the acquisition of Abbey National to proceed. In an internal report to Lloyds TSB on the projected cost savings from the merger, PricewaterhouseCoopers said, 'It is our belief that the cost savings by this exercise whilst realistic are full, and that there is little buffer within the numbers except within some areas of the implementation costs ...'. In its news release of 31 January 2001, Lloyds TSB said it believed that discussions with Abbey National could lead to an increase in the annualized cost savings.

Increased revenues

3.56. The increase in annual revenue estimated by Lloyds TSB from the merger was £450 million by the fourth year following completion of the transaction which, after bad debt provisions, costs and insurance claims, was expected to result in additional pre-tax profit of £250 million in that year. Lloyds TSB told us that as well as extending its delivery channels and providing additional products to Abbey National customers, it would introduce its customer management capabilities into the Abbey National network. In the news release giving details of the proposed merger, Lloyds TSB said that each of its customers had an average of 2.30 Lloyds TSB products, whereas each Abbey National customer had an average of 1.75 Abbey National products. Lloyds TSB told us that the latter figure came from Abbey National's interim statement for the half year to June 2000: Lloyds TSB was not aware of the basis of the calculations behind the figure. Information on the half year to 30 June 2000, which was the latest available at the time the Lloyds TSB estimates of increased revenues were made, showed operating revenue and pre-tax profits for Lloyds TSB of £4,266 million and £2,142 million respectively (excluding

restructuring charges), and for Abbey National £1,919 million and £922 million respectively relating to ongoing businesses.

3.57. The estimated additional contributions to pre-tax profit took account of a small element of potential customer loss following a merger and were expressed in the money of the year in which they were expected to be achieved. Lloyds TSB allowed in its estimates for general inflation of 2.5 per cent per year; on this basis, additional pre-tax profit of £250 million in 2005 money is equivalent to £220 million in 2000 money. The additional profit contributions were expected to arise in the following areas:

- (a) *Personal banking* (£80 million). Lloyds TSB believed that introducing its sales processes and differentiated products would improve cross-sales of, among other things, personal loans and credit cards to Abbey National customers. Lloyds TSB would also offer its added-value accounts (see paragraph 4.38(c)) to Abbey National customers.
- (b) *Business banking and asset finance* (£80 million). Lloyds TSB said that it had been successful in winning the business accounts of TSB customers following the merger in 1995 and that it could achieve similar results with Abbey National customers running their own businesses. In asset finance, Lloyds TSB was confident that its combination of customer segmentation, mailing management, risk management and delivery through specialist loan centres would increase cross-sales of personal loans and related products to the First National customer base.
- (c) *General insurance* (£70 million). Lloyds TSB considered that the Abbey National customer base provided a substantial opportunity to increase sales of general insurance products, particularly payment protection and household insurance.
- (d) *Wealth management* (£20 million). Lloyds TSB believed it could generate increased revenues from extending its wealth management products and services to Abbey National customers and from increased sales of life, pensions and unit trust products.