

**Anticipated acquisition by Lloyds TSB plc of HBOS
plc**

**Report to the Secretary of State for
Business Enterprise and Regulatory Reform**

24 October 2008

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I OVERVIEW

CONCLUSIONS

1. The Office of Fair Trading (OFT) hereby reports to the Secretary of State for Business Enterprise and Regulatory Reform (the Secretary of State) in relation to the anticipated acquisition by Lloyds TSB Group plc (Lloyds) of sole control of HBOS plc (HBOS) which was announced on 18 September 2008 (the transaction). On 18 September 2008 the Secretary of State, in exercise of his powers under section 42(2) of the Enterprise Act 2002 (the Act), gave a public interest intervention notice (the Notice) to the OFT and required it to investigate and report on the transaction in accordance with section 44 of the Act within the period ending on 24 October 2008 (see Annex 1 for the Notice).
2. As required by section 44(4) of the Act, the OFT's report contains four principal 'decisions'. These are that the OFT believes that it is or may be the case that:
 - arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation
 - the creation of that merger situation may be expected to result in a substantial lessening of competition (SLC) within a market or markets in the United Kingdom for goods or services, including personal current accounts, banking services to small and medium enterprises (SMEs), and mortgages, such that further inquiry by the Competition Commission (CC) is warranted
 - any relevant customer benefits in relation to the creation of the relevant merger situation concerned do not outweigh the substantial lessening of competition and any adverse effects of the substantial lessening of competition, and
 - it would not be appropriate to deal with the matter by way of undertakings under paragraph 3 of Schedule 7 to the Act.
3. The OFT accordingly reports and advises in accordance with sections 44(3) and (4) of the Act that the test for reference to the CC on competition grounds contained in section 33 of the Act is met.

MERGER JURISDICTION

4. The OFT believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation because as a result of this transaction Lloyds and HBOS will cease to be distinct, and given that HBOS's UK turnover is above £70 million the turnover test in section 23 of the Act is met.

SUBSTANTIVE COMPETITION ASSESSMENT

5. The OFT's competition review in this case involves a predictive merger assessment of financial markets in the UK (and also globally) that are currently experiencing extraordinary turbulence and change. These uncertain conditions, as exogenous forces affecting the market being investigated, are a reason for caution.
6. The OFT assessed the merger against two counterfactuals that it considered to be the most realistic to occur in absence of the merger:
 - In the short-term, HBOS remaining in the market with some form of Government support (the 'Stage I counterfactual'), and
 - In the medium to long-term, following withdrawal of the Government's support, the sale of HBOS to a 'no overlap' third party (one that does not raise competition concerns) or an independent HBOS once again (the 'Stage II counterfactual').
7. Against one or both counterfactuals, the OFT considers that there is a realistic prospect of an SLC in three areas: personal current accounts (PCAs), SME banking and mortgages. More specifically, the OFT has medium to long-term concerns (Stage II) in relation to all three product areas, and in addition short-term concerns (Stage I) in relation to PCAs and SME banking.
8. In relation to PCAs, the OFT has concerns at the national (Great Britain) and local levels. The merger will remove a firm, HBOS, that was (at least until less than two months ago) a major driver of competition in the market, and strengthen the current market leader, Lloyds. In addition, the merger will significantly increase Lloyds' share of the market. As a consequence of its increased market share, coupled with characteristics of the market such as high levels of customer inertia and a limited degree of price discrimination, it is expected that its incentives to compete for new customers (and those of the other major banks in the market) will be diminished – in essence, the increase in

Lloyds' customer base will encourage it to attach more weight to enhancing margins on current customers than to customer acquisition.

9. In relation to SME banking, the OFT's concerns are focussed on Scotland and are similar to those in relation to PCAs - the increased incentive on Lloyds to enhance its margins on current customers. The OFT also cannot exclude competition concerns arising at a local level across Great Britain.
10. In relation to both of these markets, the OFT's belief that the merger will result in an SLC is not formed on the balance of probabilities; rather, its belief is of a 'realistic prospect' of SLC under the 'may be the case' standard. The OFT therefore considers that it is by no means a foregone conclusion that the CC would reach an SLC finding on the balance of probabilities standard, at the end of a detailed 24 week inquiry.
11. In relation to mortgages, the OFT considers there is a realistic prospect of an SLC. However, the OFT's concerns are more marginal. Evidence suggests that the mortgages market may be tighter than it was prior to the 'credit crunch' so that barriers to entry may be higher and customer switching is more difficult. Under these market conditions, the combination of the largest and third largest mortgage providers is significant enough to cause concern. In this regard, the OFT is mindful of the fact that the mortgage business is of enormous importance to the UK economy, such that the cost of a wrongful clearance (false acquittal or type II error), even if the risk of such error is relatively low, would be very high.
12. The parties submitted that the transaction will lead to significant cost savings [REDACTED] of Lloyds and HBOS, while creating the largest and most effective retail franchise in the UK, enabling better access and service for customers. While plausible, the OFT did not receive sufficiently compelling evidence to conclude confidently at the Phase I stage of analysis that the claimed efficiencies and consequent customer pass-through would occur, and would occur such as to offset the competition concerns identified in relation to PCAs, SME banking and mortgages.
13. No further competition concerns were considered to arise in relation to the other identified overlaps between the parties in retail banking (savings, wealth management, personal loans, credit cards and pensions), corporate banking (banking services to large corporations, asset finance/fleet car hire) and insurance (PPI, life, general).

REMEDIES

14. Lloyds did not offer any structural or behavioural undertakings in lieu of reference to the CC.
15. The absence of any such offer of remedies makes it inherently difficult, particularly in light of time constraints, for the OFT to formulate a hypothetical set of undertakings and subsequently test whether they might be appropriate to deal with the competition concerns identified.
16. The OFT does not rule out entirely the possibility that, with more time and more willing engagement by the parties, it might have been possible to develop structural remedies, although it accepts that – given the competition concerns – this would certainly have been challenging in Phase I.
17. Accordingly, the OFT therefore advises that it would not be appropriate to deal with the competition concerns arising from the merger situation by way of undertakings under paragraph 3 of Schedule 7 to the Act.

PUBLIC INTEREST CONSIDERATION

18. The OFT received representations on financial stability from a number of people, including the merging parties, the Tripartite Authorities (Financial Services Authority (FSA), Her Majesty's Treasury (HMT) and the Bank of England), third parties active in the financial services sector, consumer interest groups, and several interested individuals.
19. The majority of third parties considered that, in light of the extraordinary conditions in the financial markets, the merger would benefit financial stability, and was therefore in the public interest. However, some third parties expressed concerns about the impact of the merger on competition in the medium to long term. Concerns were also specifically expressed that the impact of the merger in Scotland would be against the public interest.

II PROCEDURAL OVERVIEW

20. On 18 September 2008, Lloyds and HBOS announced that they had reached agreement on the terms of a recommended acquisition by Lloyds of HBOS under which HBOS shareholders would receive 0.83 Lloyds shares for every one HBOS share.
21. The Secretary of State issued a public intervention notice on 18 September and requested the OFT to report by 24 October.
22. On 3 October, the OFT received an informal merger submission from the parties.
23. On 8 October, after consultation with the Bank of England and the FSA, HMT announced that it was bringing forward measures to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers. In summary, it was announced that Government's intention was to provide sufficient liquidity in the short term; make available new capital to UK banks and building societies to strengthen their resources permitting them to restructure their finances, while maintaining their support for the real economy; and ensure that the banking system has the funds necessary to maintain lending in the medium term.
24. On 9 October, the OFT sent an issues letter to the parties setting out the core arguments and evidence in favour of the reference test being met. On 13 October the parties attended an issues meeting with the OFT's case team.
25. On 13 October, in view of the exceptional instability in the global financial markets, HMT announced that it would be implementing the set of measures announced on 8 October to make commercial investments in UK banks and building societies to help stabilise their position and support the long-term strength of the economy. In particular, HMT announced that it was making capital investments in HBOS and Lloyds, conditional on completion of their proposed merger. As part of this investment, the banks supported by the recapitalisation scheme have agreed a range of commitments with Government.
26. On 13 October, Lloyds announced revised terms for the acquisition of HBOS and the raising of £5.5 billion of new capital. The revised terms agreed with HBOS are that HBOS shareholders will receive 0.605 Lloyds shares for every one HBOS share. At the same time, an offer will also be made for HMT to exchange HMT preference shares in HBOS for equivalent preference shares in Lloyds.

27. The specification of the stability of the UK financial system as a public interest consideration in section 58 of the Act was laid before Parliament on 7 October. It was subsequently approved by the House of Lords on 16 October and by the House of Commons on 22 October, and comes into force on 24 October.¹

¹ www.opsi.gov.uk/si/si2008/uksi_20082645_en_1

III PARTIES AND TRANSACTION

THE PARTIES

Lloyds

28. Lloyds is a UK-based financial services group that provides a wide range of banking and financial services to personal and corporate customers. Its main business activities are retail, commercial and corporate banking, general and life insurance, pensions and investment provision. Its services are offered through a number of brands, including Lloyds TSB, Cheltenham & Gloucester and Scottish Widows. Its UK turnover in 2007 was £18 billion.

HBOS

29. HBOS is a financial services group that provides a range of banking, insurance, financial services and finance-related activities in the UK and abroad. Its UK turnover in 2007 was £4.25 billion.

TRANSACTION RATIONALE

30. Lloyds submits that the transaction was negotiated and announced over a very short period of time. The deal was negotiated and agreed in the context of the sharp worsening of the global financial markets in mid-September, when HBOS's position in terms of share price and funding became increasingly vulnerable.
31. Lloyds submits that the merger will allow it to build the UK's leading financial services company with leading market positions and a platform to create a highly efficient group.
32. For HBOS, the transaction was seen as a means to minimise the risks of further erosion to its position and the continuation of its activities in view of its otherwise uncertain future.

IV JURISDICTION AND LEGAL TEST

33. As a result of this transaction Lloyds and HBOS will cease to be distinct. HBOS's UK turnover is above £70 million and, as a consequence, the turnover test in section 23 of the Act is met. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation.
34. The OFT considers that these arrangements are sufficiently far advanced and likely to proceed to justify a reference to the CC under section 33 of the Act.
35. In addition, given the size of the markets involved in this case, the OFT considers that the markets concerned are of sufficient importance to justify the making of a reference to the CC under section 33 of the Act.
36. In its normal competition assessment under the Act, the OFT is required to make a reference to the CC where it believes that it is or may be the case that the creation of the relevant merger situation may be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services (section 33 of the Act). Following judicial review,² the OFT interprets this as meaning that the test for reference will be met if it has a reasonable belief, objectively justified by relevant facts, that there is a 'realistic prospect' that the merger will lessen competition substantially (OFT Guidance, paragraph 3.2).
37. By the term 'realistic prospect', the OFT means not only a prospect that has more than a 50 per cent chance of occurring, but also a prospect that is not fanciful but has less than a 50 per cent chance of occurring. In such cases there is no exact mathematical formulation of the degree of likelihood which the OFT acting reasonably must require in order to make a merger reference. Between the fanciful and a degree of likelihood less than 50 per cent there is a wide margin in which the OFT must exercise its judgment as to whether it may be the case that the merger may be expected to result in a substantial lessening of competition.
38. The parties argued that, in preparing a report under section 44 (i.e., following issue of an intervention notice), the duty on the OFT was to reach a definitive conclusion as to whether or not a substantial lessening of competition is or is not to be expected. This was primarily because the OFT's competition findings are binding upon the Secretary of State (section 46(2)) and the parties interpreted section 45 as requiring the Secretary of State to decide either that a

² See Court of Appeal judgment in *IBA Health v Office of Fair Trading* [2004] EWCA Civ 142.

substantial lessening of competition is expected (sections 45(2) and 45(4)) or, conversely, that it is not expected (sections 45(3) and 45(5)). However, the OFT does not accept this argument. It is contradicted by the plain wording of paragraph 44(4)(b) (which mirrors that in sections 22 and 33) which includes the double 'may' test. Furthermore, that double 'may' language is found also in section 45(4) in relation to the Secretary of State's own level of belief in making a reference. For these reasons, the OFT considers it is not under a duty to reach a definitive conclusion as to whether or not a substantial lessening of competition is expected or not (although it remains open to the OFT under section 44 to calibrate the level of its belief in the likelihood of a substantial lessening of competition should it consider it appropriate to do so).

V THE COUNTERFACTUAL

INTRODUCTION TO THE OFT'S GENERAL APPROACH TO THE COUNTERFACTUAL

39. The purpose of merger assessment is to consider whether a merger causes harm to competition and consequently to consumers. The Act therefore refers to whether a merger has resulted or may be expected to result in a substantial lessening of competition.³
40. The OFT determines the effects attributable to the merger (that is, causation) by comparing the predicted post-merger competitive outcome with the outcome absent the merger, referred to as the counterfactual. As the Guidance notes, this comparison is 'the core concept of the substantial lessening of competition test'.⁴
41. The Guidance and OFT decisional practice establish that the best proxy for the counterfactual is generally pre-merger competitive conditions. These have the additional benefit that they are observable and subject to verification from multiple sources. The effect of the merger is then safely judged against a benchmark of having held all else constant.
42. However, the Guidance notes that it will also take into account 'likely and imminent changes in the structure of competition' (the likely and imminent standard).⁵
43. In its decisions under the Act that have potentially turned on whether the pre-merger conditions are appropriate as (that is, the best proxy for) the counterfactual, the OFT has in practice applied a rebuttable presumption in favour of the status quo ante, by reading the likely and imminent standard strictly when the risk of speculation applies to a critical finding of the case. In other words, where the merger raises concerns relative to pre-merger conditions, the OFT is slow to clear a transaction based on a substitute counterfactual, such as the 'inevitability' of failure or exit of the target business, and will only do so where it has sufficient compelling evidence that, for example, such failure/exit is inevitable. Where that evidentiary threshold is not met, the OFT considers that it may be more appropriate to refer such transactions for a detailed review by the

³ See sections 22, 33, 35, 36 and, relevant for this case where the Secretary of State has issued an intervention notice under section 42, sections 45 and 47 of the Act.

⁴ OFT *Mergers - Substantive Assessment Guidance* May 2003 (the Guidance), paragraph 3.23.

⁵ Guidance, paragraph 3.24.

CC, in which the validity of the substitute counterfactual can be considered in more detail.⁶

44. The OFT has adopted a stringent approach in such cases out of recognition that substitute counterfactuals (such as claims that a target company would have exited the market absent the merger) are easily asserted but difficult, given the information asymmetries between the merging parties and the OFT, to verify independently at Phase I.
45. The OFT's general approach is therefore that it will first 'test' the competitive impact of a transaction against the pre-merger conditions of competition. In general, where the merger raises no concerns relative to pre-merger conditions, no further consideration is given to the substitute counterfactual.⁷ Where the merger does raise concerns against pre-merger conditions, the OFT will consider whether there is sufficiently compelling evidence that an alternative counterfactual should be substituted.

THE APPROPRIATE COUNTERFACTUAL IN THIS CASE

46. In light of the highly unusual circumstances surrounding this case, in particular the measures announced to date by Government to support the banking system (described further below), the OFT does not consider that the rebuttable presumption in favour of the status quo ante can be safely applied in this case. Instead, it is more appropriate to consider at the outset whether an alternative counterfactual should be considered in such an exceptional case. The OFT notes that if it were assessing a merger situation (whether in the banking sector or some other sector in the economy) that did not involve Government intervention expected to influence the counterfactual to such an extent, even under similar economic conditions, that merger would normally be analysed against the standard counterfactual, that is, the pre-merger conditions of competition, and only then, if competition concerns were found, would alternative counterfactuals be considered.
47. The OFT also notes that, in the current conditions in the financial markets, there are inherent difficulties and associated risks in trying to predict with any certainty what the conditions of competition would have been absent the merger. Accordingly, the OFT has considered a range of possible

⁶ See, for example, OFT *Anticipated acquisition by Hospedia Ltd of Premier Telesolutions Ltd* 7 October 2008.

⁷ The exception to this would be where there is evidence that the merger should be considered against a more competitive counterfactual than pre-merger conditions (for example, where one party was a potential entrant, or intended significantly to enhance its existing competitive position).

counterfactuals, and then 'tested' the proposed merger against those considered to be the most realistic.⁸

48. Prior to considering the parties' arguments on the appropriate counterfactual in this case, it is relevant and useful to provide some background to the current state of the financial markets.

