5 Views of main parties

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General

5.1. This chapter summarizes the views of Lloyds TSB and Abbey National, the main parties in this inquiry. These views were presented in a number of written submissions and also in hearings. The chapter deals first with the views of Lloyds TSB and second with those of Abbey National.

Lloyds TSB

Background

5.2. Lloyds TSB said that it was a UK-based financial services group providing a comprehensive range of banking and financial services in the UK and overseas. The bank comprised two divisions: UK Retail Financial Services, and Wholesale and International Banking. UK Retail Financial Services, in turn, incorporated three business activities: UK Retail Banking, Mortgages, and Insurance and Investments. For a breakdown of the activities of these two divisions see paragraphs 3.11 to 3.13.

5.3. The retail activities of the group had been built on its branch network. Excluding Cheltenham & Gloucester, the network comprised over 2000 branches in England, Scotland and Wales. More recently alternative distribution channels had become important. In November 1998, for example, Lloyds TSB had launched its Internet banking service, Lloyds On-line, for personal and business customers. In addition PhoneBank and PhoneBank Express were free telephone banking services, available to Lloyds TSB customers, which allowed customers to check account balances, transfer funds between Lloyds TSB accounts, pay bills, set up standing orders and buy products.

Jurisdiction

5.4. Lloyds TSB agreed that its proposed merger with Abbey National was one qualifying for investigation under the FTA. If it were concluded that a merger between the bank and Abbey National was not against the public interest, it would be Lloyds TSB's intention to proceed with the merger subject to reviewing and updating, as necessary, the relevant financial calculations.

Competition in the banking industry

5.5. Underlying its case that its proposed acquisition of Abbey National could not be expected to operate against the public interest was Lloyds TSB's contention that competition was vigorous and dynamic in the financial services sector. This sector was undergoing fundamental change. The forces of dynamism and competition were bearing on the PCA and SME markets and these forces would continue irrespective of a Lloyds TSB/Abbey National merger. 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. The proposed Halifax/BoS merger was but the latest indicator of these competitive forces.

5.6. The number and variety of suppliers of banking services had increased significantly in recent years. For example, 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 the Post Office, with 17,500 post offices,

hoped to negotiate further agency agreements and ultimately to replace many bank branches, particularly in rural areas. In this way, and under developments in the proposed Universal Banking Services scheme, the Post Office would facilitate competition between banks. There had also been an expansion of services offered by demutualized former building societies and by the building societies themselves. The PCA customers of Alliance & Leicester, for example, had the benefit of access to post offices for cheque and cash handling, as had those of Lloyds TSB itself, Barclays, the Co-operative Bank, Smile and cahoot. In addition there had been entry of insurance companies into the mortgage and savings markets and the entry of organizations outside the financial services industry into the banking services market.

5.7. Advances in technology now provided new means of delivering banking services and new routes for competitors to enter the market—telephone and Internet banking together with digital television were the key manifestations of these advances. Lloyds TSB had invested around £[✂] million in call centres and Internet banking to support 'anywhere, any time' banking, mainly in 2000. Services had increased and improved in the PCA sector, led by free-in-credit banking and added-value accounts, longer branch opening hours, improvements in the money transmission system and the growth of ATMs and the services they provided. (There were now 32,000 ATMs in the UK, many on sites away from bank branches, such as petrol stations.) Since January 2001, the major banks' ATMs had effectively amounted to an open access network—customers of LINK members could use all LINK ATMs and over 80 per cent of ATMs in the UK could be used by any such customer free of charge. Finally, there had been a number of recent notable changes on the demand side. Among the most significant were the increasing use of debit and credit cards. Consumers were also becoming increasingly discerning and aware of the range of products on offer.

5.8. These changes had had a significant effect on the structure of the markets in the retail sector. In particular, significant elements of the current account package could be provided by new entrants solely by telephone and/or through the Internet. New entrants were putting competitive pressure on the traditional banks: a prominent example was the high rates of interest offered by telephone and Internet suppliers operating at a much lower cost levels than the traditional banks with branch networks. These developments had been reflected in a reduction in the number of branches—a trend that had continued since the early 1990s. Since 1995 there had been a reduction of some 16 per cent. The developments had also had a marked effect on competition. Changes to pricing and product features were easily replicated, and new technologies and distribution channels (for example, WAP phones), not being proprietary, could be adopted by all providers.

5.9. The traditional banks had embraced competition by introducing a range of new products. Those banks and building societies which were branch-based all competed strongly at branch level. Branches were an important part of the overall facilities which Lloyds TSB had provided to its customers; and it encouraged its branch staff to compete intensively and fairly for new business for all its products. Staff were rewarded by reference to their sales success on a basis which also incentivized them to provide high-quality service and advice. Branch activity was declining but the decline was slower than Lloyds TSB had thought it would be. If a bank wanted to have a high share of the mass market as it was at present, especially for current accounts, a national branch distribution network was an essential part of the offering. However, NAB had shares of 16 and 17 per cent in Yorkshire & Humberside and Scotland respectively although its share nationally was 4 per cent. The former building societies had proportionately fewer rural branches and seemed able to operate effectively with a smaller network than the clearing banks. And one only had to look at Egg, which had over 1 million credit card holders, all supplied exclusively through the Internet, to see how technology was changing traditional reliance on competition at branch level.

5.10. The current level of competition was such that there was an unprecedented wealth of choice for customers. It was evidenced by the fact that, while the so-called big four banks had about 70 per cent of existing current account business, in terms of new business their share was much less. Moreover among other personal banking products they had only 37 per cent of credit cards, 26 per cent of personal loans, 26 per cent of mortgages and 32 per cent of savings. The intensification of competition that had occurred was such that the overall profitability of Lloyds TSB's own businesses had for some time been flat. Indeed, looking forward, there was the prospect of a fall in the overall level of profitability in its core retail businesses. The bank acknowledged that its profitability had been very good and competition less intensive in the past; looking forward this was not its expectation, however. [

Details omitted. See note on page iv.

]

Strategic issues

5.11. In its annual strategic plan Lloyds TSB said that it had, in recent years, been one of the most successful banking groups in the world, underpinned by a focus on maximizing shareholder value. It noted, however, that its revenue growth had not kept pace with national income growth over the last ten years. This and other statements on strategic matters relevant to the inquiry are set out in Appendix 5.1.

Reasons for the merger

5.12. Lloyds TSB said that Abbey National had put itself into play by announcing in November 2000 that it was in talks with BoS. Lloyds TSB had made approaches to Abbey National well before then but Abbey National had said that it wanted to maintain its independence. So Lloyds TSB had felt entirely justified in intervening when it did. The bank believed that the competitive market dynamics acknowledged in the Cruickshank report, changes in technology and falls in margins would continue to intensify, and would drive further consolidation of the financial services industry across Europe, the USA and other major markets.

5.13. The fundamental reason for the proposed merger was to achieve efficiencies in the parties' retail banking operations and to enhance Lloyds TSB's competitiveness and its ability to compete in the UK market. This did not mean that, if the merger did not proceed, the bank would be strategically impaired. But lower unit costs were essential to compete effectively in the increasingly competitive market and to support a branch network. The motivation for the acquisition was purely to support Lloyds TSB's core UK business through the efficiencies which the transaction would offer. The key was the enhancement it would provide to Lloyds TSB's profitability and to its earning capacity, competitiveness and market value. The bank had not at this juncture identified an element of the expected synergy benefits which would pass to the consumer. Indeed, its internal papers dealing with the planned bid for Abbey National (see Appendix 5.2) made 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. The acquisition would also put Lloyds TSB in a better position to pursue its longer-term aspiration of seeking to diversify beyond the UK.

5.14. In the same internal documents concerning the bid, 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 IFAs; financial strength and proven products (among which it highlighted mortgages, savings, life assurance, treasury and consumer finance). Lloyds TSB also stated in these papers 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, 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 that leadership position. Moreover in a world of declining margins the efficiencies available through the merger would enhance Lloyds TSB's competitiveness.

5.15. Lloyds TSB also believed that the combination of its and Abbey National's products, skills and distribution capability would enable the enlarged group to provide enhanced services to customers. Specific consumer benefits would include the extension of Lloyds TSB's agency arrangements with the Post Office to all personal customers of Abbey National. In addition Lloyds TSB was the only bank that had a public commitment not to close any branch where, on 1 May 2000, Lloyds TSB was the 'last bank in town'. It was the intention of Lloyds TSB to extend this arrangement, too, to all Abbey National branches, although the high degree of branch overlap between Lloyds TSB and Abbey National would mean increasing the number of such branches by only four. Finally, the merger would increase access for Lloyds TSB's and Abbey National's customers to the combined group's financial products and services. Lloyds TSB also intended to relocate some duplicated ATMs, installing 25 in remote locations and 25 in deprived areas, as designated under its New Deal for Communities scheme (see paragraph 5.32). 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.

5.16. As far as the expected cost and revenue synergies were concerned, Lloyds TSB anticipated that the transaction would result in annualized cost savings of at least £700 million in the fifth financial year

following its completion. These would be derived from the combination of internal functions, from the integration of retail banking networks and systems including co-location of branches, and from the combination of other businesses. The enlarged group was expected to generate increased revenue of some £450 million by the fourth year after the merger, yielding an additional contribution to profit before tax of about £250 million, derived from the personal banking, business banking and asset finance, general insurance and wealth management sectors. Since, in Lloyds TSB's submission, the markets affected by the merger were competitive, the bank would be obliged to pass on to customers the benefits of increased efficiency in lower prices. [*Details omitted. See note on page iv.*]

PCAs

The market

5.17. The reference was, as the DGFT's advice had indicated, primarily concerned with the proposed merger's effect on competition in the market for current accounts. Lloyds TSB considered that current account banking for personal customers was a separate market. PCAs were defined as a package of money transmission facilities including as a minimum:

(a) cash and cheque deposits and cash withdrawals; and

(b) standing orders, direct debits and/or a cheque book.

Where offered, debit cards and overdraft facilities were considered to form part of this package of services. Short-term overdrafts as a form of cash-flow cushioning might be considered to be part of the PCA product. Where customers used longer-term overdrafts they were substitutable by other forms of personal lending but, as a practical matter, it was difficult for Lloyds TSB to distinguish between uses of its overdrafts.

5.18. So far as concerned the geographic market definition, Lloyds TSB believed the supply of PCAs to be a national market. This was because:

(a) individual suppliers' terms and conditions (including prices) were uniform throughout the UK;

(b) advertising, marketing and other promotional activity was generally conducted on a consistent national basis; and

(c) new formats of PCA services (telephone, Internet, interactive television) were provided on a consistent national basis.

Although access to a branch network was considered an attractive feature by a proportion of customers, that did not suggest there were separate local markets, given the homogeneity throughout the UK of competitive conditions. In any event no substantial issues would arise from the merger on a regional or local basis. This was exemplified by the fact that, of the 693 'neighbouring locations' (ie locations within the M25 where branches of the two banks were within one-quarter of a mile of each other, or outside the M25 where they were within 1 mile of each other), just ten would have a branch of only one other provider of PCAs within the same radius as a result of the merger and only five would have none. 95 per cent of such locations would have three or more competitors within the relevant radius. This itself demonstrated the competitiveness of the high street and the adequacy of choice at a local level that would continue after the merger.

5.19. Lloyds TSB argued that, because the basic PCA service was free to the customer, quality of service was the predominant element in the customer's decision to select and remain with a PCA supplier. Other suppliers could target particular elements of the PCA package, especially those elements that were the most profitable. That could occur where PCA suppliers emphasized particular features in their offering to PCA customers; or where providers of financial services, which did not market PCA services, supplied a service (such as a savings product or a loan product) that was an alternative to a particular element of the PCA service.

5.20. Along with free current account banking, most PCA providers offered a debit card and a free-to-arrange overdraft. Thereafter there were differentiated offerings designed to attract new customers and retain existing customers. These differences could be in aspects of service format such as interest on credit balances, overdraft terms and added-value items (for example, free insurance); and in service functionality, for example in telephone/Internet banking/digital television account management and in branch services, where Lloyds TSB had invested in improvements, including automation and staff training, in order to reduce queue times and improve customer services.

5.21. At the product level, instant access saving accounts, accessible through ATMs, were available. Credit-card-based cheque-book accounts were in part substitutable for current account cheques and debit cards. Credit card usage could in part substitute for debit card and cheque-book use. Personal loans and other forms of consumer credit might substitute for overdrafts.

Entry into the PCA market

5.22. Lloyds TSB said that the Cruickshank report had shown that eight players had entered the PCA market between 1989 and 2000; and *Money£acts* listed 45 providers of PCAs as at March 2001. Providers other than the traditional banks now represented real alternatives for consumers. There had been significant entry and growth both by providers of the full PCA service and by others who supplied particular services which were alternatives to components of the PCA service (such as personal loans and credit cards). In addition new entrants were able to secure cheap money transmission services via agency agreements rather than direct membership of APACS. Some of the new entry had been by well-known institutions operating in other financial markets, some by firms with well-established businesses and brands in other sectors and some by existing personal financial services operators, notably the former building societies, which had restructured and expanded their operations. (The examples of recent entrants into the PCA market particularly mentioned by Lloyds TSB, as opposed to those for other personal banking products, were Citibank and Virgin.) Lloyds TSB agreed that there was less new entry into the PCA market than in other financial products, but that was because PCAs were not very profitable. This was probably the reason why no supermarkets had entered the PCA market although they had entered the markets for some other personal financial products such as credit cards, loans and savings. There was, nevertheless, growing sector-wide recognition of the role of the PCA in the context of the relationship with customers, both for its own sake and as a platform to cross-sales.

Switching

5.23. The DGFT had said that the low level of switching was evidence of a lack of competition. That was mistaken. Competition was effective and both the traditional high street banks and more recent entrants competed vigorously. The incidence of switching and the threat of it brought significant pressure to bear on all banks. There was also a widespread concern that there were substantial barriers to switching. These concerns were overstated and, as the DGFT had noted, the banking industry was taking steps to reduce the barriers. Switching between PCA providers had increased. In 2000, 30 per cent of new accounts represented switches from one provider to another compared with 25 per cent in 1996. A number of banks now offered inducements to consumers to switch PCA providers: Alliance & Leicester offered a £50 cash payment; and Citibank offered free flights. Switching was set to become more automated in future. BACS had the unanimous commitment of its 15 member banks to implement an automated system for switching direct debits and standing orders by the end of 2001. And Lloyds TSB had announced that it would make a unilateral commitment to facilitate switching of PCAs, by creating a new switching unit and providing the relevant information to the new providers within three days—much less than the agreed industry standard of ten days—failing which it would pay £50 to the affected customer.

5.24. In any event low levels of switching were consistent with rational customer behaviour. The financial gains that could be made by switching PCAs, unlike mortgages, was small. Moreover, over 60 per cent of all traditional high street bank customers were extremely or very satisfied with the existing provider (NOP, September 2000). Only 5 per cent had said that they were dissatisfied. A DTI report on switching had found that, although 79 per cent of PCA customers had not considered switching, 73 per cent had said that this was due to satisfaction with their current supplier. Lloyds TSB's own extensive and frequent research of its customers consistently showed high levels of customer satisfaction and willingness to recommend Lloyds TSB. This evidence was more thorough, robust and reliable than CA's assertions to the contrary.

Innovation

5.25. The longer-established or traditional high street banks had been at the forefront of innovations in the PCA market. Lloyds TSB 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. For example its Lloydstsb On-Line service for personal and business customers aimed to register 4 million of its customers by 2003. This was one of a number of online innovations. In 1997 it had been the first high street bank to create agency arrangements with the Post Office.

PCA profitability

5.26. The basic PCA service generated only modest levels of profit (for example, Lloyds TSB had made £[✄] million net after tax in 2000 on an income base of £[✄] million). The economic rationale for continuing to provide a PCA service lay in the substantial contribution that it made to fixed overheads and the opportunity that it provided to sell other products to PCA customers, although the effectiveness of the PCA as a gateway was limited. Other products such as mortgages also provided these gateways, and markets for the other products which might be sold to PCA customers were highly competitive.

5.27. Even if the supply of PCAs was not significantly profitable, as an incremental activity by a player with an existing branch network based on a mortgage/savings business, it could be attractive in its own right and certainly was when seen as a platform for further cross-sales. For an entrant without the costs of a branch network and able to use low-cost distribution methods (telephone or Internet), PCA economics might be attractive. With new entry and cross-entry by banks, building societies and others into mortgages, credit cards, savings and increasingly PCAs, it was now established firmly in the minds of consumers that there were large numbers of service providers. The likelihood, therefore, was that entry and expansion in PCAs would continue regardless of their intrinsic profitability.

5.28. Lloyds TSB said that it did not have a significant back book of higher-priced PCAs from which a degree of cross-subsidization to new customers' PCAs was funded. In general the same terms were given to new customers as to existing customers. [*Details omitted. See note on page iv.*] The bank did not, except to a very small extent, negotiate special terms for its PCA customers. And it did not make offers to new customers that it would not also make to its existing customers, except for concessions on overdrafts in a switcher's package for a limited period and for youth and student accounts. It acknowledged, however, 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 as customers chose to switch to added-value accounts.

5.29. A considerable number of the new entrants to the market were pricing extremely aggressively—unsustainably so for the long term. It would be ruinous for Lloyds TSB to follow suit. In any case, its customers valued service quality, access to branches and ATMs more than getting interest on current account balances. The average PCA customer did not expect to have significant sums of money in a current account. Lloyds TSB said that [*Details omitted. See note on page iv.*]. The bank had therefore invested in 'anywhere, any time banking' as a PCA service feature highly regarded by most customers. Looking at Halifax's recent offer of 4 per cent on current account balances, Lloyds TSB said that competitive forces might in due course force the bank 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.

5.30. Lloyds TSB said that the profit it made on individual customers varied hugely, depending on factors such as levels of activity, bad debt and other product holdings. Based on PCA results alone and taking all costs into account, [✄] per cent of its PCA customers were loss making, 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 depended heavily on the type of customer that it had. 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 that 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. 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. By May 2001 it had accepted 25,000 customers for the basic account.

5.31. [

Details omitted. See note on page iv.

]

PCA competitiveness

5.32. The PCA market was not a particularly concentrated one. Lloyds TSB 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. The Cruickshank report's conclusions on international comparisons, taken with subsequent developments, supported the view that UK customers for PCAs were well served. The market was highly competitive, with the traditional clearing banks and current and former building societies all competing for the mass market of customers. Lloyds TSB could grow its business in this environment only through creating products, services and relationships that customers really valued. The bank's next programme of competitive PCA initiatives was its New Deal for Communities scheme and included the following:

- significant changes to its overdraft charges, for both unauthorized and authorized overdrafts;
- introduction of 'real time banking', providing up-to-the-minute account information and instant access to funds from cheques drawn on Lloyds TSB accounts;
- the offer of financial healthchecks with the promise either to save the customer money or pay £50;
- the launch of the Platinum added-value account which offered benefits worth over £200 a year;
- the launch of a 'Youthbank.com' series of products directed at students, graduates and other young people; and
- the launch of a new 'Budget Account'.

5.33. Lloyds TSB agreed that in the past PCA competition had been somewhat more limited than in other retail financial sectors. Competition was nevertheless adequate. The bank pointed to several recent developments in PCA products which 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 (Lloyds TSB itself had announced in April 2001 that it would drop overdraft usage fees with effect from September 2001); overdraft buffer zones free of interest and/or fees; and the provision of assistance and incentives for switchers.

5.34. The absence of charges for most PCA transactions was a reflection of competition between providers. Lloyds TSB 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.