Current financial situation

49. The UK and global financial markets are experiencing a period of extraordinary, perhaps unprecedented change. The current turbulence, which many see as originating from sub prime mortgages in the US, took on a global dimension as it became clear that non-US banks were exposed to the risk of sub prime mortgage related securities.
50. Events in the US and Europe (including the particularly harsh financial situation affecting Iceland) since the Secretary of State's intervention in this case on 18 September 2008 indicate the progressive and severe strain affecting financial systems globally. For example: Bradford & Bingley's mortgage book has been nationalised. Hypo Real Estate, Dexia and Fortis in continental Europe have received significant government investment. Government intervention in the US has been extensive to rescue AIG, Fannie Mae and Freddie Mac. Other US banks, notably Washington Mutual and Wachovia, have been the subject of M&A activity in response to the risk of them 'failing', and the investment bank, Lehman Brothers, has filed for bankruptcy.

UK Government intervention and support

51. In the UK, to date, Government has intervened in the financial markets with a number of measures to support the UK's financial system. Most recently:
- 3 October: The FSA increases the compensation limit for deposits (with FSA authorised entities) from £35,000 to £50,000 with effect from 7 October.⁹
 - 8 October: HMT announces a £500 billion bank rescue package intended to (i) provide sufficient liquidity in the short term; (ii)

⁸ In its BSKyB judgment, the Competition Appeal Tribunal (CAT) considered that the CC was entitled to compare the competitive effects of the transaction with those of what it regarded as the most likely counterfactual of an independent ITV (see paragraphs 91-92 of BSKyB plc v CC; BERR, and Virgin Media, Inc. v CC; BERR [2008] CAT 25). The OFT's approach in this case is consistent with that judgment, when the different threshold that the OFT must apply in determining whether or not there is an SLC is taken into account: the OFT's belief is of a 'realistic prospect' of SLC under the 'may be the case' standard whereas the CC's belief is on the balance of probabilities.

⁹ www.fsa.gov.uk/pages/Library/Communication/PR/2008/114.shtml.

make available new capital to (FSA authorised) banks and building societies to strengthen their resources permitting them to restructure their finances, while maintaining their support for the real economy; and (iii) ensure that the banking system has the funds necessary to maintain lending in the medium term.¹⁰

- 13 October: HMT announces that, with continuing exceptional instability in the global financial markets, it is implementing the set of measures it announced on 8 October, to make commercial investments in the Royal Bank of Scotland Group (RBSG), and, upon completion of their merger, HBOS and Lloyds, totalling £37 billion to help stabilise their position and support the long-term strength of the economy, hereafter referred to as the 'recapitalisation'.^{11 12}

The parties' arguments on the counterfactual

52. The parties submit that the counterfactual to the proposed merger is a very significant reduction in the competitive pressure exerted by HBOS – [REDACTED], it would be a very different bank to the 'pre-credit crunch' HBOS of 2007 and prior years, and would be, at best, a very weak competitor. Accordingly, the parties argue that the merger should not be judged by reference to historic market shares or any view of HBOS's pre-merger effectiveness.
53. The parties argue that a more realistic counterfactual to HBOS remaining independent is that Government would have intervened with some form of HBOS specific 'rescue package',¹³ and further that such intervention would probably have led to structural limitations on the ability of HBOS to compete effectively [REDACTED]. As regards the possibility of HBOS failing or exiting the market, the parties argue that the OFT should be flexible in its approach to the failing firm defence. They say that it is inconceivable that Government would have stood by and allowed HBOS actually to fail, because this would have given rise

¹⁰ www.hm-treasury.gov.uk/press_100_08.htm.

¹¹ www.hm-treasury.gov.uk/press_105_08.htm.

¹² Other measures include: (i) in April this year the Bank of England launched a Special Liquidity Scheme to allow banks to swap, for a limited period to time, their illiquid mortgage-backed and other securities for UK Treasury Bills; and (ii) Government's decision in February this year to take Northern Rock plc into temporary public ownership, following various support measures granted by Government and Bank of England since September 2007. For further information, see www.hm-treasury.gov.uk.

¹³ Any reference to Government intervention and support in relation to HBOS absent the proposed merger relates to intervention/support in addition to that already provided more generally to the financial sector by Government, in particular in addition to the measures announced on 3 and 8 October (although noting that the specific recapitalisation measures offered to HBOS are conditional on the merger with Lloyds taking place and therefore would not be relevant to the counterfactual).

to unacceptable systemic risk, jeopardising the stability of the entire UK financial system, [REDACTED].

54. [REDACTED] the OFT has considered a range of possible counterfactuals under two broad categories: a private sector solution, and a public sector solution for HBOS. Prior to this, the OFT considered whether the case meets the failing firm defence.

Failure or inevitable exit of HBOS

55. The Guidance states that where one of the parties to a merger is genuinely failing, pre-merger conditions of competition might not prevail even if the merger were prohibited.¹⁴ In these circumstances, the counterfactual might need to be adjusted to reflect the likely failure of one of the parties and the resulting loss of rivalry that would have occurred in any event.
56. The parties argue that there are certain peculiarities about financial markets (for example, the fact that bank failures can happen suddenly, and can have wider consequences for both financial markets and the wider economy) that have to be taken into account in assessing the counterfactual for financial institutions, [REDACTED].
57. In particular, the parties argue that [REDACTED], would have been disastrous in terms of financial stability, in particular in terms of counterparty exposure, depositor exposure, investor confidence and general confidence in the wider economy.
58. In these circumstances, the parties argue that it is impossible to contemplate that HBOS would have been allowed to fail ([REDACTED]).
59. [REDACTED] the OFT considers that the application of the failing firm defence in this case is not appropriate given that it is not realistic to consider that HBOS would have been allowed to fail (or that its assets would have been allowed to exit the market). This decision not to apply the failing firm defence is consistent with the underlying rationale of the defence, which is to save assets from exiting the market where such exit is inevitable and there is no less anti-competitive alternative (including letting the assets fail).

¹⁴ According to the Guidance (paragraph 4.37), the following criteria must be met in order for the failing firm defence to apply: (i) the firm must be in such a parlous situation that without the merger it and its assets would exit the market and that this would occur in the near future; (ii) there must be no serious prospect of re-organising the business of the firm; and (iii) there should be no less anti-competitive alternative to the merger. Even if a sale is inevitable, there may be other realistic buyers whose acquisition would produce a better outcome for competition. These buyers may be interested in obtaining the firm should the merger not proceed: that could indeed be a means by which new entry can come into the market.

60. Accordingly, the OFT does not consider it realistic to consider that the failure/exit of HBOS (or its assets) would have occurred nor that the failing firm defence rules should be relaxed, and therefore has ruled out failure/exit as a possible substitute counterfactual.

'Private sector' solution: HBOS remaining independent without (HBOS specific)

Government support

61. HBOS told the OFT that the macroeconomic developments described briefly above led to a range of [REDACTED] impacts on HBOS. Many of these events applied to all other banks but some had a disproportionate impact on HBOS [REDACTED]. As market participants became increasingly concerned with counterparty risk and uncertainty over the scope of the sub prime crisis, so liquidity reduced, [REDACTED].
62. In these circumstances, HBOS argues there was no realistic prospect of reorganising its business. It submits that it would have been required to take steps [REDACTED]. A similar picture, it says, would have emerged in SME lending. While it would have been possible, in theory, to sell off assets [REDACTED] asset disposals would need to have been on an extraordinary scale to make any meaningful contribution [REDACTED]. Moreover, as a distressed seller of assets, HBOS would undoubtedly have incurred substantial losses even if buyers could be found.
63. HBOS acknowledged that it would still have had strong incentives to compete for retail deposits to fund its lending. However, HBOS told the OFT (and provided some supporting evidence) [REDACTED], and its expectation is that this would, absent the merger, continue inexorably.
64. With respect to the measures announced by Government on 8 October to support the UK's banking system (see above), the parties argue that, absent the announcement of the proposed merger, there is a real risk that a combination of the 'domino effect' (given other bank difficulties that have arisen since the announcement of the merger) and [REDACTED] would have, at best, acted as a material impediment to HBOS's ability to compete aggressively. In these circumstances, the parties argue, [REDACTED].
65. Therefore, even [REDACTED] HBOS could have remained an independent competitor without HBOS specific Government support, HBOS argues that it would have been a very weak competitor, not just in mortgages and other lending [REDACTED], but also with respect to retail banking more generally.
66. It is uncontroversial to accept that HBOS was (and still is) experiencing [REDACTED] difficulties under the current conditions in the financial markets, in

particular as a result of its wholesale funding model. However, the OFT notes that, even though [REDACTED] other scenarios to be, relatively speaking, more realistic, [REDACTED] HBOS itself accepts that independent survival [REDACTED].

67. The OFT notes the particular difficulty (and by implication associated risk) in making a predictive assessment about the counterfactual under the current rapidly moving market conditions. However, whatever the probability of HBOS remaining independent, the economic effects of the merger (when tested against the counterfactual of HBOS remaining independent) are in broad terms similar to those raised when tested against the counterfactual of the Government intervening with some form of rescue package, and subsequently withdrawing its support (albeit the precise degree of competitive influence HBOS would have had in the market might have differed between these two solutions depending on Government intention).¹⁵ This counterfactual is discussed further below as the Stage II counterfactual.

Private sector solution: acquisition by a third party

68. Exceptionally, the OFT also considered whether HBOS might have been purchased by a party other than Lloyds, and whether this should be an appropriate substitute counterfactual.¹⁶
69. The parties argue there was no realistic prospect of finding an alternative purchaser for HBOS. In particular, HBOS told the OFT that it did not believe that RBSG or Barclays would have the appetite to enter into such a large scale transaction with HBOS (RBSG had only recently acquired ABN Amro; Barclays' attention was focused on acquiring the US investment banking business of Lehman Brothers), and that HSBC would not have been interested in such a transaction, or at best would not have been able to move as quickly as Lloyds. In any event, the parties argue that any 'in market' bidder (by which the OFT assumes they mean one of the main banks in the UK) would have led to the similar level of consolidation, and therefore probably a similar competitive

¹⁵ This could occur in a number of different ways, including: withdrawing any support that did not involve recapitalisation, thereby leaving a fully independent HBOS once more; or, in the event recapitalisation is involved, brokering the sale of HBOS to a 'no overlap' third party purchaser (that is, one that does not raise competition concerns) or selling its shares in HBOS on the open market.

¹⁶ The OFT will generally not conduct, as part of its assessment of the appropriate counterfactual, a competitive assessment of the outcome of a sale to a different party. Such an approach risks creating an unworkable regime of first-phase merger control where: the OFT is obliged to conduct an in-depth fact-based assessment of the inevitability of the sale by the seller; and conduct a competitive assessment of the outcome with the preferred bidder against, for example, a range of potential alternative buyers without evidence from alternative buyers that would have been received had they notified a competing bid to the OFT. See OFT *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson* 11 December 2007.

outcome – in other words, an acquisition by one of the main banks would not have been substantially worse or better from a competitive assessment perspective. Similarly, HBOS considered that no overseas or 'out of market' bidder would have been able to proceed at sufficient speed. [REDACTED] FSA confirmed the parties' claims that there were no other credible bidders for HBOS during this period.

70. Whatever the probability of an acquisition by a less anti-competitive third party, the OFT's assessment would be fundamentally no different from that discussed further below, and referred to as the Stage II counterfactual (other than the fact there would be no Government support at the Stage I counterfactual but would instead move straight to the 'no overlap' bidder).^{17 18}

Public sector solution: (HBOS specific) Government support and intervention – 'Stage I' counterfactual

71. The parties argue that a more realistic counterfactual scenario (to HBOS remaining independent) is that Government would have intervened absent the proposed merger (most likely by nationalising HBOS), and that this would probably have led to structural limitations on the ability of HBOS to compete, [REDACTED]. The parties recognise that it is difficult to predict with any certainty what sort of conditions might have been attached to such Government [REDACTED] but that the authorities could well have imposed significant limitations on HBOS's commercial freedom of action in order to prevent HBOS from competing 'unfairly' in the market, so as to limit in some way HBOS's ability to compete in the market. In this regard, the parties referred to the limitations imposed on Northern Rock while it is in receipt of assistance from the UK Government. The parties argue, therefore, that under this counterfactual scenario HBOS could not be expected to compete to the same extent or in the same manner as previously, and in particular as it had done prior to the onset of the current financial crisis.
72. Clearly, the OFT is not best-placed to predict with any certainty what action, if any, Government would have taken with respect to HBOS absent the merger. However, in light of the measures taken by Government to date (as described

¹⁷ By 'no overlap', the OFT means a bidder that does not raise competition concerns; for example, a non-trade (e.g. private equity) bidder or an overseas bank not currently present in the UK would be a 'no overlap' bidder.

¹⁸ Sale to a third party purchaser would also cover the scenario whereby part of the HBOS business is sold to a third party, and part receives Government support (whether full nationalisation or some lower level of recapitalisation) – a similar approach was taken with respect to Bradford & Bingley, where its retail deposits business and branch network were sold to Grupo Santander, and its mortgage book was nationalised. Whatever the probability of this scenario, assessing the merger against this counterfactual would result in the same analysis as that under the Stage I and Stage II counterfactual, which is discussed further below.

briefly above), the OFT believes it is realistic to consider that some form of HBOS specific Government intervention and support¹⁹ would indeed have occurred absent the merger – this does not mean that the OFT considers that Government intervention would definitely have occurred, nor that it would necessarily have occurred on a balance of probabilities, but rather that there is a realistic prospect that it would have occurred.

73. Further, in light of Government's recapitalisation plans announced on 13 October in relation to RBSG and the merged Lloyds/HBOS as well as the other measures announced by Government to date in relation more generally to the banking sector, the OFT considers it is realistic to assume that any specific Government intervention and support to HBOS would have involved some level of recapitalisation.²⁰ It is too speculative, however, to try to predict with any certainty the precise level of any such recapitalisation – that is, whether Government would have taken HBOS into temporary public ownership (as was the case for Northern Rock) or whether it would have taken some lower level of shareholding in the bank.²¹
74. As regards [REDACTED] State aid restrictions, the OFT considers that it is not clear whether restrictions would apply in these circumstances (in particular in view of the uncertainty around what type and level of Government intervention would occur), and further – even assuming they were to – that it is too speculative to predict the type and scope of any such restrictions, and their likely impact on HBOS's ability to compete.
75. As regards the impact of any specific Government intervention and support to HBOS, the OFT notes that Government's recapitalisation plan for RBSG and a merged Lloyds/HBOS (announced on 13 October) includes the requirement that the recipient of the cash injection must maintain, over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels. In other words, the implication (at least in relation to mortgages and SME lending) is that the recipient bank should continue to offer competitive offerings in the market place and, at least prima facie, this does not impair its ability to compete.
76. In light of the evidence before it, while the OFT cannot exclude the possibility that State aid restrictions could apply, and further that such restrictions could

¹⁹ See footnote 13.

²⁰ The OFT notes that the recapitalisation measures announced on 13 October in relation to Lloyds and HBOS were contingent on the proposed merger going ahead, although this obviously does not necessarily mean that no help would be available to each of them if the merger did not go ahead.

²¹ Under Government's recapitalisation plans, it is understood that Government may hold a shareholding in Royal Bank of Scotland Plc of up to 60 per cent, and up to 40 per cent in a merged Lloyds/HBOS.

have some impact on HBOS's freedom to compete (compared to its position prior to the current financial crisis), the OFT believes that it is realistic to consider that HBOS would be an effective competitive force in the market place even if it received some form of Government rescue package. This reflects the statutory test that the OFT must apply in determining whether or not a merger raises competition concerns.²²

77. The counterfactual of HBOS with some form of specific Government support is referred to as the 'Stage I' counterfactual.

Private sector solution following (HBOS specific) Government support and intervention – 'Stage II' counterfactual

78. In relation to the recapitalisation measures announced by HMT on 13 October, Government indicated that it is not a permanent investor in UK banks, and that its intention, over time, is to dispose of the investments it has made.²³

79. In light of this, the OFT considers that it is realistic to consider that:

- if not in the short term, in the medium term (in other words, it would be a question of when, not if) the Government would have withdrawn its support once the current financial turbulence was over, and customer and investor confidence had been restored in HBOS. In circumstances where the Government's support included recapitalisation, this would entail Government reducing its shareholding in HBOS to zero and brokering the sale of the bank to a third party purchaser (or selling its shares on the open market). If the Government had not taken any shareholding in HBOS, it would remove its support, thereby leaving HBOS as a fully independent entity once again, and
- in the case of recapitalisation, the Government would not, as a matter of public policy, broker a sale that raised competition concerns under normal market conditions.