Branding issues

5.35. The bank regarded the brand image it conveyed in the financial services area as very important. The data from market research companies such as MORI showed that the Lloyds TSB brand was a strong one and that it had established itself as the UK's leading financial services brand in the short time since the Lloyds Bank merger with TSB. Lloyds TSB now had more customer recruitment, sold more products

and experienced less attrition than it had ever done. Looking more widely at the industry generally, there were no barriers to entry for other companies, including those in non-financial markets, which had a strong and trusted brand image of their own.

5.36. The bank regarded itself as being clearly differentiated in brand terms from the other leading banks. It was measured as being more helpful and supportive to customers; and more accessible due to its multichannel distribution strategy. This contrasted with its competitors. Barclays had positioned itself as big in a big world, HSBC as having a global reach with its financial services and NatWest as offering another, different way. These brands and others such as, particularly, Halifax were distinctive and well positioned. The strength of the Lloyds TSB brand did not, however, mean that it could charge higher prices for its products. What it did mean was that it allowed the bank to obtain more customers because of its brand strength.

5.37. Commenting on the Abbey National brand, Lloyds TSB said that it was a relatively strong brand but it was not as focused and as clearly positioned as it had once been with its 'Abbey habit' image and the resulting strong association in people's minds with savings and mortgages. As Abbey National had sought to broaden its offering, its brand had lost its distinctiveness in the market. Although Lloyds TSB agreed that Abbey National had in 2000 the highest PCA share of any supplier outside the big four, albeit only marginally ahead of Halifax, it said that it was certainly not as strong a brand as Halifax, which had firmly registered the point about 'giving you extra' in people's perceptions, or as the other leading banks.

Other personal financial services

5.38. Lloyds TSB said that Abbey National and itself were both active in the supply of a number of other financial products. Whilst the DGFT had not excluded the possibility of competition concerns affecting those products, such concerns did not form the basis of his recommendation to refer the proposed acquisition for investigation. That reflected, correctly, an assessment that competition would not be adversely affected in any of those markets. They were all competitive and the parties' combined position was, in any event, insufficient to have any adverse effect on competition, although the merger would give Lloyds TSB leading market positions in a number of financial services products for individuals.

5.39. So far as concerned the relationship of PCAs to other products and the question of cross-selling, the relevant points were these:

- Lloyds TSB did not tie any product to any other accounts and had no intention of doing so.
- PCAs established a supplier/customer relationship on which cross-marketing could develop but the level of cross-selling in the sector was relatively low. Average PCA customers held between seven and eleven financial products in total, though on average they held only two with their current account providers. For Lloyds TSB the figures were 2.2 out of 7.9.
- Lloyds TSB expected to improve upon Abbey National's performance in cross-selling but this would not be on a tied basis.
- Successful, new entrants in other products such as mortgages (Standard Life), credit cards (MBNA), savings (Egg) and consumer loans (Tesco) had achieved significant new business without offering PCAs.

5.40. The main products in the personal financial services sector, other than PCAs, in which Lloyds TSB and Abbey National had varying degrees of overlap were mortgages, credit cards, consumer credit/finance and savings.

Mortgages

5.41. The merger would produce a combined share of 22.6 per cent for the stock of mortgages and 23.8 per cent for new ones. But it was not a highly concentrated market and there were a large number of providers. Entry had been facilitated by an increase in mortgages originating from outside branch networks, with an increased use of intermediaries and direct channels, principally telephone and Internet. In 2000, 31 per cent of new mortgages were arranged through IFAs or mortgage brokers, a rise of seven

percentage points since 1997. As a result there was no need for individual companies to build their own distribution network, so entry was much easier. The increasing importance of the telephone as a distribution channel was evidenced by the entry of direct providers during the past decade. As well as these new entrants, several traditional mortgage lenders had established direct operations in addition to their branch-based services, for instance Cheltenham & Gloucester TeleDirect. Consumers now had the opportunity to use the Internet as well as the telephone to apply for mortgages. Search and information costs had declined due to the ready availability of financial information on the Internet and in newspapers and specialist publications such as *Money£acts*. There was also evidence that a substantial proportion of mortgage lending was switched between providers each year.

5.42. Recent developments, for example HSBC promising that in future its standard variable rate mortgage would not exceed base rate by more than 1 per cent, had further intensified competition in the mortgage market. As a result of the move started by HSBC and continued by Nationwide, Halifax and Abbey National, most of the big players were now offering keen rates for new borrowers and had repriced their back book as well. As a result the average mortgage margin was now down to about 1 per cent. The fact that there was a credible threat of customers switching mortgages had compelled mortgage providers to offer competitive rates to existing as well as new customers. Lloyds TSB had, however, decided against converting its mortgage customers paying the standard variable rate to a tracker rate at given percentage above base rate, as Abbey National had attempted. It had looked at the implications of leading down the market on price in this way but had concluded that it would not be practicable; its pricing was already broadly competitive.

Credit cards

5.43. The combined Lloyds TSB/Abbey National share of this market would be 15.3 per cent (stock) and 6.8 per cent (new). The Cruickshank report had acknowledged that the extent of shopping around by consumers was increasing and that there was evidence that consumers were buying new products on the market either as an additional card or as a substitute. In recent years the market for credit card services had become highly competitive, with many new entrants. *Money£acts* listed 61 participants in this sector. This merger would produce only an insignificant increment in share of both existing and new accounts. Furthermore, Abbey National was a declining force in the credit card market: it had had a share of 2.5 per cent of new accounts in 1997, which had declined to just 0.6 per cent in 2000.

Consumer finance

5.44. Here the post-merger shares would be 17.7 per cent (stock) and 14.4 per cent (new). The consumer credit sector was highly fragmented and, as with other personal finance markets, the number of providers had increased substantially in recent years. *Money£acts* listed 50 unsecured personal loan providers. Recent new entrants in consumer lending included Egg, Tesco, Sainsbury, Capital One, Prudential, MBNA, Liverpool Victoria and Beneficial Savings Bank. The Cruickshank report had acknowledged that the market was not concentrated and was characterized by a high number of small and emerging players. Branch-based lending was losing market share to direct lending and retail. And aggressive new lenders were promoting discounted headline pricing to attract borrowers.

Savings

5.45. Following the merger, the share here would be 22.9 per cent (stock) and 17.3 per cent (new). Lloyds TSB said the general consensus was that the savings market was competitive and that the merger would not have adverse effects on consumers. A wide choice of savings providers was available to consumers who were prepared to shop around, whether through branches or otherwise, and several traditional providers were losing share to new entrants. Direct providers had lower costs, associated with service provision based on new technology, not branches. By offering highly competitive interest rates and good service, new entrants had been able to secure 10 per cent of total savings inflow in the first half of 1999. Egg had captured 6.3 per cent of new accounts in its first year of operation and 4.9 per cent in 2000. *Money£acts* listed 121 participants offering savings products. The Cruickshank report had noted that this market was not concentrated and was subject to effective competition. Moreover, competition in the savings market (like mortgages) was facilitated by readily available impartial information. Switching between accounts was relatively costless, and the success of new entrants demonstrated the market's

openness. A wide range of savings products were available through non-branch distribution channels such as telephone and Internet accounts. The interests of consumers were also protected through the Banking Code.

SMEs

5.46. In Lloyds TSB's view, there were no implications of the proposed merger for the SME market. It was true that the DGFT's advice had touched upon the position in relation to SMEs. It was also true that SMEs valued access to a branch network. However, Abbey National was scarcely present in the SME market. It was a small, niche operator available only to sole traders and two-person partnerships. It did not offer an overdraft facility, which Lloyds TSB described as the cornerstone of a relationship-based offer to SMEs, and could not, therefore, be considered an effective competitor in the liquidity management part of the SME market—current accounts and short-term deposit accounts. It had announced its intention substantially to develop the SME business but that was entirely speculative. There was, moreover, no reason to believe that Abbey National would be any more likely to succeed than several other competitors which had announced their intention to expand their SME activity, or that loss of its independence would materially diminish the overall level of competition in the SME market. To the extent that there were deficiencies in the competitive conduct of suppliers in the SME market, they should be, and could be expected to be, addressed through the parallel SME monopoly inquiry: the proposed merger did not add to them or otherwise adversely affect competition in this market.

5.47. With 19 per cent of the market, Lloyds TSB was the third largest provider of services to SMEs, after RBS/NatWest and Barclays. Abbey National, however, had a minimal share of only 1 per cent and only some 3 per cent of all new SME business. Even if it were true that there were barriers to entry to the SME sector, the merger did nothing to raise them. Following the merger a number of potential entrants would remain. For example, Alliance & Leicester had stated that its target was to acquire 10 per cent of new SME accounts by the end of 2003, and to have built a market share of 10 per cent of the total SME stock within a further two years. The Post Office was attempting to renegotiate its contract with Alliance & Leicester so that other banks could also use post offices for small businesses. And Halifax and BoS, separately, had recently been reported as intending to expand in the SME banking market (see also paragraph 5.58).

5.48. Lloyds TSB said that its policy in offering concessionary terms to some switchers had not changed in recent years and it referred to its offer of interest-free overdrafts for customers switching to it from other banks for a limited period. 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'. 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. It 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.

The effects of the merger

5.49. Lloyds TSB firmly believed that its proposed acquisition of Abbey National could not be expected to operate against the public interest. Its share of new accounts in 2000 was less than those of Halifax, Alliance & Leicester and Nationwide. Measured by the stock of PCA accounts, the merger would generate a combined market share of some 27 per cent. In HHI terms this would mean the PCA market remaining moderately concentrated post-merger. Competition was vigorous and dynamic. This was bearing on the PCA and SME markets and would continue to do so irrespective of the merger. The merger would not diminish, let alone substantially lessen, competition. Numerous competitors, both branch- and non-branch-based, would ensure that that did not happen. Indeed, Abbey National was not the particularly effective or maverick competitor that it was sometimes portrayed to be. The rate that it paid on credit balances was not the highest and its overdraft rates were not the best. Its record of customer acquisition and retention was poor. It had not sought to develop its branch-based activity. In addition, Abbey National's competitive presence in the SME market was at present largely speculative. Lloyds TSB did not believe that the merger would change the competitive landscape in any way.