80. In these circumstances, the OFT believes that it is realistic to consider that any such third party purchaser (or purchasers if, for example, HBOS were sold off in parts) would therefore be a 'no overlap' bidder or, at least, one where any competition problems which might have arisen had been cured by the normal functioning of the UK merger regime (for example, through remedies). Accordingly, assessing the proposed merger against the counterfactual of HBOS

²² See the Jurisdiction and Legal Test section above.

²³ See www.hm-treasury.gov.uk/press_105_08.htm.

remaining independent would follow the same analysis as here (see discussion above).

81. While merger analysis is essentially a predictive exercise, the further in the future that the OFT must predict, the greater the margin of error. Nevertheless, in this case, it is appropriate to attach weight to the Government's stated intention not to be a long-term investor in banks, irrespective of precisely when the withdrawal of Government support would occur. This counterfactual is referred to as the 'Stage II' counterfactual, as it would be sequential²⁴ (rather than an alternative) to the Stage I counterfactual (HBOS with some form of Government rescue package). In other words, any competition concerns that arise at Stage I would be concerns arising in the short term, while those arising (only or in addition) at Stage II are based on medium to longer run effects.
82. A similar approach to the one set out above has been taken by the CC and the OFT in the special case of rail franchises, where for public policy reasons the authorities treat the award of the franchise as inevitable (in other words, rather than Government running the franchise).²⁵
83. In these circumstances (that is, post-Government rescue), HBOS would, in the hands of a 'no overlap' third party, have represented a significant competitor in the market place.
84. In particular, the OFT notes that HBOS would constitute an attractive entry point into the UK retail banking sector, particularly now that Abbey, and more recently, Alliance & Leicester are no longer 'available' as independent competitors, having been acquired by the Spanish bank Grupo Santander.

CONCLUSION ON THE COUNTERFACTUAL

85. In summary, the OFT accepts the parties' arguments that pre-merger conditions of competition is not the appropriate counterfactual in this case. Instead, the OFT has considered a range of counterfactuals, of which the two most realistic, and therefore reasonable to consider, are set out below. These would be expected to occur sequentially rather than as alternatives.
 - Government would not have allowed HBOS to fail, and rather would have intervened in the short term with some form of rescue

²⁴ The exception to this would be if the 'Bradford & Bingley' approach were followed, as discussed above.

²⁵ The approach of the CC in its report on the acquisition by First Group plc of the Great Western Franchise (8 March 2006) was to treat the counterfactual *not* as the bidder who came second – which might also pose competition concerns – but as a hypothetical 'no overlap' bidder or one whose competition problems had been cured (and in any event not the Government running the franchise in the medium term).

package: the Stage I counterfactual. In these circumstances, the OFT believes it is realistic to consider that HBOS would still be able to exert competitive pressure in the market (although it recognises the possibility that HBOS might, at least in the short term, be a weaker force when compared to the HBOS prior to the current financial crisis).

- In the medium to longer-term, Government would have withdrawn its support, leaving either a fully independent HBOS once more, or an HBOS in the hands of a 'no overlap' purchaser: the Stage II counterfactual. In these circumstances, HBOS would also constitute a significant player in the market place in the medium term.

86. The OFT has assessed the impact of the proposed merger against both the Stage I and Stage II counterfactuals in order to determine whether it may be expected to result in a substantial lessening of competition. Under both counterfactuals, HBOS is assumed to be exerting competitive pressure in the market place, although in Stage I it might be weaker than it was before the current financial crisis and therefore it is likely to be a stronger competitor in Stage II comparatively. When HBOS's weaker position under Stage I is of relevance for the competitive analysis, this is taken into account accordingly.

VI AREAS OF OVERLAP

87. The parties overlap in the supply of banking (personal and corporate) and insurance services. The OFT was told by Lloyds that the parties overlap in the following activities:

Personal banking

- PCAs
- Savings
- Wealth management
- Personal loans
- Credit cards
- Mortgages
- Pensions

Corporate banking

- Banking services to SMEs
- Banking services to large corporations
- Treasury and capital markets
- Asset finance / fleet car hire

Insurance

- PPI
- Life
- General

88. This report considers the impact of the merger on competition in each area of overlap, but will focus on PCAs, banking services to SMEs, and mortgages, where the OFT considers that the merger raises potential competition concerns.
89. The banking sector has been examined extensively in recent years by both the OFT and the CC, in the context of both merger control and market reviews. The OFT has drawn heavily upon the learning from these various reviews in its assessment of the proposed merger, given their particular relevance and the limited time available for this review. In particular, the OFT has drawn upon learning, where relevant, from:

- the CC's report on the proposed acquisition by Lloyds TSB of Abbey National (2001) (Lloyds/Abbey)
- the CC's market investigation report into personal current account banking services in Northern Ireland (2007) (the CC's Northern Ireland PCA Market Investigation Report)
- the OFT's market study in personal current accounts in the UK (2008) (the OFT's PCA Market Study Report)
- the CC's market investigation report on the supply of banking services by clearing banks to small and medium-sized enterprises (2002) (the CC's SME Market Investigation Report), and
- the OFT's review of the undertakings given by banks following the SME Market Investigation Report (2007) (OFT's SME Review Report).²⁶

²⁶ Competition Commission *Lloyds TSB Group plc and Abbey National plc: A report on the proposed merger* July 2001; Competition Commission *Personal current account banking services in Northern Ireland market investigation* May 2007; Office of Fair Trading *Personal current accounts in the UK – An OFT market study* 2008; Competition Commission *The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK* March 2002; and Office of Fair Trading *SME Banking - Review of the undertakings given by banks following the 2002 Competition Commission report* August 2007.

VII PERSONAL CURRENT ACCOUNTS

MARKET DEFINITION

Product market

90. The CC in Lloyds/Abbey distinguished banking services provided to personal customers from banking services provided to enterprises.
91. In the Northern Ireland PCA Market Investigation Report the CC defined a PCA product market to include four functions: (a) to provide a facility to deposit and store money, with quick and easy access; (b) to provide a facility to receive payments by cheque or electronic transfer; (c) to provide a facility to make instant and/or regular payments without using cash, e.g. through cheques, switch payments, bank transfers, standing orders and direct debits; and (d) to provide the means for short-term borrowing through an overdraft.²⁷ Lloyds used the same approach to the market. Third parties generally agreed with this approach. The evidence before the OFT does not suggest that it should assess the proposed merger under a different product market definition for PCAs.

Geographic market

National and regional

92. In Lloyds/Abbey the CC found there to be distinct PCA markets for Northern Ireland and Great Britain.²⁸ Lloyds does not operate in Northern Ireland and therefore the OFT has focused its investigation on Great Britain.
93. In Lloyds/Abbey the CC found that the parties to that merger had similar market shares and business strategies across Great Britain and therefore it was not necessary to consider the issue of whether the relevant market should be segmented further from a geographic standpoint.²⁹
94. Lloyds argues that the same approach should be taken in this case. Its main arguments are that:

²⁷ This definition includes packaged accounts but does not extend to basic bank accounts, instant savings accounts, credit union accounts, offset/current account mortgages or other personal financial products. For more details see the CC's Northern Ireland PCA Market Investigation Report, page 50.

²⁸ Paragraph 4.24.

²⁹ Paragraph 4.23.

- terms and conditions are generally uniform throughout Great Britain
- reputational risks cause banks to avoid treating different regions unfavourably
- customer mobility reinforces these effects
- marketing campaigns tend to be consistent across Great Britain, and
- remote formats of PCA services make it impractical to deviate from a consistent national approach to services.

95. Competitors to the parties generally considered that the appropriate scope of the geographic market is UK-wide.

96. In this merger, distinct from the case in Lloyds/Abbey, the parties' market shares are not consistent throughout Great Britain. Indeed, as it will be seen in the horizontal assessment section below, HBOS's market share is three times bigger in Scotland than it is in England and Wales. Furthermore, while the mergers between banks that largely operated in different parts of Great Britain (RBS/NatWest in 2000 and Halifax/BOS in 2001) may have tended to create a Great Britain-wide market, the present merger may tend to reverse this by significantly changing the relative market shares between Scotland on the one hand and England and Wales on the other. A similar point was raised by a competitor to the merging parties. On the basis of the limited evidence available, the OFT cannot exclude the possibility that Scotland should be considered as a separate geographic market.

Local markets

97. From a demand perspective, as noted in the OFT's recent PCA Market Study Report, branch access remains a vital part of the banking relationship for most consumers, notwithstanding the growth in services provided by ATMs, over the telephone and on the internet.³⁰ In particular, according to a survey carried out by the OFT as part of that study, across all respondents branch location was considered to have been the most important factor when choosing with which bank they should open their main account. This finding is supported by the CC's Northern Ireland PCA Market Investigation Report which showed that consumers attached considerable weight to whether a bank had a branch near them when

³⁰ See, in particular, paragraph 3.18 onwards.

choosing a their PCA provider. Indeed, internet-only PCA providers have not individually or collectively achieved significant market shares.

98. Lloyds accepts that access to a branch network is considered an attractive feature by a proportion of customers. However, it submits that, because competition conditions are homogeneous across Great Britain and it is therefore easy to expand branch networks, and because banks do not differentiate their offers according to their branch position in a particular area, there are no separate local markets. In the response to the issues letter, Lloyds submitted that the scope for decision-making at the branch level is [REDACTED], that branch managers have [REDACTED] or [REDACTED], and that [REDACTED] are set nationally. HBOS does have a branch-based incentive programme but submits that such programme has a limited budget.
99. The OFT's starting assumption for retail markets is that there is local competition to attract and retain customers, even if not on every parameter of price, quality, range and service specifications (PQRS).³¹ Even if the current national pricing and marketing policies of the merging parties preclude the lowering of prices to gain customers locally, this does not preclude the merged party from finding this an attractive strategy as a result of the merger. In addition, a bank³² could still invest more on other aspects of its QRS position such as staff service, waiting times, a branch's location, and in reaction to local competition.
100. In the time available, the OFT was not able to conduct an empirical exercise to measure the impact of local competition on PQRS. In view of the strong local aspects associated with the demand for PCAs and of the OFT's experience in retail mergers described above, the OFT cannot exclude the possibility that a merger that significantly increases local market concentration in the supply of PCAs through branch access raises substantial competition concerns at the local level.

HORIZONTAL ASSESSMENT

Introduction

101. The PCA market is very large. There are at least 64 million PCAs in the UK (54 million are estimated to be in use) and the OFT estimates that the revenue accrued by banks from PCAs in 2006 was at least £8.3 billion.³³ The average

³¹ See OFT *Completed acquisition by Home Retail Group plc of 27 stores from Focus (DIY) Ltd* April 2008.

³² Note that [REDACTED], but the level at which the decision-making occurs is irrelevant: central management might take local decisions.

³³ See the PCA Market Study Report, page 1.

daily credit balance over the year for the 16 banks contacted in the OFT's PCA Market Study Report was £97 billion.

102. Past studies of the market have identified a lack of competition in at least certain aspects of the PCA market.³⁴ In particular, the OFT's PCA Market Study Report found that some barriers to entry and expansion, in particular consumer inertia, have constrained competitive pressures (although did not remove them entirely). Also of relevance for the present analysis are the findings that competition tends to be stronger for some new-to-banking customers (especially students) as they do not need to switch accounts,³⁵ and that while some price dimensions of the PCA product are subject to stronger competitive pressures (for example zero transaction charges and credit interest rates), others (such as insufficient fund charges) are not.³⁶
103. Given its scope and the fact that it is very recent, the OFT considers that the findings of its PCA Market Study Report provide an accurate description of the competitive conditions of the PCA market and therefore it has been used as the starting point for this merger analysis. However, as discussed in the counterfactual section above, the OFT accepts that HBOS, under the Stage I counterfactual, may not be as strong a competitor as it was pre-credit crunch. However, the OFT cannot exclude that HBOS would still exert a competitive constraint in the market place, in particular given that it is by no means clear how the other banks in the market place have been affected by the current market conditions.

Market shares

Comments on the relevance of the market share data

104. The OFT did not have access to information relating to the extent to which market shares have changed since August 2008 and more specifically since the worsening of the financial crisis in the UK in mid-September.³⁷ HBOS told the OFT that [REDACTED] but did not provide further details. The OFT does not have any evidence regarding the extent to which other banks have seen customers switching away (or gaining share) since the beginning of the crisis.

³⁴ Including the Cruickshank report which found that competition was not working effectively in any of the retail banking markets it studied (including PCAs) (Report to the Chancellor of the Exchequer on Competition in UK Banking by Mr Don Cruickshank, Chairman of the Banking Review Team, in March 2000).

³⁵ PCA Market Study Report, paragraph 3.115.

³⁶ PCA Market Study Report, paragraph 3.113.

³⁷ In any event it is not obvious that they would be of particular relevance to the present analysis because of the exceptional events of September and October 2008 in the banking sector.

105. The OFT accepts that, absent the merger, HBOS under the Stage I counterfactual may have been a weaker competitor than it had been pre-credit crunch, and therefore that the market share of new accounts may over-estimate its likely competitive strength, at least in the short term. However, as discussed above, the OFT cannot exclude the possibility that HBOS would still have been an effective competitor under the Stage I counterfactual (as it would more clearly have been under Stage II). Further, the OFT notes that it does not have any evidence regarding the extent to which other banks have been affected by the current market conditions (for example, the extent to which other banks have seen customers switching away (or gaining share) since the beginning of the crisis). In these circumstances, the OFT considers it reasonable to use the data as a useful starting point in relation to both counterfactuals.

Share of PCA stock

106. On the basis of 2007 market share estimates, the merged entity will be the clear market leader in terms of stock of PCAs in Great Britain, with a combined market share of 33 per cent (increment 14 per cent).³⁸ The next three players (RBSG, HSBC and Barclays) have market shares between 14 and 17 percent, and the concentration ratio of the top four players in the market (C4) is increased by the merger from 67 per cent to 80 per cent. All other players have shares of less than ten per cent each. The post-merger HHI³⁹ is 1950, which indicates that this is a highly concentrated market, with an increment of almost 500. The Guidance⁴⁰ states that any market with a post merger HHI in excess of 1000 is concentrated, and that in a concentrated market a merger with a delta in excess of 100 may give rise to potential competition concerns.
107. In Scotland, the parties' combined share of stock of PCAs is [40-50] per cent. RBSG has just above [20-30] per cent, and all other players have less than ten per cent. The C4 increases from [40-50] per cent to [70-80] per cent, and the HHI increases by [500-1000] points from [1000-2000] to [2000-3000].
108. Notwithstanding that the more widely dispersed distribution of population in rural Scotland might intuitively suggest that barriers to entry there in the form of establishing a brand network would be higher, the OFT has not received evidence that barriers to entry and switching costs are any different in Scotland to England and Wales. Even given this, however, any unilateral effects identified in the PCA market in Great Britain as a whole are nonetheless expected to be stronger if Scotland is considered in isolation.

³⁸ Market shares by number of PCA customers, 2007. Source: PCA Market Study Report, table 3.1 based on Mintel.

³⁹ Herfindahl-Hirschman Index. See Guidance, paragraph 4.3.

⁴⁰ Paragraph 4.3.

Share of PCAs opened in the previous 12 months

109. Historical market share data indicate that HBOS has enhanced its position as the lead challenger to the big four banks in Great Britain (Barclays, HSBC, Lloyds and RBSG) since the merger of Halifax and the Bank of Scotland in 2001, growing its market share of new accounts from around [10-20] per cent at the time of the merger to [10-20] per cent in 2007. Although its rate of growth has declined since 2003, it is still positive on the basis of the latest data provided by the parties.⁴¹
110. The market share data provided by the parties indicates that the 'challenger' banks (the main ones being HBOS, Santander and Nationwide) are gaining a disproportionate share of new accounts in comparison with their share of stock accounts. Conversely, 'traditional', or 'big four' banks (Lloyds, Barclays, HSBC and RBSG) are gaining proportionally fewer new accounts, though—given the small proportion of all accounts that new accounts represent—the market shares of the big four have been stable for this time and (the OFT understands) a good deal longer.

⁴¹ The parties provided in Annexe 4 to their response to the issues letter data indicating the flow versus stock variance for PCAs updated until July 2008.

Table 1 – Market shares of PCAs

	2003			2004			2005			2006			2007			2008 (Aug)		
	Stock	New	New minus stock	Stock	New	New minus stock	Stock	New	New minus stock	Stock	New	New minus stock	Stock	New	New minus stock	Stock	New	New minus stock
Big four																		
Lloyds	[20-30]	[10-20]	-[0-10]	[20-30]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]
Barclays	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	0	[10-20]	[10-20]	-[0-10]
HSBC	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	0
RBSG	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]	[10-20]	[10-20]	-[0-10]
Main challengers																		
HBOS	[10-20]	[20-30]	[10-20]	[10-20]	[20-30]	[10-20]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]
Santander	[0-10]	[10-20]	[0-10]	[0-10]	[10-20]	[0-10]	[0-10]	[10-20]	[0-10]	[0-10]	[10-20]	[0-10]	[0-10]	[10-20]	[0-10]	[10-20]	[10-20]	[0-10]
Nationwide	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]	[0-10]

Source: [REDACTED], submitted by Lloyds

111. Table 1 clearly indicates that, over a five year-period, while all main challengers (including HBOS) have proportionally gained more new accounts than their share of stock, all 'big four' (apart from HSBC in 2004 to 2006) have consistently gained fewer new accounts than their share of stock. This indicates that the main challengers are taking business away from the big four.
112. Lloyds submits that the impact of HBOS has declined over the last five years. That is true: while in 2003 HBOS's share of new accounts was [10-20] per cent, in the period up to August 2008 it was [10-20] per cent. However, it is also true that, until August 2008 at least, HBOS continued to 'punch above its weight', that is, it proportionally gained more new accounts than its share of stock.

Theories of harm – national and regional

Introduction

113. In Lloyds/Abbey the CC identified two theories of harm in relation to PCAs. First, as already mentioned above, the increase in Lloyds' customer base would encourage it to attach more weight to enhancing margins than to customer acquisition, and, second, in relation to all major banks, the merger would cause the removal of one of the main sources of actual and potential competition.⁴² The evidence before the OFT suggests that this merger would give rise to unilateral concerns of a similar nature.

Margin enhancement

114. On the basis of the above, the OFT considers that the scope for competition between banks is largely limited to new customers and the small proportion of customers who are likely to be 'switchers', that is, who are not 'inert'. In what follows, these customers (new to PCAs and switchers) will be collectively referred to as 'active' customers as opposed to the 'inert' customers who are unlikely to switch. On the basis of the evidence on the low switching rates and high switching costs, the OFT considers it likely that the proportion of PCA

⁴² The CC in Lloyds/Abbey found that the merger would lead to coordinated as well as unilateral effects. In this section the OFT is considering primarily a unilateral effects theory of harm (for coordinated effects, see separate section below). However, the finding that the merger may change the incentives of all firms present in the market to compete is not inconsistent with a theory of harm that relies purely on multi-lateral effects. Indeed, multi-lateral effects (when the equilibrium prices of the other firms in the market rise in response to a – unilateral – price rise by the merged firm) are associated with unilateral effects, and not with coordination.

customers who are 'inert' is very high and by far the most significant element of the PCA market.

115. In a market such as PCAs with high switching costs, banks must balance the incentive to charge a high price or worsen costly non-price factors such as service to exploit locked-in customers, against the incentive to charge a low price/improve non-price factors to improve value for money and attract new customers who build up the bank's current market share and affect its future profitability. The more banks value current profits over future profits, the more the incentive to worsen the bank's offer to exploit locked-in customers dominates the incentive to improve value for money to attract new customers. A consequence of this is that banks with lower market shares tend to offer a better value for money PCA proposition than established banks with higher market shares because smaller banks have less to lose (in terms of foregoing the opportunity to exploit locked-in customers) and more to gain (in terms of attracting new customers) from charging low prices and/or improving non-price factors such as service.
116. Conversely, in some circumstances, larger banks in markets with switching costs such as PCAs may still be competitive. For example, the ability to discriminate between active and inert customers in terms of price and/or non-price factors may give large banks the same scope to compete at the margin as smaller rivals. In particular, if 'introductory' or other offers are typically available both to new PCA customers and to PCA customers of other banks, then each large bank is willing to offer improved value for money to other banks' customers because it can do so without having to offer the same to its own customer base. However, if all banks behave in this way, the customer base of each bank may be able to avail itself of the improved value for money of the other banks and the actions of active customers protect the interests of inert customers leading to better PCA value-for-money propositions generally.
117. As such, offering a better value for money PCA proposition to active customers will still tend to reduce the profitability of inert customers. This in turn means that the incentives to offer better value for money PCA propositions to win active customers will still be lower for a bank with a large base of inert customers than it will for a bank with a smaller base of such customers. Furthermore, the bigger banks will tend to offer worse value for money PCA propositions to active customers and to have lower shares of active customers (i.e. to have lower shares of new PCA business) relative to their shares of inert customers (i.e. relative to their shares of the stock of PCA business).
118. Consequently, the interaction of high switching costs and price discrimination (or discrimination between active and inert customers in terms of value for money PCA propositions) is at the crux of the OFT's 'margin enhancement' theory of

harm. On balance, it is difficult for the OFT to tell on the basis of the evidence before it (reviewed below) whether the degree to which banks are able to price discriminate might mitigate or exacerbate competition problems associated with high switching costs but the problematic characterization of banking competition described in the preceding paragraph is nonetheless the one most closely suggested by the evidence available to the OFT.

119. Turning to that evidence, on the basis of the OFT's PCA Market Study Report, it appears that, when trying to grow their business, banks tend to focus on customers new to PCA banking, such as students, rather than attracting their competitors' customers.⁴³ Conversely, many banks operate multiple banking brands (e.g. HBOS' Intelligent Finance, HSBC's First Direct and Santander's Abbey and Cahoot), which may be used as smaller 'fighting' brands to win market share.
120. In addition, the OFT was told by the merging parties that their [REDACTED] between customer groups is very limited and that there is [REDACTED]. On the basis of anecdotal evidence, this seems to be true to a certain extent. Evidence before the OFT suggests that banks tend to offer a standard 'menu' of prices regardless of whether the customer is an established customer, is new to PCAs or is a switcher. However, there are two caveats to this general proposition. First, more beneficial terms tend to be offered to students and graduates. Second, the OFT was told that even if introductory offers (normally targeted at new customers or switchers) are offered to stock customers as well, the low level of switching between account types within the same bank means that these offers are, to a certain degree, an opportunity to differentiate between customer groups, albeit imperfectly. In other words, few existing customers may actually take up the more attractive accounts, especially at the big four banks. Evidence collected in the OFT's PCA Market Study Report about the distribution of credit interest paid on balances supports this.⁴⁴
121. The evidence before the OFT suggests that Lloyds and the other 'big four' could be considered to be in the 'harvesting' stage of the market, that is, in a position in which it is more profitable for them to extract margins from inert customers than to compete for active customers. Indeed, the evidence indicates that [REDACTED] (see Figures 1 and 2). Challenger banks in general have also maintained a more favourable distribution of credit interest paid to their customers, according to the OFT's PCA Market Study Report—though the OFT does not know whether the same is true for the 'fighting' brands of the leading banks.⁴⁵ In addition, [REDACTED].

⁴³ See paragraph 3.94 of the PCA Market Study Report.

⁴⁴ See OFT's PCA Market Study Report page 40, chart 3.12.

⁴⁵ See Chart 3.12.

Figure 1

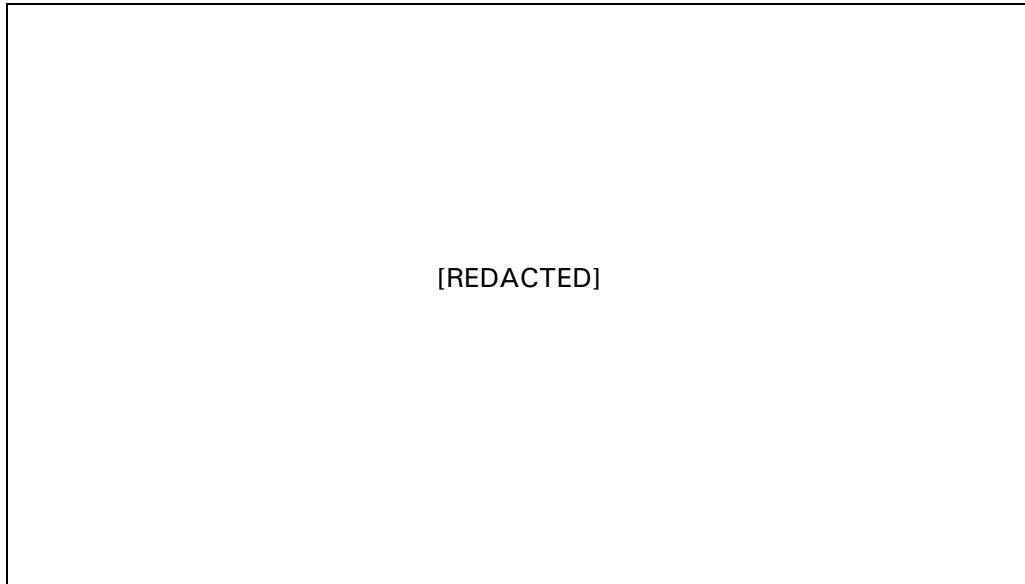
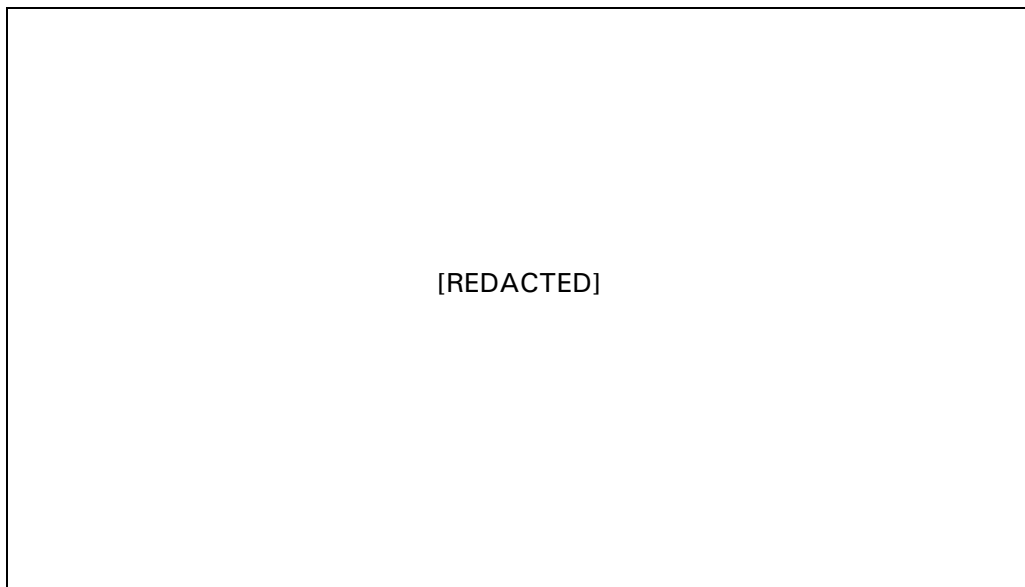


Figure 2



122. These observations are also supported by the market share figures over time discussed above, which indicate that generally the big four are only very slowly losing their share of business to the challengers and even then perhaps only in recent years. It is also consistent with Lloyds' submission that it 'competes actively both to retain existing customers and to acquire new accounts to offset those losses that it cannot prevent'. This seems to indicate that Lloyds' strategy

is to maintain its market share levels rather than to fight to gain a bigger share of the market.

The effect of the merger on margin enhancement

123. The merger will not change the total number of active customers (regardless of whether they are being served by one of the merging parties, by another bank, or by no one). However, the number of inert customers in Lloyds' customer base will increase: it will be the sum of its inert customers pre-merger and HBOS's inert customers pre-merger (notwithstanding that a higher proportion of HBOS's stock of inert customers will have previously been active, given its status as a challenger bank).⁴⁶ As a consequence, the ratio of inert customers served by the merged bank (which the merger increases) to the number of active customers (which remains equal) increases with the merger.
124. The theory of harm is that, by increasing Lloyds' customer base and its ratio of inert customers to the total number of active customers in the market, the merger encourages Lloyds to attach (even) more weight to the enhancement of margins than to the growth of market share. In other words, Lloyds is expected to be a less aggressive competitor following the merger, even if it is accepted that it must compete, to a certain extent, to maintain its market share levels. In this regard, one third party felt that the extensive database the merged firms would hold on a significant number of UK customers would allow them to better target new customers, and thus build on their leading position.
125. It is important to note that this theory of harm does not rely on the assumptions made in relation to HBOS's likely future strength absent the merger (in other words, on the counterfactual). This is because this theory does not focus on the removal of HBOS as an independent competitor, but rather on the increased size of the combined entity, in particular in terms of installed base of inert customers. Therefore the fact that HBOS may have been losing share of new accounts does not affect this analysis.

⁴⁶ The OFT notes however, that this does not mean that HBOS will necessarily have proportionally a larger stock of potentially active customers than Lloyds. This is because some of HBOS's active customers will have been new to PCA banking: these customers may become inert now they have a PCA. Others of HBOS's active customers will previously have been switchers: it seems just as plausible that these customers are now less likely to switch in future (having found a good value-for-money PCA proposition) as it does that they are more likely to switch in future.

Elimination of a particularly important challenger

Introduction

126. The second theory of harm, that is, that the merger eliminates a particularly important independent challenger to the 'big four' banks (a 'prime challenger'), is more dependent on the counterfactual against which the merger is considered. As will be discussed below, the OFT considers that the reference test would be more likely to be met in relation to this theory of harm under the Stage II counterfactual than under Stage I.
127. The big four banks, with the exception of HSBC in the period between 2004 and 2006, tend proportionally to gain less new business than their share of stock. As discussed above, it is plausible and indeed consistent with the evidence before the OFT that the big four are less interested in gaining new net business than in maintaining their market share levels. In addition, as indicated in Figures 1 and 2 above, [REDACTED]. As a consequence, the OFT considers that a key driver of competition in the PCAs market are the challenger banks.

HBOS as a 'prime challenger'

128. HBOS's position as a challenger bank to the big four in terms of its market share and its consequent incentive to gain margins underpins the OFT's 'margin enhancement' theory of harm above. However, HBOS's importance as 'prime challenger' in the PCAs market is distinct from its position as a challenger per se. In particular, evidence before the OFT suggests that HBOS had a distinct business proposition from the other banks even given its smaller size, in terms of pricing strategy as well as marketing – anecdotal evidence suggests that HBOS borrowed more of its thinking on winning market share from other retail industries than from banking. As such, HBOS can be characterised as a particularly dynamic force injecting competition in the market.
129. In particular, the evidence before the OFT indicates that in the PCA market HBOS has been one of the two key challengers to the big four banks (the other being the now enlarged Grupo Santander). Despite the general inertia of consumers, illustrated by the low switching rates, coupled with low growth in the market, HBOS has increased market share somewhat, and much more than almost all other players, over the last few years. Several competitors who responded to the OFT identified HBOS as the bank to whom they tend to lose the most PCA customers. HBOS is a leader of the competitive fringe and, with the exception of Grupo Santander, the only player that currently comes close to the big four in terms of number of branches. While competition may not be fierce in the PCA market, in large part due consumer inertia, the removal of a

'prime challenger' to the big four is likely to be detrimental to the level of actual and potential competition.

130. Lloyds argues that Nationwide is also an active competitor. However, while it is true that Nationwide is the only other challenger bank that has managed to increase its market share significantly, it remains a smaller player with a much smaller branch network, which implies that it faces greater capacity constraints than HBOS or Grupo Santander. The same can be said in relation to the fringe of competitors: even if small challenger banks are 'punching above their weight' to some extent in winning new business, the competitive impact of small challenger banks is not as extensive as that lost from HBOS given the smaller branch networks of other challenger banks⁴⁷ and the small proportion of the stock of PCAs accounted for by the flow of new PCAs.

The effect of the merger

131. The OFT considers that the merger might cause two distinct effects under this 'prime challenger' theory of harm, one static and one dynamic.

Static effect

132. As discussed above, the OFT considers that HBOS is a 'prime challenger' in the market. The merger will cause the merged entity to have a combined market share in Great Britain of [30-40] per cent (increment [10-20] per cent). The merged entity would account for around a third of all PCAs in Great Britain and would have its incentive to increase prices heightened. This is true in particular in view of the relatively favourable credit interest rates of HBOS's PCAs.⁴⁸ Given customer inertia in the PCA market (as identified in the OFT's PCA Market Study Report), and the very high barriers to entry, this strategy is likely to be profitable all else being equal.
133. The combined effect of increasing Lloyds' market share significantly and of removing an important challenger is expected to be the dampening of competitive conditions in the market as a whole, and the associated unilateral effects. As a result, the value for money of PCA propositions is expected to worsen not only for the merged entity but for the industry as a whole because the merger may change the incentives of all firms present in the market to compete by worsening value for money in equilibrium.