5.50. The acquisition of Abbey National would mean buying its customer base, a considerably quicker and less expensive operation than mounting an aggressive campaign to attract Abbey National's customers. The acquisition of Abbey National's PCA customers was not, however, the main reason for the merger proposal. Abbey National was a fine business but Lloyds TSB believed that it could run that business better than Abbey National had. It believed that recently Abbey National had taken its eye off the ball. It had lost focus on the PCA and other main retail banking markets; it had publicly declared its intention of building its business overall by diminishing its dependence on its retail arm—mortgages and savings. This was hardly consistent with a company keenly seeking to develop its retail franchise.

Competition

5.51. Looking at branch-based competition, Lloyds TSB said that in terms of branch overlap the merger would not materially reduce choice at a local level. Nor would it remove an essential branch-based competitor. It could not, therefore, be expected to operate against the public interest on this score. There was extensive competition between branch-based competitors other than Abbey National and from other forms of supply. This would continue to develop further post-merger. Further, Lloyds TSB did not consider that the merger would convey overwhelming advantages based on the size of its branch network. Any relationship between the size of a bank's branch network and its ability to attract customers had considerably weakened, with increasing competition and technological innovation altering the range of products and distribution channels available to customers. Figures for new account openings suggested that the branch network and the reputation of the established banks might be less significant in winning new business than was sometimes suggested. Ownership of a bigger branch network would not necessarily make a current account provider more attractive to consumers. Abbey National's own shrinkage of its branch network suggested that it shared this view. Its role as a branch-based competitor in the competitive process had not been of such significance that its removal could be expected to operate against the public interest.

5.52. There was a growing number of alternatives to the traditional bank branch for a consumer wishing to transact basic banking business such as paying in and withdrawing cash. The 17,500 post offices already provided core banking services free of charge to customers of Lloyds TSB, the Co-operative Bank, Alliance & Leicester and Barclays. And the Post Office was keen to extend similar services to other banks. Supermarkets and convenience stores offered cashback facilities, and Tesco also accepted deposits. In addition ATM numbers, their functionality and location away from banks, were all increasing, while branch numbers were, in contrast, declining. The Post Office had plans to install 3,000 ATMs and had announced that it was in advanced discussions with LINK to connect its post offices to the major high street banks and building societies. This would enable their customers to use post offices for simple transactions. Furthermore 30 per cent of all current account holders now used telephone banking and 6 per cent used Internet banking. This latter figure would increase given that over one-quarter of all current account customers had PC-based Internet access and, as noted, these new channels had lower costs of supply than traditional branch networks. Competitive pressures in PCAs were not, therefore, confined to those between branch-based operators.

5.53. Abbey National's customer satisfaction levels had also declined recently as a result of the introduction of a £5 charge to customers paying a bill over the counter at an Abbey National branch. This fee had been withdrawn in January 2001, but the ability to pay bills at branches had been withdrawn simultaneously. These measures and others were thought to have been introduced by Abbey National to dissuade customers from using branches and to encourage use of other distribution channels. It had also announced that it would reduce counter positions by 20 per cent in an effort to discourage branch use. Factors such as these appeared to be reflected in Abbey National's recent performance in the PCA market: its rate of attrition was poor for its peer group, as was its rate of growth in new PCAs, and it was losing share.

5.54. Lloyds TSB did not accept that competition between the traditional high street banks was muted. In any event though, Abbey National was not the key player implicit in its assertions and its acquisition by Lloyds would not substantially lessen competition from outside the traditional high street banks. There would continue to be competition from Halifax and Nationwide, which were outperforming Abbey National in the PCA market, and from Alliance & Leicester which was outperforming Abbey National on net switches.

Effect of the Halifax/BoS merger

5.55. Asked to comment on the proposed Halifax/BoS merger, Lloyds TSB said that, even without that merger, Lloyds TSB's acquisition of Abbey National could not be expected to operate against the public interest. The financial services markets were becoming increasingly competitive through a variety of changes. The merger of Halifax and BoS was another step in this process. It would allow these two parties from outside the big four to compete even more effectively across a broader range of products and geography. Both already competed vigorously, even outside their core markets, through a combination of innovation and a policy of diversification. Halifax had acquired new brands and products. Its merger with BoS would complete its product set and it would now have a customer franchise comparable with those of Lloyds TSB, Barclays, HSBC and RBS Group.

5.56. The merger of Halifax and BoS would also create the fifth largest bank in the UK, with a valuation approaching the same order as those of Barclays, Lloyds TSB and RBS Group. Consequently if, contrary to Lloyds TSB's submission, particular value was seen in there being a 'fifth force' in banking, HBOS would fulfil such a role. As a consequence Lloyds TSB's acquisition of Abbey National would not remove the possibility of a fifth force being created. Moreover, if this inquiry concluded that the big four had advantages of scale and scope it should also recognize that these were more attainable by Halifax than Abbey National, given the former's more extensive network and product range, and that would now be achieved through the merger with BoS. In particular, if it were held that the 'anywhere, any time' multichannel model which Lloyds TSB espoused required scale, HBOS would have that scale and so could be expected to be a fifth force of that type.

5.57. HBOS had stated that it aimed to 'make life tough' for the major players in the personal financial services and business banking markets. This would mean increased competition in price and product innovation. HBOS was likely to develop Halifax's aggressive campaign to win PCA market share, primarily through payment of a much higher rate of interest on PCAs. Lloyds TSB said that in the six months to March 2001 Halifax had taken a market share of 8.6 per cent of all new PCAs, far in excess of its share of the stock of PCAs. In the same period, Lloyds TSB's share of new PCAs had fallen to 17.4 per cent and of existing business to 21.9 per cent. More than 50 per cent of the accounts Lloyds TSB was losing were going to Halifax. Extension of Halifax's aggressive PCA approach to BoS and Scotland was likely to mean a response from RBS; in which case it was difficult to see that the RBS Group could avoid doing likewise in England and Wales through NatWest, particularly if Lloyds TSB itself introduced an interest-bearing PCA product (see paragraph 5.69).

5.58. The new company would have a branch network throughout the UK and a leading Internet banking product in Intelligent Finance. Halifax/BoS had also stated that HBOS would become a new competitive force in SME banking, which would develop from the combination of BoS's skills and Halifax's brand and geographic penetration. The merger would also enable both companies to leapfrog Abbey National in the PCA market, in branch penetration (around 1,250 branches compared with Abbey National's 744), in geographical coverage and in market share. Lloyds TSB already regarded Halifax as a more effective PCA competitor than Abbey National. HBOS had stated publicly an intention to generate revenue synergies of £315 million by the end of the third year of the merger. Assuming a marginal cost:income ratio of 35 per cent, this implied total additional revenues of some £500 million, which equated to an increase in revenues of some 8 per cent. Such growth was going to be achieved only through aggressive cross-selling and competition on both price and product innovation. The merger would also undermine any suggestion that the so-called big four would inevitably dominate or acquire all other players.

Customer service

5.59. Lloyds TSB said that 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.

Access to financial services

5.60. Lloyds TSB said that its acquisition of Abbey National would have no adverse effects on issues relating to access to financial services. On the contrary, it would increase access, particularly for vulnerable consumers—those with limited access to transport, the elderly and customers with disabilities. Abbey National's personal customers who currently had approaching 750 branches available to them would be able to use more than 2,200 Lloyds TSB branches and, since Abbey National was mainly based on major high streets, its customers would now be able to access financial services in more rural and satellite urban communities. They would also benefit from access to post offices to carry out essential banking transactions. This helped customers in areas where branch representation was low or where customers found it difficult to get to a branch. It also created additional business for local post offices, particularly those in rural or deprived areas. Finally, Lloyds TSB had been one of the first banks to offer a basic bank account, under developments in the proposed Universal Banking Services scheme, to meet the needs of the unbanked. It would make this account available in Abbey National branches. Unlike Lloyds TSB's basic account, Abbey National's Instant Plus product did not meet PAT 14 standards.

Employment

5.61. The merger of Lloyds Bank and TSB had provided wider development and career opportunities for staff and Lloyds TSB was confident that a transaction with Abbey National would also improve career opportunities for the substantial majority of employees. Lloyds TSB invested substantially each year in training, education, and career and personal development programmes through its corporate university. It would also extend to Abbey National staff its highly acclaimed Work Options programme which provided staff with the opportunity to seek flexibility in determining their work schedules. Lloyds TSB estimated that the merger would result in a loss over four years of approximately 9,000 jobs from an enlarged group with over 100,000 staff. But this would be achieved largely through natural wastage, with minimal compulsory redundancies. Annual staff turnover rate within Lloyds TSB alone was 7,000. Following the Lloyds Bank/TSB merger, Lloyds TSB had signed detailed job security agreements. These had included guaranteed protection for redundancy payments, a redundancy appeal process with union officials on the panel, and a commitment to compulsory redundancy being a last resort. Existing employment rights, including pension rights, of the employees of Lloyds TSB and Abbey National would be fully safeguarded. The union with the largest staff membership within Lloyds TSB had indicated that it supported the case for a merger as being in the interests of both Lloyds TSB and Abbey National staff.

Remedies

5.62. Lloyds TSB firmly believed that its proposed acquisition could not be expected to operate against the public interest. It pointed out that, were the inquiry to conclude to the contrary, any remedies had to be proportionate to meet any adverse effects expected from the merger. Misgivings about the operation of the PCA and SME markets were, in Lloyds TSB's view, misplaced. Even if justified, however:

- the proposed acquisition by Lloyds TSB of Abbey National would not generate or exacerbate the misgivings nor prevent or retard their erosion;
- if there were barriers to switching or if there were an absence of cost-reflective pricing, the merger would have no effect on them;
- if Lloyds TSB's profits were deemed excessive, it was not likely that the independence of Abbey National would stop this or its acquisition preserve it;
- if competition was failing, implying that Abbey National had had minimal impact on Lloyds TSB to date, then the merger would not make the position worse;
- if Abbey National was a 'bud to be protected', given the fragility of competition, then it was one of several and its removal would not be of such significance as to warrant prohibition; and
- if there were concerns about customer awareness of products, the merger would have no effect on the ability of suppliers to offer a range of products or on product transparency.

Prohibition

5.63. From this it followed that prohibition would be wholly disproportionate to any adverse effects. More proportionate, limited remedies would address any adverse effects that might be expected to arise. If the PCA or SME markets were not thought to be competitive, a key issue remained whether, and if so how, the loss of Abbey National would generate adverse effects. Given the range and number of other competitors and the ineffectiveness of Abbey National to date, Lloyds TSB submitted that this was not a case where prohibition would be required. Rather, the merger control process could be used to ensure that, through remedial commitments given by Lloyds TSB, a proportion of the benefits of the merger was passed to customers and that the competitive process was supported.

Divestment of branches

5.64. Transfer of a package of vacated branch premises could be used to address any concern that the loss of Abbey National as a branch-based competitor would unduly limit choice on a local basis in areas where a sufficient number of competitors were not currently present. However, these were few in number—around 35 where there would be two or fewer competitors as a result of the merger. Clearly it would be practicable to require Lloyds TSB to sell vacated Abbey National branch properties. However, since access to property was not an issue and Lloyds TSB's co-location programme would in any event within two to five years cause surplus properties to come on to the market, this might not be a necessary remedy to any adverse effects (or their cause) identified.

5.65. To the extent that concerns stemmed from the increment in Lloyds TSB's market share, transfer of branch-based businesses and/or customer accounts to a third party could be feasible without customer consent, through a statutory transfer scheme mechanism under the FSM Act. But this would be a complex exercise, where the interests of customers would clearly need to be borne in mind, and might be difficult to secure. In addition there were three major difficulties:

- First, 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.
- Second, divestment of Lloyds TSB or Abbey National branches and customers on any significant scale would cause significant damage to the brands and to customer relations. This would be disproportionate to any adverse effects identified and unacceptable to Lloyds TSB.
- Third, divestment of Lloyds TSB or Abbey National branches and customers on any significant scale would make the merger transaction commercially unviable.

Lloyds TSB would, therefore, be unwilling to contemplate any extensive divestment.

5.66. 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 fallback process whereby a move could be enforced. 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 that 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.

Divestment of businesses

5.67. The issues statement (see Appendix 2.1) had identified the sale of Cheltenham & Gloucester as a possible remedy. 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.

5.68. However, there was vigorous competition in the mortgages and savings markets. Cheltenham & Gloucester was not active in PCAs and its sale would not, therefore, directly address concerns in that market. Other than cahoot, which Lloyds TSB had already offered to divest if it acquired Abbey National, Lloyds TSB considered that no other Lloyds TSB or Abbey National business would be candidates for any divestment relevant to the issues raised.

Product and pricing commitments

5.69. If it were concluded that the merger would enable Lloyds TSB to impose less favourable terms on customers than would otherwise be the case; or that it would weaken the competitive pressure on Lloyds TSB or the so-called big four as to the terms and conditions that were offered for PCAs; or that the merger would enable Lloyds TSB to retain all the benefits of the merger without passing any of them on to customers and thus earn profits higher than would otherwise be the case, it would be practicable to secure that Lloyds TSB, as a condition to clearance of the merger, provided:

(a) a guarantee that no current Abbey National branch-based mortgage, savings, loans or overdrafts customer would be disadvantaged in relative price terms as a result of the merger by requiring Lloyds TSB to maintain at least existing pricing margins by reference to base rate in all existing Abbey National branch-based mortgage, savings, loans and overdrafts products for, say, two years;

(b) a guarantee that, for the same period, any such Abbey National product currently rated in the first quartile of comparable products remained in that quartile and available. This could specifically include continuing any specified, existing and innovative Abbey National SME product;

(c) an offer of a new and additional PCA product which would include the following features:

Details omitted. See note on page iv.

More details of Lloyds TSB's suggestions for *(c)*—a new PCA product—and of the possible consequential or ancillary changes to its current account range are set out in Appendix 5.3. The bank said that the proposals would secure that an appreciable proportion of the merger benefits were immediately passed on to customers and would change the competitive dynamics of the PCA market; further intensify competitive pressure in that market; and introduce an account with a more cost-reflective price structure. Lloyds TSB said that it believed the annual cost to it (that is, reduction in profit) 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. However, the bank agreed that it was possible that, as the market became more competitive, it might have to take an initiative on these lines anyway. In the separate context of the SME monopoly inquiry, Lloyds TSB argued 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.

Other commitments

5.70. Lloyds TSB also pointed out that it remained ready to implement the commitments which it had offered to the DGFT in the hope of avoiding an inquiry into the proposed merger (see Appendix 5.4),

including an offer to extend to Abbey National customers its commitment not to close any branch which was the 'last bank in town'. Lloyds TSB said that, although there were only four locations where an Abbey National branch was currently in this position, if there were concern that the branch co-location programme, consequent on the merger, might reduce access to banking services in poorly-served locations, it would be prepared to make this commitment as a formal undertaking under the FTA for five years.

Abbey National

Background

5.71. Abbey National said that it was the UK's fifth largest bank and, in terms of revenue growth, the fastest growing over the last five years. Since being the first building society to convert to a bank in 1989, Abbey National had pursued a strategy of growing its business organically, by acquisitions and by partnerships/joint ventures. It had evolved from being a narrowly-focused mortgage and savings account provider to a full-service retail bank providing a wide range of financial service products. As a diversified retail bank, Abbey National now made over half its earnings in markets other than mortgages and savings.

5.72. It had increased its number of branches from 674 in 1989 to 756 in 2000. Customer accessibility and service had also significantly improved over this period. Thirty-eight branches had been opened in Safeway stores and joint ventures had begun with partners such as Costa Coffee and Carphone Warehouse. It had also invested and innovated in money transmission systems. It was the market leader in the development of inter-bank data exchange for cheque clearing and high-speed transmission for BACS files. The bank regularly featured in 'best buy' tables. It had launched Inscape, a wealth management service, in November 2000. In 1992 Abbey National had acquired Scottish Mutual, then a small life assurance company based in Glasgow. It had rapidly grown to become the eighth largest UK life assurance company, and was soon to be enhanced by the acquisition of Scottish Provident. This would bring total group investment funds under management to over £40 billion.

5.73. In PCAs, Abbey National now had some 2.7 million customers, a 6.8 per cent share of the PCA market. At the 2000 results presentation, the bank had confirmed its intention to grow its current account base by 1 million new customers over the next three years. Abbey National had achieved growth in customer numbers by offering customers more attractive product offerings in price, choice and convenience, through a national branch network.

5.74. Abbey National also provided financial services to businesses and larger corporate clients. SMEs were served through two main channels under common management. Abbey National Business and Professional Banking aimed to provide an attractive alternative to the big four banks and had announced plans in June 2000 to win 5 per cent of the SME banking market by 2005. And First National, a wholly-owned subsidiary with assets of £10.8 billion, provided asset-backed finance in vehicle contract hire, equipment leasing and hire purchase. Abbey National had built a wholesale banking presence from scratch over the last 12 years through its wholly-owned subsidiary ANTS, which now had £100 billion of assets. It specialized in providing funds for structured finance and equity finance and provided about 15 per cent of the UK's social housing funding. It was a leading provider of private equity finance to businesses. In July 2000, it had also completed the purchase of Porterbrook, one of the three train rolling stock companies. In addition, Abbey National was the largest player in the Government's Private Finance Initiative during 2000.

Competition in the banking industry

5.75. To achieve its current position Abbey National had had to overcome barriers raised by the dominance of the big four retail banks which, it said, together held 74 per cent of UK PCAs and accounted for 89 per cent of SME banking.

5.76. Abbey National said that it was a key competitor—it had the distribution, brand and infrastructure to compete with the big four—but control of the PCA and SME markets remained almost

entirely with them. A high share of current accounts held the key to the sale of other financial services. There was little evidence of competition between the big four: the key impetus for greater competition would have to come from outside. Yet the nature of these markets was such that the scope for further effective and sustainable new entry was limited. It had taken Abbey National 12 years to build a 6.8 per cent market share in PCAs.

5.77. There was evidence that other financial services providers, for example Egg, considered barriers to entry in these markets to be too high to consider entry. Egg had made a significant impact in the savings market, but it had 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. To be an effective competitor across the consumer and SME banking markets it was important to have a large branch network. Even online banks increasingly followed a 'bricks and clicks' strategy. In this context it was highly significant that, post-merger, the big four would control 74 per cent of branches. Indeed, although the big four had been closing branches, they had nonetheless increased their share of branches (from 54 per cent in 1995 to 68 per cent in 2000) through mergers and acquisitions (LloydsTSB/Cheltenham & Gloucester; Barclays/Woolwich; RBS Group/NatWest).

5.78. Further, there were currently 680,000 Abbey National Instant Plus Accounts, current accounts offering money transmission services though not overdraft facilities; they were particularly appropriate for the 'socially excluded'. Abbey National said that this product failed to meet PAT 14 standards 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. From the supply-side perspective, the only other significant provider of current accounts similar to Instant Plus Accounts was Halifax. The big four had instead tended to focus their current account products on consumers whose credit ratings made them eligible for overdraft facilities.

5.79. The big four's share of the stock of PCAs, excluding acquisitions, had remained relatively stable. In addition, what the big four had lost through customer attrition they had typically regained through acquisition. Mergers involving the big four—notably RBS Group/NatWest and Barclays/Woolwich—had significantly increased their combined share of current accounts.