⁴⁷ According to the PCA Market Study Report (table 3.1), HBOS had in 2007 1002 branches in the UK. Abbey and Alliance & Leicester had, combined, 966 branches. The smallest of the 'big four' in number of branches (HSBC) had 1492 branches. Nationwide had 748 branches and the other banks had well below 500 branches.

⁴⁸ See for example chart 3.12 of the PCA Market Study Report which is at least representative of challengers compared to the leading banks.

Dynamic effect

134. In addition, it is possible that the merger might cause the elimination of a more efficient business which will diminish the long-term competitive pressure on the market as a whole. This is because, if it is true that HBOS is a more efficient competitor in the PCA market, the merger will cause the loss of positive effects on competition that an efficient competitor can bring on a dynamic basis, for example the introduction of innovative new PCAs.

Counterfactual

135. The OFT considers that HBOS would be more likely to constitute a 'prime challenger' under the Stage II counterfactual, but cannot also rule out the possibility entirely under Stage I.

Third party comments

136. The OFT has received a number of comments from third parties who expressed competition concerns about the impact of the merger at the PCA market. For further details, see section XIV below.

Theory of harm – local markets

137. In addition, as discussed above, the OFT cannot exclude the possibility that the merger will raise competition concerns in local markets due to increased concentration at a local level. The merger reduces the number of fascia from three to two or from two to one in [REDACTED] local retail centres, and from four to three in [REDACTED] local retail centres. In this context, a reduction of 'fascia' refers to a reduction in independently owned branches, and does not refer to a reduction in number of branches. These levels of fascia reduction are sufficient to raise competition concerns in certain retail industries in the absence of strong evidence to the contrary.
138. It might be the case that the barriers to setting up a bank branch are lower than, say, a mid size or one-stop grocery store (where planning conditions and availability of land can be a barrier to entry), and consequently that a different fascia-reduction threshold could be appropriate for banks. However, the OFT does not have any evidence in this regard, nor on whether a local retail centre is a relevant geographic market for the purposes of merger control.

CONCLUSION

139. As discussed in the counterfactual section above, the OFT's competition review in this case involves a predictive assessment of markets and of firms that are

undergoing very significant transformations at a greatly accelerated rate. The current financial crisis means that it is difficult to predict what the competitive behaviour and force of the different players in the market in the short and medium term will be. As a result, there is an inherent margin of error in any prospective analysis undertaken by the OFT. These exogenous forces affecting the market being investigated are an additional reason for caution.⁴⁹

140. The OFT's belief that the merger will result in a substantial lessening of competition on the basis of the two theories of harm is not formed on the balance of probabilities; rather, its belief is of a 'realistic prospect' of an SLC under the 'may be the case' standard. The OFT therefore considers that it is by no means a foregone conclusion that the CC would reach a similar finding, to the balance of probabilities standard, at the end of a detailed 24-week inquiry.⁵⁰
141. In summary, the merger will significantly increase Lloyd's share of the market and, as a consequence, it is expected that its incentives to compete (and those of the other major banks in the market) will be diminished. This theory of harm applies under both Stage I and Stage II counterfactuals. In addition, the merger will remove a firm that the OFT considers was, at least until less than two months ago, a major driver of competition in the PCAs market; and will strengthen the current market leader. While more likely against Stage II, the OFT considers that it is realistic also to occur against Stage I. The OFT therefore

⁴⁹ Difficulties of the same nature were identified the OFT in BSKyB/ITV (OFT *Acquisition by British Sky Broadcasting Group plc of a 17.9 per cent stake in ITV plc* 27 April 2007) and more recently in Project Kangaroo (OFT *Joint venture between BBC Worldwide Limited, Channel Four Television Corporation and ITV plc* 30 June 2008). However, in those two cases the markets were changing rapidly due to technological development.

⁵⁰ For example, the harm from margin enhancement may lessen the more symmetric in terms of market share all firms in the market become. This could arise if the reduced incentive of the merged Lloyds/HBOS to compete for new business enhanced the incentives of the other leading banks to do so, as they effectively became challengers to Lloyds/HBOS post-merger. Similarly, this harm from margin enhancement may be less compelling were Lloyds to run HBOS (or one of its subsidiary brands) as a 'fighting' brand, though this seems unlikely given its presence in the market is already nearly as great as the big four banks, meaning HBOS could hardly be described as a niche player.

considers that there is a realistic prospect that the merger will result in a substantial lessening of competition in the PCA market at both the national (GB) and local level.

VIII BANKING FOR SMES⁵¹

MARKET DEFINITION

Product market

142. The CC in the SME Market Investigation Report considered that the sector for banking services to SMEs was split into four relevant product markets:

- a) liquidity management services - including business current accounts, together with short-term bank deposit accounts and overdraft facilities provided in conjunction with current accounts, and excluding personal accounts used by SMEs
- b) general purpose business loans supplied to SMEs
- c) other types of business loans to SMEs which can be segmented into invoice discounting and factoring, hire purchase, leasing and other asset finance, and
- d) other business deposit accounts held by SMEs.

143. In this case the OFT has considered the impact of the merger on the supply of banking services to SMEs using the same product market definition adopted by the CC. In the time available and given the unavailability of data for each of the four relevant product markets identified by the CC (as set out above), the OFT considered the provision of banking services to SMEs as a whole. The merging parties did not dispute the OFT's approach to market definition, and third parties generally agree with it as well.

Geographic market

National and regional

144. Three distinct geographic markets were identified by the CC in the SME Market Investigation Report: England and Wales, Scotland, and Northern Ireland. The appropriate geographical markets for CC's product markets (a) and (b) were considered to be England and Wales, Scotland and Northern Ireland. The CC's

⁵¹ The exact definition of SME (small and medium sized enterprises) varies, but the OFT has previously classed firms as SMEs where they have an annual turnover of up to £25 million.

product markets (c) and (d) were considered to be UK-wide in geographical scope.

145. Lloyds submits that there are significant national dimensions to competition. In particular, it said that pricing and credit policies are national, and that relationships may be held or managed centrally through call centres or according to national principles by relationship managers.
146. However, conditions of competition do not seem to be similar in England and Wales on the one hand, and in Scotland on the other. The CC in the SME Market Investigation Report found that the big four were charging excessive prices in England and Wales, but, for the most part, found no such excessive prices in Scotland.⁵² In addition, as discussed in further detail below, the parties' market shares are very different in England and Wales from Scotland, which is indicative, although not determinative, of distinct geographic markets.
147. Lloyds does not operate in Northern Ireland and therefore the OFT has focused its investigation on Scotland, and England and Wales. For completeness, the OFT also considered the impact of the merger in Great Britain as a whole.⁵³

Local

148. For reasons similar to those discussed in the PCA section above, the OFT cannot exclude the possibility that a merger that significantly increases local market concentration in the supply of banking services to SMEs through branch access raises substantial competition concerns at the local level. In particular, some activities associated with SME banking such as cash handling have a strong local component. The OFT in its SME Review Report found that branch networks remain important both in terms of acquiring new SME customers and in servicing existing customers (although technological changes are gradually altering this position).⁵⁴

HORIZONTAL ASSESSMENT

Introduction

149. The CC's SME Market Investigation Report in 2002 found that the big four banks were charging excess prices and earning excess profits in England and Wales. The main factors contributing to this finding were the unwillingness to

⁵² SME Market Investigation Report, paragraph 1.8.

⁵³ In England and Wales the market structure is similar to that in Great Britain, and the parties' combined market share is lower. As a consequence, the OFT considers that the competitive assessment for Great Britain applies to England and Wales as well.

⁵⁴ Paragraph 4.105.

switch among customers (itself caused by practices adopted by banks), specific practices adopted by the main banks which have the effect of limiting the scope of competition for the majority of customers, and entry barriers.

150. As a result of the CC's SME Market Investigation Report, remedies were put in place to make the market more competitive by making switching easier and faster, making prices more transparent and stopping banks from bundling SME services with other services (such as loans or personal current accounts). To protect customers from the adverse effects of the lack of competition until the main set of remedies had taken effect, the CC also introduced 'transitional' remedies which required the four main banks in England and Wales to offer SME accounts that met certain criteria with respect to their minimum interest rate (no less than 2.5 per cent below base rate) and/or no money transmission charges. In 2006 the OFT launched a review of the market and considered whether there had been any changes in the market since 2002 that would justify a varying or releasing any of the undertakings.⁵⁵ In 2007, on the basis of the OFT's advice followed by its own analysis, the CC decided to release the four banks from most of the transitional undertakings but maintain the main set of behavioural and switching undertakings.
151. The findings of the OFT's review exercise (as a result of market developments since the CC's SME Market Investigation Report) led the OFT and the CC to conclude that competition would constrain the pricing behaviour of the four main banks and limit their ability to charge excessive prices. However, neither competition authority concluded that the market was functioning well or that improvements could not be achieved. In particular, although a greater proportion of customers are considering switching, customers still appear reluctant to carry out an actual switch to another bank, and in some cases appear not to be fully aware of either their current banking costs or the potential benefits of moving to another bank.
152. The main developments in competition since the CC's SME Market Investigation Report found in the OFT's SME Review Report were that:
- several of the smaller banks have increased their market share in England and Wales (HBOS, Alliance & Leicester and Abbey have moved from around three per cent to nine per cent collectively) and are looking to increase this growth. The share of the four main banks has fallen
 - SMEs are now more likely to consider a move to one of the smaller banks

⁵⁵ The OFT's findings are reported on the OFT's SME Review Report.

- SMEs are increasingly banking with more than one provider. The behavioural undertakings appear to have had a positive impact in reducing the bundling of business current accounts with other banking services, and
- new technology is playing an increasingly important role in the business banking market. In key parts of the market, the increasing proportion of customers using internet technology has reduced the importance of branch access as a barrier to servicing customers. Similarly, greater use of automated payments technology has encouraged banks to develop new tariffs offering cheaper rates for use of automated payments. This has contributed to a greater variation in tariffs now than was the case in 2002.

Market shares

153. For the reasons explained above in relation to PCAs, the OFT considers it reasonable to use historic market share data as a useful starting point in relation to both counterfactuals.
154. According to Lloyds, the parties' combined market share of banking to SMEs (stock) in Great Britain is [20-30] per cent (increment [0-10] per cent).⁵⁶ The merged entity will be the second largest player in the market, the first being RBSG with a market share of [20-30] per cent. The other big four banks (Barclays and HSBC) each have market shares in the 15 to 20 per cent range. The HHI is [1500-2000] pre-merger, which indicates that this is already a highly concentrated market, with an increment of [0-500]. For start-ups, the combined market share is [20-30] per cent (increment [0-10] per cent). RBSG has [20-30] per cent of the market, Barclays [20-30] per cent, HSBC [10-20] per cent and Santander [10-20] per cent.
155. In Scotland the parties' market shares are very different from those in Great Britain as a whole, and the combined market share is significantly higher. According to Lloyds, in 2006 HBOS had [30-40] per cent of the SME stock, and

⁵⁶ The market share estimates provided by Lloyds for stock of SME banking refer only to SMEs with an annual turnover of up to £1 million. The internal OFT estimates are not significantly dissimilar to that provided by the parties, except in relation to the market share of Grupo Santander, which the OFT estimates is much lower than indicated by Lloyds (in particular in the top-end of the market in terms of customer's annual turnover), and of RBSG, which the OFT estimates is higher than indicated by Lloyds.

Lloyds had [0-10] per cent (combined [40-50] per cent).⁵⁷ For start-ups, the market shares in Scotland in 2007 were [10-20] per cent for HBOS and [10-20] per cent for Lloyds (combined [30-40] per cent).

156. In both England and Wales and Scotland the market has been concentrated for many years. In 1999 the market structure was broadly similar to the one just described, with Lloyds / RBSG/ HSBC / Barclays accounting for 80-90 per cent of the market in England and Wales, and HBOS and RBSG accounting for around 70 per cent of the Scottish market.

Theory of harm - Scotland

157. The market share estimates discussed above indicate that the Scottish SMEs market is highly concentrated, and that the merger will significantly increase this concentration. The HHI pre-merger is [3000-3500], and will increase to [3000-3500] with the merger (delta over [0-500]) on the basis of shares of stock. On the basis of share of start-ups, the HHI pre-merger is [2000-2500], and post-merger it is [2500-3000] (increment of more than [500-1000]).⁵⁸
158. A comparison between HBOS's market shares of stock and of start-ups indicates that it has been proportionally gaining fewer new accounts than it has as stock.⁵⁹ This trend is consistent over the last five years. However, under both measures the merger will consolidate the merged entity as one of the two (by far) largest suppliers of banking services to SMEs in Scotland. On the basis of shares of start-ups, the market shares are as follows:

HBOS	[10-20]
Lloyds	[10-20]
Combined	[30-40]
Grupo Santander	[0-10]
RBSG	[30-40]
NAB Group ⁶⁰	[0-10]
Others	[10-20]

Source: TNS, provided by Lloyds

⁵⁷ Lloyds has also provided market share data for 2007, but these included companies with a turnover between £15 million and £250 million and therefore were considered to be less appropriate.

⁵⁸ In the parties' estimates of market shares for start-ups a larger portion of the market was attributed to 'others' (13 per cent). In the HHI estimates the OFT used the conservative assumptions that each 'other' player had one or two per cent market share.

⁵⁹ Although it must be noted that a difference in the definition of 'SME' for each set of market share estimates (turnover between £1million and £25 million for stock and up to £15 million for start-ups) means that both sets of data are not perfectly comparable.

⁶⁰ Includes Clydesdale.

159. The data shows that RBSG will still be the largest competitor, but that the merged entity would still be far ahead of the third competitor, NAB Group. On the basis of shares of stock, the market shares are as follows:

HBOS	[30-40]
Lloyds	[0-10]
<i>Combined</i>	<i>[40-50]</i>
RBSG	[30-40]
Barclays	[0-10]
HSBC	[0-1-]
NAB Group	[10-20]
Others	[0-10]

Source: TNS, provided by Lloyds

160. The data shows that the merged entity will be [0-10] percentage points ahead of the next competitor (RBSG) and [20-30] percentage points ahead of the third competitor, NAB Group. The merger would make the market more duopolistic in the competition for start-ups (and consolidate the merged entity and RBSG as the clear market leaders in the Scottish SMEs banking market in terms of stock).
161. The CC in the SME Market Investigation Report concluded that in the UK barriers to entry to the market for liquidity management for SMEs were significant and inherent characteristics of the market. The main barriers to entry were identified as being the need for a network of branches, the importance of a well-established reputation, the large personal customer base of the four main banks from which most new SME customers are drawn and customers' unwillingness to switch.⁶¹ Although the OFT's SME Review Report noted that some of the barriers to entry have been lowered by technology, the OFT did not, in the time available, find evidence to suggest that entry is likely to be sufficient in time, scope and likelihood to prevent anti-competitive effects arising from the merger.
162. Switching rates in SME banking in the UK are low at around four per cent per year.⁶² As a consequence, the OFT does not believe that the threat of customer switching would be sufficient to constrain the merging parties behaviour post-merger.
163. The OFT considers that the high levels of concentration that will be consolidated by the merger, in the absence of constraints such as the threat of entry or high switching levels, raise competition concerns.

⁶¹ SME Market Investigation Report, paragraphs 1.3 to 1.5, and 2.235 to 2.242.

⁶² OFT Review Report, paragraph 4.17.

164. The theory of harm in relation to SMEs is similar to the 'margin enhancement' theory of harm developed in the PCAs section. In short:

- A large proportion of SME customers are inert. Banks compete primarily for the proportion of the market which is active, which comprises start-ups or those interested in switching.
- Banks cannot perfectly 'price discriminate' (that is, discriminate in terms of the value for money of the SME banking offer) between their inert customers and their active customers and, as such, offering a better deal to active customers will tend to reduce margins made on inert customers.⁶³
- This in turn means that incentives to offer lower prices and win active customers will be lower for banks with a large base of inert customers than for banks with a smaller base of such customers.
- As such, the bigger banks tend both to offer worse terms to active customers, and to have a low share of start-ups, relative to their share of the 'stock' of customers. The converse is true for the smaller banks.
- Since a merged Lloyds/HBOS will have a still larger base of inert customers in Scotland, its incentive to offer attractive terms might be expected to be reduced.