Events leading up to the proposed merger

5.80. Towards the end of 2000/early 2001, Abbey National and BoS had held talks regarding a possible merger of the two businesses. The proposed merger was cleared by the Secretary of State on 5 February 2001. However, following publicity over the proposed merger with BoS, Lloyds TSB twice approached Abbey National with takeover proposals. The proposals were rejected by Abbey National as being inadequate and uncertain. In reaching this conclusion, the board had had particular regard to the advice which it had received on shareholder value, deliverability and regulatory risk. Nevertheless, on 31 January 2001 Lloyds TSB had announced its firm intention to make an offer for Abbey National, subject to preconditions. Abbey National rejected this offer.

PCAs

General

5.81. Abbey National submitted that the PCA market was important in its own right. From the customer's perspective, one of the primary purposes of a current account was to provide access to money transmission services—paying in salary, use of ATMs, debit cards, cheques, standing orders, direct debits etc. Current accounts could also provide short-term credit, through overdrafts, and a vehicle for temporary savings. The OFT's 1999 report on vulnerable consumers and financial services had recognized that current accounts were increasingly vital for consumers at all levels of society. The PCA market also held the key to competition in other financial product areas as it was a gateway to cross-selling other products. In spite of a lack of competition on their part, the big four, with their incumbency advantages and comprehensive branch network, were achieving a share of new current account openings broadly in line with their stock position. The stock figure was the more relevant for the inquiry's

purposes. Abbey National estimated that the annual level of new business (including switchers) represented under 4 per cent of the total market. The reasons for this were that the PCA market was characterized by very low levels of switching and, by its very nature, the market was slow growing. It had grown at a compound annual growth rate of only 1.7 per cent over the last five years.

5.82. Based on its progress to date and in its relative market strength, Abbey National said that it considered itself, along with Halifax, to be best placed to mount a meaningful challenge to the big four. Abbey National had demonstrated strong and consistent growth since it had entered the market 12 years previously. It provided product pricing and services which were significantly different from, and more attractive than, the big four including Lloyds TSB. A typical customer banking with Lloyds TSB was significantly worse off than a typical customer banking with Abbey National.

Competition in the PCA market

5.83. There was evidence to suggest that competition in the market as between the big four was muted. This was consistent with conventional economic analysis which suggested that it was frequently optimal for firms in a concentrated oligopoly to engage in tacit coordination. Specifically, a policy of 'live and let live' arose as each player recognized that any major commercial initiative designed to steal market share—such as a significant increase in deposit rates or reduction in loan rates—would quickly be detected, leading to a rapid competitive response that left little or no long-term gain in overall market share, but with lower profitability per customer. The situation on PCAs was in marked contrast to that of some other personal financial services. Abbey National said that, for example, the general consensus was that the savings market was competitive and that the merger would not have adverse effects on consumers. There was no shortage of choice for savers who were prepared to shop around, whether through branches or otherwise.

5.84. The current account market, already concentrated between the big four, exhibited several characteristics conducive to collective dominance: product homogeneity and low levels of product innovation with a basic PCA product that had remained essentially unchanged; high market transparency regarding key competitive parameters, which meant that 'cheating' by individual members of the oligopoly, for example by undercutting prices, was unlikely to happen because it was relatively easy to monitor; stagnant demand growth; low price sensitivity of demand; insignificant buyer power (individual consumers did not have the ability to force the big four to improve their services); and, in particular, the fixed costs of a branch network and switching costs.

5.85. However, the ability to sustain tacit coordination was rendered significantly more difficult by the presence of 'mould-breakers' who did not respect the 'rules of the game'. In the present context, Abbey National had consistently adopted a competitive strategy that was non-standard, for example by product innovation and attractive pricing. It was, therefore, a key competitor. Outside the big four, Abbey National and Halifax were unique in *(a)* achieving a market share of more than 5 per cent and *(b)* continuing to grow that market share. Abbey National itself continued to demonstrate strong growth in the current account market.

5.86. By contrast, the lack of competition between the big four was manifest in, first, uncompetitive overdraft rates: charges on current account overdrafts among the big four were similar to one another, and substantially in excess of those offered by either Abbey National or Halifax. Indeed HSBC had recently increased its overdraft rate to 18.3 per cent, in line with the rest of the big four, stating that the move was due to 'increased competition'. Second, lack of competition was evident in the big four's uncompetitive charges and rates. Associated with their current accounts were also very similar interest and non-interest charges. These were less favourable than those offered by Abbey National and Halifax. Abbey National had discontinued most minor fees whereas Halifax's charging structure remained similar to those of the big four. Neither charged overdraft usage fees. However, Abbey National had introduced new charges for paying bills over the counter. It said that this was to reduce queuing times for other customers and to encourage customers to use methods which were more cost-efficient for the bank, such as ATMs and deposit points, thus reducing costs to the benefit of the bank and all customers. Lloyds TSB and Barclays had reluctantly announced an intention to discontinue their overdraft fees in the autumn, and Barclays had said that it would cut its overdraft rate, although its rate would still be in the region of 15 per cent.

Cross-selling

5.87. The OFT had recognized that, due to the strategic importance of PCAs as a source for cross-selling and for customer information, providers were willing to cross-subsidize their current account activities. And the Cruickshank report had found that the supply of PCAs held the key to competition between suppliers in other product areas. Further, the current account banking relationship, once established, was of long duration. The average length was believed to be in excess of 11 years. This made it an ideal medium for cross-selling of other consumer banking and financial products. A branch network provided important information advantages in this regard. The attempt to cross-sell had been a key element in the strategy of Lloyds TSB and other members of the big four over recent years.

5.88. That the PCA was unique in offering cross-selling opportunities was shown by the fact that 80 per cent of current account customers visited their branch at least once a month. All current account customers received regular statements and mailings which could include information about other products. Other opportunities were also provided via telephone contact, use of ATMs and other points of contact, for example WAP phones or digital television. On average, PCAs provided almost 100 opportunities for contact a year. That compared with only a handful for mortgages. In any event, 60 per cent of mortgages were sold via intermediaries who retained the customer relationship and sought to cross-sell other products themselves (with no commitment to the supplier of the mortgage). PCAs were also a rich source of information about customers' financial situation and behaviour.

5.89. The big four were able to exploit cross-selling opportunities to sell uncompetitive products to their captive current account customers. Many customers did not shop around and were attracted by the convenience of a one-stop shop for all, or a large proportion, of their financial services. These customers represented a captive market for the big four, who succeeded in cross-selling other financial products to their PCA customers at a rate in excess of their natural share. The evidence suggested that customers of the big four purchased less competitive products as a result. Revenues generated across the industry from cross-holdings of products by current account customers were estimated to be around £100 billion a year.

Innovation

5.90. Abbey National said that, despite their overwhelming market share, most significant innovations in the PCA market 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. Among changes which the smaller banks had been responsible for in recent years were use of post offices (Alliance & Leicester), online debit cards (Abbey National), Internet banking (Nationwide), current account mortgages (Virgin) and step increases in interest payable on PCA credit balances (Halifax). It was notable that, although Lloyds TSB had presented its own list of innovations, only 44 per cent of that list was attributable to the big four; this contrasted with their market share for PCAs of 74 per cent.

5.91. Abbey National itself had been responsible for many innovations in banking over a long period. In the mortgage market, for example, Abbey National had been the first lender to launch a fixed-rate mortgage offer (June 1988) and was the market leader in removing extended tie-ins on mortgage products (October 1998). Innovations in the PCA market had included the introduction in 1988 of interest-bearing current accounts and high-interest cheque accounts together with a £100 cheque guarantee card. In 1996 it had been one of the first banks to offer a basic bank account without overdraft (the Instant Plus Account, a product designed for people who would otherwise be at risk of financial exclusion—see paragraph 5.78); and in 2000 it was the first bank in the world to offer a current account product with access through both digital television and the Internet. In addition, Abbey National had striven to remove hidden costs to the customer. In particular, it made no charges for the majority of its current account services (in contrast to the big four). The bank did not, except to a very small extent, negotiate special terms for its PCA customers.

Profitability

5.92. Despite Lloyds TSB's assertions to the contrary, the PCA market was profitable in its own right. Abbey National had a customer proposition that offered better value to consumers than the big four: despite this, Abbey National's PCA business had been profitable in the last two financial years. 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. In addition, as noted already, the PCA provided further opportunities for profit through cross-selling.

Branding issues

5.93. Abbey National said that consumers could and did differentiate between brands in financial services, and in particular between Abbey National and the big four banks. It said that it monitored the health of its brand through a mix of monthly qualitative and quantitative tracking research among 1,000 customers and non-customers, which allowed robust and direct comparison of competitor images. The bank had a clearly distinct brand image from the big four—fairer, more straightforward, more friendly and unstuffy and offering better value for money.

5.94. Reputation and brand image were important in attracting new customers**.** Entrants such as Abbey National needed to spend considerable sums on advertising and promotion to communicate their brand proposition to customers. Such campaigns tended to stress the superior product/service available and to assist the customer in distinguishing the various propositions that were on offer. Abbey National presented figures showing that, of total advertising spend by PCA providers in 2000, 57 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. The big four, on the other hand, were able to benefit from their incumbency advantages. In relation to the size of their PCA market share, the big four spent much less on advertising their PCA products than the smaller and newer banks did. Big four campaigns tended to be aimed at promoting the brand generally, rather than highlighting or distinguishing any specific product benefits.

Barriers to entry and growth

5.95. The considerable expenditure on advertising which new entrants had to undertake was one of the many barriers to entry and expansion in the PCA market. These high barriers meant that the success of new entrants in securing new business had been muted. There had been only 13 entrants in the period since 1987 and their growth had been slow. Abbey National said that, more than ten years after it entered the PCA market and demutualized, many people still did not associate it with PCAs. Thus recent higher expenditure on brand awareness was required.