165. The OFT's belief that the merger may result in a substantial lessening of competition on the basis of this theory of harm is not formed on the balance of probabilities; rather, its belief is of a 'realistic prospect' of SLC under the 'may be the case' standard. The OFT therefore considers that it is by no means a foregone conclusion that the CC would reach such a belief on the balance of probabilities given a further 24-week inquiry.

166. It is important to note that this theory of harm holds regardless of the assumptions made in relation to HBOS's likely future strength absent the merger. The fact that HBOS still has a sizeable customer base is in itself sufficient for the merger to cause a detriment to competition by changing the merged entity's incentives by increasing Lloyds' share of inert customers.

⁶³ The evidence from the OFT Review Report (paragraphs 4.74 and 4.75) indicates that price discrimination in SMEs works in a similar fashion as for PCAs: banks tend to offer a better deal for start-ups for a limited period (start-ups, like students, are new to the market). Some deals are also offered to switchers, but to the extent that these offers are open to any SME who chooses to switch, they do not allow banks to price discriminate in the same way as is possible in making an offer to a start-up business.

167. In line with the CC's geographic market definition discussed above, the OFT considers that these concerns refer only to those markets that are no wider than Scotland, that is, liquidity management services and general purpose business loans.

Theory of harm – Great Britain

168. Taking Great Britain as a whole, the OFT considered whether the merger would raise competition concerns by eliminating one of the two main challengers to the big four banks (the other being Grupo Santander) – a theory similar to that found in relation to PCAs. According to the OFT's SME Review Report, the two challengers gain more business from the big four than the other way around.⁶⁴ This was confirmed by one of the big four in the course of this investigation.
169. However, the OFT does not consider this to be a realistic theory. First, the combined market share for start-ups is below [20-30] per cent, and a number of sizeable players remain in the market, including three players with market shares above [10-20] per cent and Grupo Santander with [10-20] per cent. Second, the increment caused by the merger on the basis of start-ups market shares is small: the increment to Lloyds's market share caused by the merger is only [0-10] per cent, and the HHI will be increased by less than [0-500] from [1500-2000] to [1500-2000].
170. The OFT therefore considers that there is no realistic prospect that the increment to Lloyds market share in SME banking at a national (Great Britain-wide) level will amount to a substantial lessening of competition.

Theory of harm – local markets

171. The OFT cannot at this stage exclude the possibility that the merger will raise competition concerns in local markets due to increased concentration at a local level and the importance of branch access. In particular, some activities associated with SME banking such as cash handling have a strong local component.

Third party comments

172. A number of third parties raised concerns about the impact of the merger on banking services to SMEs, in particular in view of the combined market shares and the perception that HBOS has an aggressive business model. For further details, see section XIV below.

⁶⁴ See paragraph 4.19.

CONCLUSION

173. In sum, the OFT considers that there is a realistic prospect that the merger will result in a substantial lessening of competition in banking services in Scotland, although it acknowledges that, at the end of a Phase II investigation and under a balance of probabilities test the CC might come to a different view. Given the increased concentration caused by the merger at the local level, and the lack of evidence on local competition, the OFT cannot rule out local concerns, and therefore considers the test for reference is also met in this regard. Finally, the OFT does not believe that it is realistic that the merger will result in a substantial lessening of competition in Great Britain as a whole.

IX MORTGAGES

MARKET DEFINITION

174. The parties overlap in the supply of mortgages. In a number of previous cases (for example Lloyds/Abbey and Fortis/ABN Amro⁶⁵) mortgages were assessed separately from other personal banking products. A mortgage is a loan secured on a property. Unlike PCAs and savings accounts, mortgages are marketed both directly to consumers and through intermediaries.
175. The CC in Lloyds/Abbey⁶⁶ noted that branches are less important for personal financial products other than PCAs (including mortgages), and that most third parties providing evidence in that case suggested there was a national market for mortgages, referring in particular to uniform pricing across geographical regions. The CC therefore considered the appropriate geographic relevant market for mortgages to be the UK. In this case, third parties generally considered that the market is national in scope.
176. Given that Lloyds is not present in Northern Ireland, the OFT will focus its investigation on the impact of the merger on the mortgage market in Great Britain.
177. The OFT also considered whether competition takes places at a local level, in particular given its conclusions on the PCA market, and the 'gateway' link between the PCA and mortgage markets (in other words, the fact that a number of mortgage customers buy their mortgage from their PCA provider, which most likely involves a visit to the branch). However, the OFT does not consider it necessary to conclude on this issue given that, as described further below, concerns arise at the national level.

HORIZONTAL ASSESSMENT

178. The mortgages market represents one of the largest segments of the financial services industry. According to Mintel, in 2007 gross advances of mortgages totalled £363 billion.

⁶⁵ Case No COMP/M.4844 – Fortis/ABN Amro Assets.

⁶⁶ Paragraph 4.25.

Market shares

179. Mortgages can vary in a number of respects, for instance, repayment versus interest-only, fixed or variable interest rates, and the possibility of borrower making overpayments and/or underpayments.⁶⁷
180. Lloyds estimates that the merging parties' combined market share is [20-30] per cent (increment [5-15] per cent). The next player in the market is Grupo Santander with [10-20] per cent, followed by Nationwide with [0-10] per cent, Barclays with [0-10] per cent, RBSG with [0-10] per cent and Northern Rock with [0-10] per cent in 2007.⁶⁸ On the basis of market shares in 2007, the C4 is [REDACTED] per cent, and the C5 (concentration ratio of the top five players in the market) is [REDACTED] per cent. The HHI is at around [500-1000] pre-merger and [1000-1500] post-merger, which indicates that this is a concentrated market. The market share and HHI figures described above indicate that the proposed acquisition might lead to competition concerns on a prima facie basis depending on the other characteristics of the market.
181. The parties argue that, absent the merger, HBOS would have been a severely weakened competitor in relation to mortgages [REDACTED], and that, as a consequence, its market share levels pre-merger are not good indicators of its likely future performance in mortgages. While the OFT accepts that the historic market share data may be less useful when assessing the merger against the Stage I counterfactual, it does not consider this clearly to be the case against the Stage II counterfactual. Accordingly, the OFT considers that the market share data is of some relevance to its competitive assessment.

The parties' arguments

182. Lloyds' main arguments in support of the contention that the merger does not raise competition concerns in the mortgages market can be summarised as follows:
- the mortgages market is highly competitive with a large number of alternative providers
 - intermediaries play an important role in maintaining competitiveness in the market
 - barriers to entry are low, and

⁶⁷ See Lloyds/Abbey, paragraph 4.93.

- barriers to customer switching are low, while the potential cost savings from switching can be high given that a mortgage is a large one-off transaction.

183. Lloyds submits that barriers to entry are low. It notes that a number of new entrants gained considerable business without a strong customer brand or a branch network, and that intermediaries (who broker 65 per cent of all UK mortgages) facilitate entry.

Impact of the credit crunch on the mortgages market

184. The OFT considers that the current financial crisis may have a significant impact on the mortgages market in the short and medium term at least. Therefore, in the assessment of the impact of the proposed merger on the mortgages market, the OFT must consider not only how the current crisis affects HBOS's ability to compete, but also how it dampens competition on the market as a whole such that, all else being equal, a merger in this market during/after the credit crunch may have a worse impact on competition than it would have been the case before the crisis.

185. The main potential effects that are relevant for the competition assessment of the proposed merger are (i) rising barriers to entry; (ii) rising switching costs; and, consequently, (iii) dampening competition.

Rising barriers to entry

186. In Lloyds/Abbey the CC considered that barriers to entry into mortgages are low, and that there is considerable competition for new customers.⁶⁹ It also noted that back-book pricing has been a feature of the market, with lenders offering special terms only to new borrowers and customers and frequently paying switchers' valuation and legal fees.⁷⁰

187. Since the onset of the so-called 'credit crunch', however, it has become progressively more difficult for banks to raise funds in wholesale markets. Medium and long-term credit markets have effectively 'closed for business' with the result that funding has focussed on the 'short' end of the market (overnight to 12 months).

188. As a result, wholesale funding has become more costly and more restricted. This may have the effect of differentially raising barriers to new entry into mortgages

⁶⁸ Following the nationalisation of Northern Rock earlier this year, Lloyds estimates that Northern Rock's market share in the first half of 2008 is less than two per cent.

⁶⁹ Lloyds/Abbey, paragraph 2.178.

for suppliers who rely to a large degree on the wholesale money markets for funding, but not raising barriers to expansion by incumbent suppliers who are deposit-takers as well as mortgage lenders and rely less on the wholesale money markets. If so, barriers to new entry into mortgages may not continue to be as low as they have been until recently, at least in relation to providers that rely, to some degree, on the money markets for funding. The evidence before the OFT is not sufficient to conclude whether any increase in the cost of wholesale funding has differentially raised barriers to new entry, nor consequently whether this may exacerbate any realistic prospect of an SLC between incumbent mortgage suppliers.

189. The OFT also considers that it may be the case that, in view of the low liquidity in the money markets, mortgage lenders are returning to less leveraged lending models, i.e., those that are less reliant on borrowing from the money market to lend and more reliant on attracting deposits through fixed-income bonds, ISAs and savings accounts. As a result, it may be that businesses that were previously willing to enter the mortgages market on the basis of easy and cheap access to money are no longer able to do so, and therefore they no longer constrain the established mortgage providers. In fact, it may be the case that recent entrants who relied on this more highly leveraged business model might even exit the market over time. Lloyds noted, in relation to some of the recent entrants into the mortgages market, that: '... some of these businesses did not have long-term sustainable business models because of the nature of their funding....'.⁷¹

Rising switching costs

190. The CC in Lloyds/Abbey noted that, because mortgage payments tend to be an important expense for consumers as a proportion of income, the rate of switching of mortgages is higher than for some other personal banking products.⁷²
191. Nevertheless, it seems that the credit crunch, by reducing the size of the market and the range of options available for borrowers, causes lenders to focus on low-risk lending (at least in the short to medium term). As a consequence, it becomes more difficult for borrowers that are perceived to be more 'risky' to obtain mortgages, and the costs of switching mortgages provider increases significantly for sub-prime borrowers at least.

⁷⁰ Lloyds/Abbey, paragraph 2.176.

⁷¹ Response to the issues letter, page 14.

⁷² Lloyds/Abbey, paragraph 2.175.

192. The evidence available to the OFT would tend to support this concern. A number of independent market reporters consider that the credit crunch has tightened the mortgages market such that (i) it is more difficult to obtain money to lend, and (ii) the scarcity of mortgages on offer reduces the choice available to consumers. According to Mintel 'the credit crunch means that lenders are no longer fighting for market share. Instead, they are picking and choosing who to lend money to, cutting their exposure to risk and – in the process – fattening margins'.⁷³ Datamonitor states that 'lenders are currently in a position where they can charge higher prices without this affecting demand'.⁷⁴

Theory of harm

193. A possible consequence of higher switching costs is that providers will be more able to exploit their existing customer base. In Lloyds/Abbey the CC considered that back-book pricing was a feature of the market, but that it was likely to have its effects limited by the increasing levels of switching. In the context of a market in which switching costs are higher and barriers to entry are potentially significant, the ability and incentive of mortgage lenders to exploit its current customer base increases. The proposed merger, by increasing Lloyds' mortgage customer base, is likely to increase its incentive to exploit its current customer base rather than compete for new customers. The theory of harm here is similar to the margin enhancement theory of harm described in the PCA section and therefore will not be explained in further detail again. Anecdotal evidence suggests that banks are able to price discriminate mortgage customers more effectively than they are in relation to PCA customers.

Third party comments

194. Third parties have expressed serious concerns in relation to the impact of the merger on the mortgages market. They were generally concerned about the high combined market share. A number of third parties said that they consider the merging parties to be each other's closest competitor and that the merger would reduce the number of alternatives to the parties. A competitor said it considers HBOS to have an aggressive business model which will be lost by the merger. A number of third parties raised concerns that the merging parties would be able to cross-sell products following the merger – these have been dealt with in the non-horizontal theories section below (section XII). For further details on the third party comments, see section XIV below.

⁷³ Mintel *Mortgages: Weathering the credit storm* March 2008, page 9.

⁷⁴ Datamonitor *Competitive dynamics in the UK mortgage market* May 2008, page 8.

Counterfactual

195. The evidence before the OFT suggests that the mortgages market is tighter than it was pre-credit crunch. As a consequence, it is more difficult to enter and options to consumers are more limited. Given that the financial crisis is still acute, the OFT is not in a position to predict how long these effects are likely to last. While it might be that funding becomes more easily available as the financial crisis eases (and/or Government intervenes to achieve that result), it might be that the shift in business model for mortgage providers (which, as discussed above, has the effect of raising barriers to entry) may have a longer-lasting effect.
196. However, the question to be answered in this investigation is whether *the proposed acquisition* may result in a substantial lessening of competition in relation to either of the two relevant counterfactuals identified in this case.
197. The parties have argued that absent the merger HBOS would have been a severely weakened competitor (in particular, that it would need to [REDACTED]), and that, as a consequence, its market share levels pre-merger are not good indicators of its likely future performance in mortgages.
198. The OFT accepts that, in particular in relation to mortgages, HBOS may have been a weaker competitor under the Stage I counterfactual than it was 'pre-credit crunch', and further that its ability to compete, at least in the short term, is likely to have been relatively limited. However, the OFT does not consider that the same analysis would necessarily apply under the Stage II counterfactual, where the OFT believes it may be the case that there are potential scenarios under which HBOS would have been an effective competitor, even if operating under a different business model.

CONCLUSION

199. Even if the parties' pre-merger market share levels are considered (which, combined are [20-30] per cent), they would not necessarily be cause for serious concerns in the presence of mitigating competitive constraints such as low barriers to entry, or ease of switching (which seems to be the prevailing market conditions prior to the credit crunch).
200. However, the evidence before the OFT suggests that the mortgages market may be tighter than it was prior to the credit crunch so that barriers to entry are higher and switching more difficult. Given that the financial crisis is still acute, the OFT is not in a position to predict how long its effects are likely to last, but evidence suggests that the shift in business model for mortgage providers

(which, as discussed above, has the effect of raising barriers to entry) could have a long-lasting effect.

201. The OFT considers that it could be the case that, with more time and evidence, it would be possible to measure more precisely the effect of the credit crunch on the mortgages market and conclude that the increment caused by the merger was not substantial enough to cause competition concerns.
202. However, the present case is exceptional given the fast moving nature of the current market conditions (which have even been changing substantially as the investigation has progressed), which have particularly grave impact on the mortgages market. These exogenous forces affecting the market being investigated are an additional reason for caution. The OFT is also mindful of the fact that the mortgage business is of enormous importance to the UK economy, such that the cost of a wrongful clearance (false acquittal or type II error), even if the risk of such error is relatively low, would be very high.
203. In light of these market conditions, the combination of the largest and third largest mortgage providers is significant enough to cause concern. The OFT therefore considers that there is a realistic prospect that market conditions have changed to such an extent that the proposed increased Lloyds' market share and market concentration generally would result in a substantial lessening of competition, when tested against the Stage II counterfactual.

X AREAS IN WHICH COMPETITION CONCERNS DO NOT ARISE

INTRODUCTION

204. The parties also overlap in a number of market segments in which, on the basis of the evidence available to it, the OFT does not consider that it is or may be the case that the merger will result in a substantial lessening of competition.
205. In these areas of overlap, the merger does not give rise to competition concerns relative to pre-merger conditions of competition (which is considered to be a 'worst case scenario' in terms of the counterfactual), and so it has not been necessary to 'test' these areas against a substitute counterfactual.

SAVINGS

206. Savings accounts are deposit-holding accounts that do not require the money transmission facilities necessary for providing PCAs. Lloyds argues that other liquid investment products, such as ISAs, bonds and National Savings certificates are substitutable with savings deposit accounts and should be considered as part of the same product market. In Lloyds/Abbey, the CC adopted the narrower market definition for the purposed of that report, which followed in this investigation.⁷⁵
207. Lloyds also contends that the market for savings is national, as interest rates and other terms are set across Great Britain. Although the OFT cannot rule out that this market has regional or local aspects, it does not consider that the merger is likely to raise competition concerns on any geographic basis for the reasons discussed below.
208. In 2007, according to number of accounts in the UK, HBOS was estimated to be the largest provider of savings accounts,⁷⁶ and Lloyds the third largest. The parties would have a combined market share of [20-30] per cent (increment [0-10] per cent) in the UK (according to balance). HBOS has lost market share since 2001, when Halifax had [10-20] per cent of the UK savings accounts market.⁷⁷ According to the parties, their shares calculated in terms of balances are broadly similar.