5.96. Substantial barriers to entry undermined potential competition from other providers. Abbey National said that a bank wishing to compete on a national scale with the big four in the provision of PCAs had to incur all the fixed costs—in particular, the cost of a branch network, money transmission and marketing—in circumstances where low levels of switching placed an inherent limit on growth and constituted a very substantial barrier. Three key factors appeared to serve as a disincentive to switching: the risk to the credit status of the customer concerned; disruption to other banking or financial arrangements, such as mortgages, that might be linked to the current account banking relationship; and delay and complexities in switching accounts. It took time to alter all the facilities associated with current accounts—debit cards, standing orders and other money transmission arrangements—so that the switcher had to run 'dummy' accounts over a switching period that could extend for six to eight weeks.

5.97. Abbey National said that there was no prospect of significant improvement in the short to medium term in the very low switching levels—2 per cent a year. The big four were reluctantly—under external and media pressure—beginning to address the time they took to effect switching. However, direct debit/standing order originators also needed to speed up their processes—and there was no sign of this happening.

5.98. Abbey National, also 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 twelve months and a competitive interest rate thereafter, while Halifax was focusing on its offer of 4 per cent interest on credit balances. Both were spending heavily on advertising to get their message across to consumers.

Fully-automated switching was unlikely to be available in the foreseeable future. The low level of switching was a question of consumer perception as well as industry practice. Faster switching would not, however, address consumer concerns over the effect of switching on their credit status and disruption to other services.

5.99. It was therefore questionable, in Abbey National's view, how much difference in practice the new voluntary Banking Code would make. Recent experience of Abbey National and Intelligent Finance had shown that the big four were failing to respond to requests for customers' details within ten working days as required under the Code. These shortcomings had also been highlighted by the Fifth Report of the Treasury Select Committee, published in March 2001.

5.100. In order to be able to compete in the provision of PCAs with the big four, a bank had to be able to offer:

(a) a wide branch network offering the convenience of a local branch in all major population centres;

(b) attractive, innovative products (in order to induce switching);

(c) an IT and telephony infrastructure capable of servicing current accounts; and

(d) detailed information about the credit histories of customers (so as to be able to offer overdraft and other credit facilities).

In addition, as noted above, once the bank had the ability to serve PCA customers effectively, it would need to mount a substantial advertising campaign, typically using television advertising, to attract new customers.

5.101. Consumers remained cautious about the security implications of Internet banking. In any case the majority of the adult population still did not have ready access to the Internet. Thus, whilst Internet and telephone banking had made limited inroads, most consumers still preferred to be able to visit, or have the option of visiting, a branch when obtaining financial services. Indeed, the Cruickshank report had concluded that only a minority of consumers were likely to want to bank exclusively on the Internet for a number of years to come.

5.102. Among non-big-four PCA suppliers only Abbey National, Halifax and Nationwide had a substantial branch network. Others had a less extensive network or were regionally based. The costs associated with developing or significantly expanding a branch network were likely to be prohibitive, and it was no accident that new entrants to the market were forced to rely on direct telephone or Internet selling with limited prospects of short-term success on a large scale. A branch network was also important to the cross-selling of other banking or financial products.

5.103. Other barriers to entry into the PCA market included the attractiveness to consumers of a multidistribution offering (encompassing some or all of branch, ATM, telephone, Internet and interactive television); customer preferences for a wide product portfolio including, for example, savings products and credit cards; staff skills, for example for credit assessment; and information, in particular for credit scoring. One of the main reasons for changing current accounts was the refusal by an existing lender to continue or increase a facility. When assessing a new customer, however, a bank did not have access to that customer's recent credit history. New customers were in this sense inherently more risky and therefore cost more to recruit.

SMEs

5.104. Abbey National said that the big four had a stranglehold over the SME market and the evidence suggested a lack of competition between the big four in this market too. Its own 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 between £400 and £789 banking with Abbey National rather than with one of the big four. In particular, the big four each imposed substantial charges even for in-credit accounts. They currently had a combined market share of business bank accounts of nearly 89 per cent. Their two largest competitors were BoS and NAB group (Clydesdale and Yorkshire Bank), both of which had a regional rather than national branch 'footprint'. Abbey National said that it had entered the SME market only in 1997. It had developed significant expertise in the provision of a range of business financial services. It also provided private equity via investments in Private Equity Partnership funds as well as through a small amount of direct investment. At year end in 2000, Abbey National had committed £[✂] in [✂] funds with [✂] separate investments.

5.105. The bank recognized that branches would need to play an important role in enabling it to grow its share of the SME banking market. Abbey National had initially limited itself to a remote offering in order to avoid overburdening its branch counters. SME marketing literature was, however, available in its branches and 80 per cent of Abbey National's business banking customers had been introduced via its branch network. Branches therefore played a crucial role as a source of information and as a point of referral of new customers.

5.106. To date, Abbey National had succeeded in obtaining around 1 per cent of the SME market by providing a more attractive product than the big four, including Lloyds TSB. It 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. In 2000 Abbey National's Business and Professional Banking division had increased its number of current account customers by 78 per cent and its total customer deposits had increased by 72 per cent.

5.107. In June 2000**,** Abbey National had publicly stated its intention to achieve a 5 per cent share of business banking customers within the next five years. [

Details omitted. See note on page iv.

] Abbey National said that, even with its present limited offer, it was already achieving [✂] per cent of new accounts in SME banking. The big four were starting to take notice and had copied Abbey National's initiative in offering free in-credit banking for 12 months for switched accounts. Abbey National [*Details omitted. See note on page iv.*]. It was well advanced in developing systems to allow it to offer a current account to limited liability companies. Those systems would be operational in September 2001 and would allow Abbey National to access a far wider market. The bank also said that, as from September 2001, it would offer overdraft facilities to SME customers, alongside the full range of asset and cash-flow finance and structured lending products.

Entry barriers

5.108. There were considerable barriers to entry in the SME market. Abbey National said that there had been almost no entry into it. In its submissions to the SME inquiry, Lloyds TSB itself had recognized that there were significant barriers by saying that, in its view, the prerequisites for entry were:

- access to a branch network, where customers could deposit and withdraw cash conveniently;
- a trusted reputation, encouraging confidence in the supplier's competence and reliability;
- a skilled body of relationship managers, who could understand the business needs of SME customers and make well-informed credit decisions, as and when required; and
- the need to have adequate resources and capital.

5.109. On access to branches, the big four had substantially the largest number. Among other competitors in SME banking, Abbey National was unique in having a substantial national network and a powerful and trusted brand. It would be prohibitively expensive for a new entrant to put in place a new branch network serving the SME banking market only. New players had, therefore, tended to adopt mono-line or cherry-picking strategies within the market.

5.110. As in current accounts, switching levels were very low—according to the Band of England, only 3 to 4 per cent of SMEs changed their current account provider each year. There were a number of

reasons for this. First, a major concern of the SME customer in switching to a different lender was the loss of credit record and the time it would take to build up credibility with the new provider. Second, as with current accounts, there were actual and perceived costs to switching. Apart from the time taken to find a new supplier there was a risk that transactions might not be transferred smoothly. If standing orders or direct debits went wrong, the goodwill of the SME's customers could be permanently lost. Research had shown that this inertia factor was reinforced by SMEs' relative lack of trust in new types of provider.[1]

5.111. Again as in PCAs, SME customers consistently cited convenience of branch location as the most important reason for choosing a bank. These customers valued access to personal, face-to-face advice and guidance. Local knowledge of the SME business environment was important for lending decisions. And 30 to 40 per cent of SME customers had a high volume of cash and/or cheque transactions for which access to a local facility was considered essential. Taken together, all these factors amounted to very high barriers to entry to this market.

Effects of the merger

General

5.112. The proposed merger between Lloyds TSB and Abbey National had to be understood against the backdrop of the clear collective dominance of the big four. In particular, in a market already characterized by concerns about the state of competition, this merger would remove one of the two most significant competitors to the big four and one of only two providers (with Halifax) able to mount a sustainable national challenge to the big four.

5.113. The removal of Abbey National as an independent competitor would have a significant detrimental effect on consumers in terms of price, quality and choice. Economic and competition literature emphasized the importance to be attached to preservation of 'mould-breaking' firms able and willing to challenge successfully the members of an oligopoly exhibiting features of collective dominance. In addition, in markets with switching costs, firms with low market share tended to grow (or 'sow') market share, and those with high market share to exploit (or 'harvest') it. The acquisition of Abbey by Lloyds TSB would replace a firm in sowing phase by one in harvesting phase, to the detriment of consumers and competition.

5.114. Following a takeover by Lloyds TSB, it was probable that the current competitive choice in prices, charges, terms and conditions for banking products currently offered by Abbey National would be eliminated: Lloyds TSB had already indicated its intention to close or co-locate 600 overlapping branches (representing 80 per cent of the total Abbey National branch network). If 80 per cent of Abbey branches were closed, Abbey considered it inevitable that customer service standards would decline, thereby reducing the quality of the banking services (especially for passbook-based savers with little choice but to use branches). Since reductions in quality harmed consumers as badly as increases in price, the co-location programme was effectively a disguised price rise.

5.115. The product offering of the merged entity would almost certainly be aligned with that of Lloyds TSB, which was typically less favourable to consumers and closely aligned with the rest of the big four. Elimination of differentials by levelling down to the more consumer-friendly Abbey National products would, in view of the much greater size of the Lloyds TSB business, be disproportionately expensive for Lloyds TSB. Following the Lloyds Bank takeover of TSB for instance, Lloyds TSB had reduced the current account interest rate paid to former TSB customers to the Lloyds Bank level. It was also unlikely that Abbey National's record of innovation would survive a takeover by Lloyds TSB. Following its acquisition by Lloyds TSB, Cheltenham & Gloucester had ceased to be at the forefront of market innovations. So it still retained extended tie-ins on mortgages, and it still promoted mortgages that calculated interest on an annual rather than daily basis at an approximate additional cost equivalent to 13 basis points. Moreover its price promise on mortgages had lasted less than 12 months after the takeover.

5.116. In Abbey National's view, improvements in efficiency post-merger depended on synergies, which were uncertain. [*Details omitted. See note on page iv.*]

[1]KPMG, *The last real relationship: the future of small business banking*, March 2001.

Details omitted. See note on page iv.

Competition effects

5.117. In terms of the HHI for current accounts, a Lloyds TSB/Abbey National combination would see an increase by 318 to 1,849, a significant increase in an already concentrated market. Lloyds/TSB, already the single largest provider of current accounts, would increase its share to over 30 per cent and the combined share of the big four would rise from 74 to 81 per cent. Halifax, now proposing to merge with BoS, would be left as the only other player with a market share of 5 per cent or more. The remaining smaller players accounted in aggregate for only 13.7 per cent. Moreover, there were currently only three players left outside the big four (Abbey National, Halifax and Nationwide) which had a national, as distinct from regional, branch network. The merger would, effectively, consolidate the stranglehold which the big four currently had on the PCA and SME markets.

5.118. Abbey National was also a critical and growing source of competition to the big four in the SME market. Its takeover by Lloyds TSB would therefore have significant detrimental effect on future competition. By removing the one significant existing bridgehead into the SME banking market, the takeover would consolidate the position of Lloyds TSB and the other big four in both banking and wider financial services to the detriment of the SME community.

Effects of the proposed Halifax/BoS merger

5.119. A merger between BoS and Halifax would not materially alter the above analysis. At this stage the consummation of such a merger remained uncertain, as did Halifax and BoS's future strategy in relation to both PCA and SME banking. In the PCA market, HBOS would have a combined national market share of under 7 per cent, well below any of the big four. The combination would not make a significant difference to competition in the PCA market.

5.120. HBOS might not increase the competition posed by either party to the big four. BoS, as an incumbent with a large share of the stock of PCAs in Scotland to protect, and Halifax as a new entrant in the current accounts market, had fundamentally different outlooks on competition. In particular, BoS had not marketed its current account offering as aggressively as Halifax (or Abbey National), relying instead on its incumbency advantages in Scotland to maintain market share. Its pricing was currently not competitive and its charging structure was also similar to that of the big four.

5.121. To the extent that BoS might improve its competitiveness following a merger with Halifax, which was questionable, it was highly unlikely to affect competition between the big four in England and Wales. Of BoS's 360 branches, only 25 were outside Scotland. Any merger involving BoS would not, therefore, affect competition at the local level in England and Wales. Of the big four, only RBS/NatWest and Lloyds TSB had branches in Scotland. There was no reason to believe that either would be willing to match any improved customer offer from BoS north of the border—particularly if they believed that doing so could have an impact on pricing in England and Wales.

5.122. Halifax did not currently have an SME offering nor had it previously expressed any interest in having one. BoS had a national share of only around 3 per cent—its share in England and Wales was 2 per cent. Following a merger, it would take some time before significant numbers of SME customers were recruited through Halifax branches. And Halifax did not have the capability—in terms of systems or infrastructure—to roll out SME banking via its branches quickly. Halifax would also need to overcome inherently low levels of switching.

5.123. In conclusion, without an independent Abbey National, Halifax or HBOS was unlikely to be able to mount a meaningful challenge to the big four in the short to medium term in either PCA or SME banking. The continued presence of both Abbey National and Halifax would remain important, as effective competition was better secured by preserving a situation where the challengers also had to

compete vigorously between themselves. Finally, in view of the lack of competition between the big four, SME customers would in any event benefit significantly from a choice of more than one alternative provider.

Remedies

5.124. Abbey National said that the acid test of any remedy was whether it would be effective to restore fully the competition lost as a result of the merger and to address any other public interest concerns. In this case, Abbey National considered that prohibition was the only effective remedy open. No other remedy could compensate for the loss of Abbey National as an effective and innovative competitor. Its views on the other hypothetical remedies put forward for consideration (see Appendix 2.1) were as follows.

Divestment of branches to competing providers of retail financial services in localities where Lloyds TSB and Abbey National together have a high share of total branches

5.125. The acquisition of branches on its own would not allow either an incumbent outside the big four or a new entrant to compete effectively against the big four. Any remedy would need to include the divestment of the attached customer base and supporting systems and information. But the identification of such customers was problematic since an Abbey National current account customer was not attached to a particular branch with its own sort code.

5.126. In order to compensate for the loss of Abbey National, any divestment package would need to be structured so as to ensure that the purchaser had a comprehensive national branch network (about 800 branches). Overall, the number of branches that would need to be divested was very substantial.

5.127. 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.

5.128. In Abbey National's view 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.

5.129. 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 were effected, it would be impossible to ensure that they did not transfer out again.

Divestment of any of the existing businesses of either Lloyds TSB or Abbey National, for example Cheltenham & Gloucester, cahoot

5.130. There was no existing stand-alone business within either Lloyds TSB or Abbey National that could, either alone or in conjunction with a purchaser's existing business, be a substitute for Abbey National in the key current account and SME banking markets:

- Cheltenham & Gloucester did not provide current accounts, and the mortgage market was not the primary concern in this merger.

- Cahoot was essentially an Internet product with [✄] current account customers, and [✄] customers in total. Its divestment was no substitute for Abbey National as a national branch-based competitor with 2.8 million current account customers and over 15 million customers in total across the group.

Undertakings in relation 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

5.131. The issues here were structural in nature—the big four had a stranglehold over the PCA and SME markets. The takeover of Abbey National, by removing one of two key competitors, would consolidate that stranglehold. In these circumstances, behavioural remedies—even assuming they could be crafted—would not offer a satisfactory solution. They could not replace Abbey National as an innovative and mould-breaking competitor. Moreover, behavioural remedies would apply only to Lloyds TSB whereas Abbey National currently provided effective competition to all of the big four. Behavioural undertakings were, finally, notoriously difficult to draft, and even more difficult to police.

Steps to improve customers' awareness of the terms of the products they are buying from the enlarged group and how those terms compare with those available from competing providers

5.132. Whilst improvements in customer awareness were desirable, these would not be an effective substitute for Abbey National as an independent competitor to the big four. Customer awareness only helped if *(a)* customers had a real choice and *(b)* they were able to exercise that choice at little risk and inconvenience to themselves.

Remedies suggested by Lloyds TSB

5.133. Abbey National also provided its views on the possible remedies outlined by Lloyds TSB.

A guarantee that no current Abbey National branch-based mortgage, savings, loans or overdrafts customer would be disadvantaged in relative price terms as a result of the merger by requiring Lloyds TSB to maintain at least existing pricing margins by reference to base rate on all existing Abbey branch-based mortgage, savings, loans and overdraft products for, say, two years

5.134. Fundamentally, a two-year price promise did not address the issues arising from the reduction in competition that would follow a takeover of Abbey National and appeared to be predicated on a wholly improbable assumption that the current situation of big four collective dominance would have broken down and the market become sufficiently competitive at the end of the two-year period. The specific proposal also raised a number of additional questions and issues:

(a) If the market was competitive, why would Lloyds TSB not want to provide attractive pricing in any event?

(b) Why was it limited to two years?

(c) Why did it apply only to current customers?

(d) Why was it limited to branch-based customers?

(e) Why was it limited to certain products?

(f) There was no guarantee that, when cross-selling new products to existing Abbey National customers, Lloyds TSB would seek to sell the more competitive Abbey National products.

(g) The remedy also did not appear to include any guarantee to maintain Abbey National's basic Instant Plus Account, an important product in addressing social exclusion.

(h) The remedy did not address the SME market.

(i) It was limited to current products.

(j) Abbey National did not compete only on the basis of price. A price promise would not address the reduction in levels of service that was likely to follow the takeover.

(k) Such a remedy would also be extremely difficult to police.

That, for the same period, any such Abbey National product currently rated in the first quartile of comparable products remains in that quartile and available. This could specifically include continuing any specified, existing and innovative Abbey National SME product.

5.135. This proposal raised many of the same objections and questions set out in the previous paragraph. In addition:

(a) Rival suppliers would cease to fear undercutting from the Abbey National products subject to the undertaking, and hence would not make pre-emptive improvements in the pricing or quality of products.

(b) What guarantee would there be that these products would continue to be actively marketed?

(c) A product could still be repriced within a quartile. There were significant differences in the attractiveness of products within each quartile.

(d) There would also be practical difficulties associated with assessing which products would be considered to be in the first quarter of comparable products.

5.136. The undertaking would in any event be circular. Without an independent Abbey National, competition would suffer and this would impact on the attractiveness of all products within each quartile. Accordingly, it would be possible for the Abbey National products to remain in the same relative ranking as before but for the absolute level of all products offered in the market to be worse.

Offering a new and additional PCA product which would include the following features:

- *tiered rates of interest on credit balances measured by reference to base rate;*
- *a small monthly administration charge together with itemized and cost reflected tariffs for customers who impose significant money transmission costs; and*
- *overdraft rates in a specified range dependent on credit risk.*

5.137. The proposed remedy raised difficulties similar to those in paragraph 5.134 and a number of other questions:

(a) It was not clear whether it was intended that this would be a permanent commitment, or time limited.

(b) It was also not clear whether the new PCA being proposed would be competitive on an ongoing basis.

5.138. There were also difficulties of detail:

- The appropriateness or otherwise of rates of interest fluctuated over time, as would the appropriateness of any administration charge and the cost reflectiveness of tariffs.
- It was not clear how charges and tariffs would be set.

- It was not clear whether the overdraft rates referred to would be related to credit risk or whether they would relate to credit scoring of the individual borrower. Data on credit risk associated with PCA borrowing were relatively unsophisticated.

5.139. As with the other Lloyds TSB proposals, this remedy was unworkable and would not solve the problem even if workable. Fundamentally, it could not substitute for the competitive process. It failed to recognize the fact that mould-breaking firms were free to 'break the rules', undercut, innovate, behave unpredictably and generally make life difficult for the incumbents.