⁷⁵ Lloyds/Abbey, paragraph 4.81.

⁷⁶ Mintel *Safe Haven Savings Products* December 2007.

⁷⁷ Lloyds/Abbey, table 4.13.

209. Some of the barriers to entry identified in the PCA market are common to the savings market – for instance, the need for a banking licence, branches and arguably brand recognition.⁷⁸ However, overall barriers to entry are somewhat lower in this market than in PCAs since transactions systems and access to payment systems are not required. There has been considerable new entry in this market in the last few years, particularly by insurance companies, supermarket groups and banks with headquarters outside the UK.
210. The OFT's PCA Market Study Report found that 20 per cent of respondents had switched savings accounts in the last five years, which is lower than for most financial products but higher than for PCAs. However, Lloyds argues that switching rates may be an inaccurate measure of the competitiveness of this market as customers can hold several savings accounts at no extra cost, reducing certain balances to zero while never actually closing the account. Competitor responses suggested switching is moderate to relatively high in this market.
211. Third parties expressed some concerns that the combined size of the merged entity, and its correspondingly large dataset of customers, would give Lloyds/HBOS an extra advantage over other competitors. However, the entry of new competitors and the ability of customers to switch should mitigate any concerns of this nature.
212. The evidence before the OFT suggests that the UK savings market is contestable. There are reasonable levels of switching, and many examples of entry in the recent past. The combined market share of the merging parties is below [20-30] per cent, and there are a number of other sizeable players in the market, followed by a long tail of smaller players. For these reasons, the OFT does not consider that the merger will raise competition concerns in the market for savings.

PERSONAL LOANS

213. In Lloyds/Abbey, the CC defined the relevant product market for personal loans to include both secured and unsecured loans.⁷⁹ Lloyds agreed with this market definition. Demand side considerations suggest that it may be appropriate to consider the secured and unsecured loan markets separately. However, the OFT does not consider it necessary to conclude definitively on the precise scope of the loans product market given that the merger does not raise competition concerns on any basis. The evidence before the OFT suggests that the geographic scope of this market is the UK.

⁷⁸ Lloyds/Abbey, paragraph 4.86.

⁷⁹ Lloyds/Abbey, paragraph 4.105.

214. Lloyds is the largest provider of personal loans in the UK with [10-20] per cent of the market by value. HBOS is the joint second largest with nine per cent, giving the merged entity a combined market share of [20-30] per cent. The parties' market shares are similar when the secured and unsecured loan markets are considered separately.
215. There is a string of other competitors in the loans market, including other large banks and smaller players. Many suppliers, especially of point-of-sale loans, do not offer financial services as their principal business, but rather build on other core strengths and brand names (for example Tesco, and several car manufacturers).
216. The market appears to be characterised by only moderate customer switching. However, Lloyds submits that customers may substitute (unsecured) loans with other products such as overdrafts, credit cards and point of sale loans, and that these would not be accounted for in switching estimates.
217. In Lloyds/Abbey the CC considered that this market is very competitive.⁸⁰ The market is relatively fragmented and barriers to entry are relatively low. In addition, it seems plausible, as Lloyds argues, that competitors in this market are constrained by other financial products such as overdrafts and credit cards. For these reasons, the OFT does not consider that the merger raises competition concerns in the market for personal loans.

CREDIT CARDS

218. In previous cases the OFT has distinguished between the supply of credit card services to consumers and the supply of credit card services to third party partners (retailers). Consumer credit cards are payment cards which are not directly linked to a bank account or one store (or narrow selection of stores) and offer an ongoing line of credit. Supply of credit card services to third party partners involves the card having third party branding, with the financial services provider either splitting the profits with the third party (in the case of retailers, for example) or making a donation to the third party (in the case of a charity, for example).
219. The merger would bring together two of the larger players in the consumer credit card market, with a combined market share of [20-30] per cent (increment [0-10] per cent). However, there are a number of remaining sizeable players in the market, including Barclays (with a market share of [10-20] per cent), RBSG, HSBC, MBNA and Capital One, and a number of smaller competitors.

⁸⁰ Lloyds/Abbey, paragraph 4.107.

220. The evidence before the OFT does not suggest that barriers to entry into this market are high. Switching is relatively frequent in this market. The OFT PCA Market Study found that 31 per cent of customers had switched credit card provider in the last five years. Third party responses indicated a switching level of high to very high and noted that customers can hold cards from a number of providers at any one time. Lloyds submits that the market in general is set up to encourage switching, and all major players have systems and incentives in place to make this process as straightforward as possible for the customer.
221. The overlap in the supply of credit cards to third party partners is very limited, given that Lloyds has [REDACTED] third party relationship [REDACTED], and the [REDACTED].
222. For these reasons, the OFT does not consider that the merger raises competition concerns in either part of the market for the supply of credit cards.

GENERAL INSURANCE

223. The overall insurance market, excluding payment protection insurance (PPI), can be further divided into general insurance, life insurance and reinsurance. Some third parties argued that a narrower product market definition is more appropriate, along lines of different types of risk (home insurance, motor insurance and so on). This seems appropriate from a demand side perspective as consumers are unable to substitute between home and motor insurance, for example. On the supply side, however, the OFT was told that it is relatively easy and inexpensive for suppliers to substitute between different types of risk.
224. The EC has in past cases considered that insurance markets are national in scope.⁸¹ This view is generally confirmed by third party responses in this case.
225. Lloyds and HBOS act as both underwriters and distributors of general insurance. They each supply a wide range of life and general insurance products, being particularly active in the home and motor insurance segments. Their combined market share in general insurance is [0-10] per cent. Taking a narrow market definition and considering the two segments in which the parties' market shares are most significant, the combined market share is [10-20] per cent (increment [0-10] per cent) in home insurance and [0-10] per cent (increment [0-10] per cent) on motor insurance.
226. Third parties raised concerns that, given the volume of distribution of insurance by the merged parties, the underwriting arm might be able to foreclose access to

⁸¹ See Case No COMP/M.4284 – AXA/Winterhur, paragraphs 17 and 18.

insurance policies to third party distributors, thereby increasing third party costs. However, given the relatively modest combined market share, and the number of other upstream competitors, the OFT does not consider that a post-merger Lloyds/HBOS would have either the ability to foreclose distributor rivals. Similarly, there does not appear to be a risk of foreclosure of third party underwriters by the merged entity's distribution arm. This issue is discussed in more detail in the non-horizontal section below.

227. There have been a number of successful new entrants in recent years. Many of the new entrants are not existing suppliers of financial services but build on the strength of their brands in other markets. There also remain numerous competitive challenges from more traditional insurance companies and banks.
228. The extent of switching varies considerably between products, and in some of them switching appears to be fairly common. Lloyds notes that there has been significant new entry of online comparison sites, which may encourage switching through greater awareness of relative prices.
229. In sum, given the parties' combined market share of [10-20] per cent even on a narrow market definition, the number of competitors active in this market and the recent history of successful entry, the OFT does not consider that the merger raises competition concerns in the market for the supply of general insurance .

PAYMENT PROTECTION INSURANCE

Market definition

Product market

230. PPI enables a consumer to maintain loan repayments in the event of certain unforeseen circumstances. The main risks covered by PPI policies are accident, sickness or unemployment. Policies are available to protect most forms of personal credit, the principal ones being:
- first charge mortgage payment protection insurance (MPPI)
 - second charge mortgage or secured loan PPI
 - unsecured loan PPI
 - credit card PPI, and
 - store card PPI.
231. Typically, PPI cover is purchased by consumers at the same time as the credit agreement, with both the credit agreement and insurance cover being arranged by the credit institution/lender. Standalone provision of PPI, where a consumer

with a credit product buys PPI from a third party PPI provider, is almost negligible.

232. PPI can be split into two levels of the supply chain: PPI distribution and PPI underwriting. PPI policies are underwritten by insurers. Four of the largest retailers or distributors of PPI products to consumers are vertically integrated, with their own underwriting arm operating from their insurance business. In its PPI Provisional Findings Report,⁸² the CC found the PPI underwriting market to be competitive.
233. In its PPI Provisional Findings Report, the CC defined the distribution market as narrowly as an individual distributor's or retailer's sales of a particular type of PPI. For example, MPPI sold by HBOS is seen as a separate market from MPPI sold by Lloyds. This is because consumers focus on the credit transaction rather than the price or alternative sources of supply of PPI, generally taking PPI at the point-of-sale and therefore giving PPI retailers a point-of-sale advantage.
234. The OFT has received no evidence to depart from this conclusion.

Geographic market

235. The CC concluded that the relevant geographic market for PPI (underwriting and distribution) is UK-wide. The OFT has received no evidence to depart from this conclusion.

Horizontal assessment

Market shares

236. Self-evidently within the narrow 'own label' PPI product market definition above, each supplier has a 100 per cent market share in every product market in which it operates, and there are no overlaps between the parties. However, Lloyds is the largest distributor of PPI overall, and HBOS the third largest. In overall PPI distribution, the parties' combined market share is [10-20] per cent.
237. In PPI underwriting, the parties' combined market share is [20-30] per cent, representing both own-brand and third-party distribution.

⁸² Competition Commission *Market investigation into payment protection insurance – Provisional findings report* June 2008 (the PPI Provisional Findings Report).

Theories of harm

PPI distribution

238. Notwithstanding that the merger could be viewed as simply bringing together two stand-alone monopoly suppliers of their own PPI, in its Notice of Possible Remedies,⁸³ the CC proposed a number of measures aimed at increasing competition between PPI providers. These remedies may have the effect that, over time, the relevant product market could expand to cover all providers of a type of policy (all MPPI policies for example).
239. In such an event there would be greater overlap between the parties, which may give cause for greater concern over unilateral effects arising as a result of the merger. In particular, switching between consumers of PPI is reasonably rare, and generally limited to a switch in the underlying credit product.
240. Barriers to entry for standalone distributors of PPI are high. A standalone provider faces an 'adverse selection' problem where the consumers approaching a standalone provider judge themselves as needing PPI protection, and thus generally have a greater risk of default on loan repayments. Credit providers who supply PPI face no such problem as they are able to sell PPI to all consumers, not just the riskier ones. Furthermore, consumers are not well aware of PPI insurance generally and the costs of attracting consumers for a stand alone provider are high compared to the costs of a point-of-sale distributor.
241. However, the OFT notes that it is difficult at this stage to precisely anticipate the effects of the CC remedies, and as such the likely consequences for competition.

PPI underwriting

242. Switching of distributors between providers of PPI underwriting services is much more common than switching of consumers between PPI distributors. Moreover, underwriting tends to be put out to tender by PPI distributors and the credibility of underwriters bidding to underwrite the business of PPI distributors does not obviously depend on their market shares. Consequently, the parties' combined market share is too low to give the OFT cause for concern over unilateral effects.

⁸³ www.competition-commission.org.uk/inquiries/ref2007/ppi/pdf/notice_of_possible_remedies.pdf.

Third party views

243. Third parties expressed concern that the high market share of Lloyds and HBOS in other markets such as mortgages and credit cards will allow the merged entity to sell significantly more PPI policies.
244. However, since Lloyds and HBOS currently each capture PPI sales from their respective consumers of other credit products it is difficult to see how the merger could increase this effect.
245. One third party was concerned that the parties' combined market share in PPI underwriting could give the merged firm the ability and incentive to refuse to underwrite competing distributors' PPI (total input foreclosure) or worsen the terms to them of underwriting, raising their costs (partial input foreclosure).
246. However, the OFT considers that a necessary condition for such vertical foreclosure is that the merger generates sufficient market power both in underwriting (so that competing PPI distributors have little choice of alternative underwriter) and in PPI distribution (so that the merged firm attracts a large share of consumers who divert from the competing PPI distributors whom it has adversely affected).
247. The OFT does not, however, consider that the merger generates sufficient market power to give it cause for concern over vertical foreclosure—even on the basis that the CC's remedies mean each PPI distributor is no longer a standalone monopolist. The OFT also considers that the joint pricing by vertically integrated PPI providers (i.e. those that both underwrite and distribute PPI) of underwriting and distribution further complicates this. For further details, see section XIV below.

CONCLUSION

248. Overall then, the merger would appear to have a limited effect on the provision of PPI:
- the parties' combined market share in PPI underwriting—a market the CC found to be competitive—is not high enough to give prima facie concerns over unilateral effects
 - the parties do not currently overlap in the PPI distribution market
 - third party concerns about the ability to sell PPI on the back of leading positions in other product markets should not be increased by the merger, and

- the effects of the CC's remedies—which could generate an overlap between the parties in PPI distribution—are at this stage uncertain.

249. On the basis of the above, the OFT therefore concludes that the proposed merger will not result in a realistic prospect of a substantial lessening of competition in the markets for PPI distribution and underwriting.

WEALTH MANAGEMENT

250. Both Lloyds and HBOS (via BOS Investment Service (BOSIS) and The St. James's Place Group (SJP)) provide wealth management services. Although the parties noted that it is difficult to estimate the overall size of the market for wealth management, they estimate that their individual market shares are less than five per cent, and that their combined market share would be 'considerably' below [10-20] per cent. There are a number of alternative providers of wealth management services. Only one third party commented specifically on wealth management, expressing a low level of concern about the effects of the merger. For these reasons, the OFT does not consider that the merger raises competition concerns in the market for the supply of wealth management services.

PENSIONS

251. Both parties are active in the pensions segment, and act as manufacturers (underwriter) and distributors (broker) of pension, assurance and investment products.

252. In past cases⁸⁴ the EC considered splitting pension and life assurance products into separate product markets. Taking a cautious approach and considering pensions as a separate product market, the parties' combined market share is less than [10-20] per cent. There are two other players with market shares above ten per cent, and eight competitors with individual market shares between [0-10] per cent.

253. Some customers and competitors expressed concerns about the merger, but these typically referred to the size of the combined entity, and generally did not articulate competition concerns.

254. For these reasons, the OFT does not consider that the merger raises competition concerns in the market for the supply of pensions.

⁸⁴ For example, see case No. COMP/M.4047, Aviva/Ark Life, paragraph 11; Case No. COMP/M.4701, Generali/PPF Insurance Business, paragraph 20.

BANKING SERVICES TO LARGE CORPORATIONS

255. Lloyds submits that corporate banking comprises a broad range of banking services offered to general corporate clients, including deposits, lending (including asset finance), international payments, letters of credit and advice concerning mergers and acquisitions. It adds that it is not sensible to distinguish between different products within the corporate banking market.
256. Lloyds also submits that products in this market are often tailor-made to meet its clients' specific needs. Larger customers pick and choose the products they require, and commonly source from multiple providers. In particular, for corporate clients with turnover in excess of £25m per year,⁸⁵ there are significant levels of 'multi-banking', that is, customers will have accounts, products and relationship with several banks. The services are often more sophisticated, and pricing and service offers tend to be more bespoke.
257. Lloyds submits that the geographic market is global due to the worldwide nature of corporate banking and that there are a number of international banks providing services in the UK. In Lloyds/Abbey the CC considered that the market for financial products sold to customers larger than SMEs is global.⁸⁶ Third parties generally considered the geographic market to be at least UK-wide, and possibly wider. Lloyds estimates that the merged entity's share of supply would be below [0-5] per cent on a global basis. In the UK, the parties estimate that their combined market share is [10-20] per cent.
258. Some competitors expressed concerns about some aspects of this market on the basis of the merging parties' combined market shares. Two competitors considered that HBOS was an innovative competitor. Customers were generally not concerned with this market.
259. On the basis of the parties' combined market share of [10-20] per cent in the UK and less than [0-5] per cent globally, and of the fact that evidence suggests that the market is wider than the UK and possibly worldwide, the OFT does not consider that the merger raises competition concerns in the market for the supply of banking services to larger corporations.

TREASURY AND CAPITAL MARKETS

260. In Lloyds/Abbey, the CC considered treasury and capital markets activities to fall under the broader category of wholesale banking, including money market and foreign exchange dealing.

⁸⁵ That is, not SMEs.

⁸⁶ Paragraph 4.4

261. There are three main areas of overlap in treasury and capital markets between Lloyds and HBOS:
- Financial markets: Both parties supply risk management and hedging products to their SME and large corporate customers. These products facilitate the hedging of a variety of risks including interest rates, inflation, commodity prices and currency exposure.
 - Capital markets: Both parties provide services for securitisation, loan syndication and corporate bonds. Lloyds also provides some equity advisory services, while HBOS has historically confined this service to its own assets.
 - Structured debt origination: Products offered include project finance for large infrastructure and energy projects, asset finance for the marine, rail and aircraft sectors, and acquisition finance for leveraged transactions and management buyouts. In a number of these sectors HBOS also provides equity in addition to debt.
262. In Lloyds/Abbey the CC found that the merger would not lead to competition concerns in the wholesale banking market due to the presence of global competitors and strong, well-informed customers.
263. Customers indicated in their survey responses that they are unconcerned about the effects of the proposed Lloyds/HBOS merger on this market. The parties' combined market share as a result of the merger is below 15 per cent in each of the three segments. For these reasons, the OFT does not consider that the merger raises competition concerns in the market for the supply of treasury and capital markets activities.

ASSET FINANCE – FLEET CAR HIRE

264. Companies may use a fleet car hire (leasing) based scheme to lease cars to employees. The key benefits to leasing include tax benefits (typically some form of VAT refund) and support services. Approximately 50 per cent of all company cars are leased from leasing businesses.⁸⁷ By far the most popular form of lease is an operating lease, whereby the corporate customer chooses the car and the contract hire supplier buys the car and retains ownership, receiving a fixed monthly amount for an agreed time period. Both parties are active in this market.

⁸⁷ Initial submission, page 50.

265. In 2005 the OFT cleared unconditionally the acquisition of HSBC's fleet car hire business by Lex.⁸⁸ In its decision the OFT concluded that no separate product markets existed for the funding, maintenance and servicing of leased cars. The product market was taken to include all types of funding through leasing. In Lex/HSBC, the OFT deemed the geographic market to be UK wide, although Lloyds and HBOS suggest that the market may be at least EU-wide.
266. Taking the geographic market to be the UK, the combined market share of the merging parties will be [10-20] per cent, making them the largest provider of fleet car hire services in the country. The market shares of the next two largest players are [0-10] per cent each. One customer submitted concerns about the competitive effect of the merger, arguing that, post-merger, the reduced number of competitors will reduce negotiating strength and switching possibilities. However, another customer held the opposite view, submitting that there are an adequate number of alternative suppliers and switching is fairly easy.
267. The evidence before the OFT suggests that barriers to entry into this market are not high. The parties submitted that many customers in this market, particularly larger corporations, also possess significant buyer power. In view of these competitive constraints, and notwithstanding that the merged entity will be the largest provider (albeit with a share of less than [10-20] per cent), the OFT does not consider that the merger raises competition concerns in the market for the supply of asset finance/fleet car hire.

LIFE INSURANCE

268. Life insurance policies are paid out upon the death of the policy holder or at the end of a specified period, depending on the type of policy. Policies are sold by both IFAs and by 'bancassurers' (i.e. banks that sell life policies, underwritten by a life company with the same group, through their branch network). Both parties provide a broad range of life insurance products.
269. In past cases the EC has considered that markets for insurance products are national in scope.⁸⁹ Third parties generally considered that the market for life insurance is UK-wide.
270. The combined gross market shares of Lloyds and HBOS post-merger aggregating across the life market is [10-20] per cent. In previous OFT decisions⁹⁰ the market was characterised as being highly fragmented with numerous competitors. No

⁸⁸ OFT *Anticipated acquisition by Lex Vehicle Leasing Limited of the fleet car hire business of HSBC Bank plc* November 2005.

⁸⁹ See Case No COMP/M.4284 – AXA/Winterhur, paragraph 17

⁹⁰ OFT *Anticipated acquisition by Royal London Mutual Insurance Society Limited of certain businesses and assets of Resolution PLC* December 2007.

consumers raised significant concerns about the impact of this merger on competition in the life insurance market.

271. For these reasons, the OFT does not consider that the merger raises competition concerns in the market for the supply of life insurance.

XI COORDINATED EFFECTS THEORIES CONSIDERED BY THE OFT

INTRODUCTION

272. In Lloyds/Abbey the CC found that there were several features of the banking industry that made it vulnerable to tacit collusion (without concluding whether there was tacit collusion) and that the removal of Abbey as a competitor would reduce the incentives to compete of the big four banks collectively, by removing one of the main sources of actual and potential competition.

273. However, in its own ex-post evaluation of the decision, the CC noted that 'the treatment of coordinated effects (tacit collusion) in this case pre-dated the CC guidelines and does not accord with the method of analysis which is now recommended, but rather merely notes market features and conduct consistent with coordination.'⁹¹ In this regard, and consistent with the accepted treatment of coordinated effects post-Airtours⁹² alluded to in the CC's evaluation of Lloyds/Abbey, in the context of the present merger the OFT considers that, for there to be a realistic prospect of a merger creating or strengthening coordinated effects, the following conditions must all be satisfied.

- First, it must be possible for all firms in a market to reach the terms of coordination without any express agreement: there must therefore be a focal point for coordination and sufficient transparency that all firms can identify it.
- Second, coordinating firms in a market must be able to monitor deviations from the coordinated outcome: again, this requires that there be sufficient transparency to detect 'cheating'.
- Third, there must be a credible threat of retaliation to discipline firms deviating from the terms of coordination, such that fear of retaliation drives firms to coordinate in spite of incentives to deviate.

⁹¹ Competition Commission *Evaluation of the Competition Commission's past cases – Final report* January 2008.

⁹² *Airtours plc v Commission* Case T-342/99 [2002] ECR II-2585.

- Fourth, there must be insufficient constraints outside the coordination to defeat it (for example, entry must be hard and/or buyer power absent).
- Lastly, the merger must make coordination more likely (e.g. by removing a maverick that would otherwise disrupt it) or strengthen existing coordination.

FINANCIAL PRODUCTS SOLD TO LARGER FIRMS AND WHOLESALE BANKING

274. The CC found in Lloyds/Abbey that markets for financial products sold to larger firms and wholesale banking were characterized by the presence of global competitors and strong buyers, such that no competition concerns would have arisen from the proposed merger. The evidence we have received suggests that global competition and buyer power have increased in these areas in the intervening period. Consequently, there appear to be sufficient constraints outside any coordination in these areas to defeat it and the OFT does not consider markets for financial products sold to larger firms or wholesale banking further in this section.

275. The remainder of this section therefore considers whether the necessary conditions for coordinated effects as a result of the merger are met in markets for financial products sold to personal customers and markets for financial products sold to SMEs.

FINANCIAL PRODUCTS SOLD TO PERSONAL CUSTOMERS AND SMES

Reaching and monitoring terms of coordination: transparency

276. For coordinated behaviour to take place there needs to be a high degree of transparency in the market. The OFT considers that reaching and monitoring the terms of coordination is therefore consequently easier when:

- the market is sufficiently concentrated such that firms recognize their interdependence
- the terms of market transactions (for example, price) are clear to market participants
- there is stability of underlying costs (when costs vary, it may be difficult to determine whether a change in price or some other coordinated variable represents a deviation from coordination or a response to changes in costs), and

- there is stability of demand (when demand varies, it may be difficult to determine whether a change in price or some other coordinated variable represents a deviation from coordination or a response to changes in demand).

Concentration

277. As discussed above, only the markets for PCAs and financial products sold to SMEs appear sufficiently concentrated for firms to recognize their interdependence. This is also the case if market shares are measured on the basis of new rather than existing business.

Terms of transactions

278. PCAs—although branded—are relatively homogeneous products and the terms of PCA market transactions are transparent (to banks if not to customers) with little or no negotiation over terms by personal customers. Notwithstanding this, however, any such coordination would need to involve numerous competitive parameters and levels of service quality, which militates against coordination. Further, the parties submitted that—even if they can observe the terms and conditions of each others' PCAs—banks cannot observe what proportions of customers choose one type of account over another, or how their rivals' revenues are derived from each type of PCA.

279. Consequently, it is not clear whether the terms of market transactions for PCAs appear sufficiently clear to market participants for them to reach and monitor terms of coordination.

280. Similarly, the evidence received by the OFT suggests that financial products sold to SMEs—although branded—also are relatively homogeneous products and the terms of these financial products sold to SMEs are transparent with little or no negotiation over terms by SMEs. Conversely, any such coordination would need to involve numerous competitive parameters and levels of service quality, which militates against coordination. In addition, the scope for bilateral negotiation between banks and their SME customers would make coordination problematic.

281. Consequently, it is unclear whether the terms of market transactions for financial products sold to SMEs are sufficiently clear to market participants for them to reach and monitor terms of coordination.

Stability of costs and demand

282. For coordinated behaviour to take place, the OFT considers that there must be stability of firms' profit incentives—that is, stability of costs and demand. The

OFT considers stability of market shares over time to be an appropriate measure of this.

283. As discussed above, market shares of the stock of PCAs have been relatively stable for several years. However, market shares have been more volatile on a flow basis. Similarly, market shares of the stock of financial products sold to SMEs also have been stable for several years but market shares on a flow basis have been more volatile.
284. Consequently, it is unclear whether firms' profit incentives are sufficiently stable for coordinated behaviour to take place.

Credible threat of retaliation

285. For coordinated behaviour to persist, firms must have sufficient incentives not to deviate. In respect of PCAs, the market shares of the big four are well matched, suggesting each would equi-proportionally gain from coordination (i.e. that their incentives are aligned). Further, coordination is harder when sales occur in large, discrete blocks (e.g. tenders) because deviations from coordination are relatively more profitable and such deviations are harder to detect: for PCAs, however, interactions are small and frequent, suggesting deviation is less profitable and punishment for deviation is credible. Lastly, the big four banks meet each other in numerous financial services product markets (and arguably local geographic markets) and such multi-market contact can facilitate coordination by permitting punishment in other markets for deviation in one.
286. Set against this, given the evidence we received on customer inertia in PCAs, any big four bank that deviated from a coordinated outcome by (say) raising the credit interest rate on its PCA, or by lowering the overdraft interest rate, would win only a small proportion of customers from the other big four banks. As such, the other banks would have little incentive to respond by also raising interest rates. That is, if the danger of customer switching in PCAs is so low, it is not clear that the big four banks really need to coordinate to prevent it.
287. Furthermore, there does not appear to be much of an incentive for the big four banks to coordinate their offers to the small proportion of potential switchers who do exist. Although the cost of targeting such a change in a bank's competitive offer to the small group of potential switchers would be small, the evidence the OFT has received (discussed above) suggests that competitors outside the big four (that is, HBOS, Abbey, Nationwide and others) have gained market share at their expense. Consequently if what little switching there is, is from the big four to the competitive fringe, then there does not appear to be any benefit to the big four of coordinating to prevent switching between them.

288. In respect of financial products sold to SMEs, the market shares of the big four are not well matched, suggesting that their incentives may not be well aligned. Set against this, coordination is harder when sales occur in large, discrete blocks but for financial products sold to SMEs, interactions are small and frequent. Similarly, the big four banks meet each other in numerous financial services product markets (and arguably regional geographic markets) and such multi-market contact can facilitate coordination by permitting punishment in other markets for deviation in one.
289. The OFT's SME Review Report found that SME customer inertia is high (with switching of just four per cent per annum). Consequently, the countervailing constraints on coordination between the big four in respect of PCAs discussed in the two preceding paragraphs also apply to SMEs.

Insufficient constraints to defeat coordination

290. For coordinated behaviour to take place, there must be insufficient constraints to prevent it. Principal amongst these constraints would be low barriers to entry and high levels of buyer power. According to the OFT's PCA Market Study Report, the PCA market exhibits some barriers to entry and expansion. These barriers include low levels of consumer switching—which increases the importance of establishing a wide branch network—and the importance of an established brand name. Together, the OFT's market study found, these have constrained the ability of challenger banks (principally HBOS, Abbey National and Nationwide) to the big four to expand quickly; low customer switching in particular appears to have reduced incentives to compete.
291. Further, in terms of buyer power, the OFT's market study concludes that consumers appear not to pay attention to some of the key implicit and explicit payments for their accounts: the lack of visibility of these effective costs to consumers has reduced the incentive for banks to compete on them. Similarly, the OFT's PCA Market Study found that customer switching rates for PCAs (13 per cent) were much lower than in comparable markets (such as insurance and utilities, which ranged from 35 to 61 per cent). Neither of these observations is consistent with consumers having buyer power.
292. Consequently, barriers to entry for PCAs do not appear to be low enough, nor buyer power strong enough, to defeat coordination.
293. For financial services to SMEs, in its SME Review Report, the OFT found that there had been new developments in technology which had lowered some of the previous barriers to entry and expansion, in particular access to a branch network.

294. Further, the evidence the OFT received suggests that there appears to be more scope for large SME customers to negotiate terms but it is not clear whether and how any such buyer power on the part of large SME customers protects smaller SMEs.
295. Consequently, unlike PCAs, there may be some evidence that barriers to entry for SME banking are now low enough, and buyer power strong enough, to constrain coordination.

Effect of this merger and the Santander/A&L merger

296. Lastly, for coordinated behaviour to take place as a result of a merger, the merger must strengthen pre-existing coordination or make coordination more likely. We received no evidence to suggest there was pre-existing coordination in financial products sold to personal customers (consistent with the OFT's PCA Market Study Report in the UK and with the CC's Northern Ireland PCA Market Investigation Report) or in financial products sold to SMEs (consistent with the CC's SME Market Investigation Report in the UK).
297. In respect of whether the merger might make coordination more likely, however, the evidence is mixed for PCAs. On one hand, the merger increases the asymmetry in market shares in both the stock and flow of PCAs between banks by giving the merged firm [20-30] per cent of existing PCA customers and [20-30] per cent of new PCA customers. As discussed above, all else equal, greater concentration—and greater symmetry between firms—in a market makes coordinated effects more likely. In this regard, then, although the merger appears to increase concentration, it also increases asymmetry; conventionally militating against coordinated effects. Further, the OFT notes that to the extent that significant efficiencies were to arise from the merger and were to be passed through to consumers (for example, in the form of lower prices or a better value for money proposition more generally), this might further reduce the incentives on the merged entity to coordinate with other players in the market. However, as discussed further below, the efficiencies claimed by the parties have not been demonstrated to the requisite standard for the purposes of the OFT's merger review.
298. On the other hand, Halifax was seen by the CC in its Lloyds/Abbey report in 2001 as one of the two most successful branch-based banks to have shown the capability and staying power to win a significant share of the PCA market despite the barriers to growth. Similarly, the OFT's PCA Market Study Report found that the market share of HBOS has grown since the Halifax/Bank of Scotland merger in 2001. According to the OFT's PCA Market Study Report, HBOS has consistently offered distinct PCA pricing from the big four—in particular, higher credit interest rates and lower arranged overdraft interest rates.

Consequently, HBOS could be seen as a 'maverick' firm likely to disrupt any attempt at coordination by the big four. Post-merger, the constraint of HBOS as a possible maverick will disappear.

299. For financial products to SMEs, the evidence suggests that the merger may make coordination more likely. In particular, the merger increases concentration and increases the symmetry in (stock and flow) market shares. Likewise, the CC's SME Market Investigation Report found that—although Halifax had no SME experience and BoS had only a limited presence in England and Wales—there was a real prospect of the merger of BoS and Halifax enhancing their ability to compete, and this could have an earlier impact on the market than competition from other sources. Further, according to the OFT's SME Review Report, HBOS had subsequently made the most notable gains from the big four. Consequently, HBOS could be seen as a 'maverick' firm likely to disrupt any attempt at coordination by the big four. Post-merger, the constraint of HBOS as a possible maverick will disappear.

300. In this regard, however, the parties submitted that the acquisition of Alliance & Leicester by Santander now makes it such a significant player that coordination in either the PCA or SME markets would be unfeasible without its cooperation yet, given its 'challenger' strategy in these markets, it is implausible that Santander would participate in any coordination.

CONCLUSION

301. On the basis of the above, the necessary conditions for the merger creating or strengthening coordinated behaviour do not appear to be met in the markets for PCAs or financial products sold to SMEs.

XII NON-HORIZONTAL THEORIES CONSIDERED BY THE OFT

302. The OFT considers that mergers between firms producing complementary products (such as the different financial product ranges sold to personal customers of Lloyds and HBOS) can give rise to anticompetitive effects if they enhance the merged firm's scope for tying. In particular, if there are markets where the parties' financial products are market leaders facing little competition post-merger, then this may give the parties the incentive to tie sales of other products that face more competition to sales of these market-leading products. This can foreclose competition in the 'tied' markets for these other products and potentially raise barriers to entry (as new competitors essentially have to enter the tied market(s) as well as the main market).
303. However, notwithstanding the OFT's concerns over unilateral effects in PCAs, SME banking and mortgages discussed above, the merger does not appear to give the parties such an unassailable position of market strength even in these markets that such a foreclosure strategy would be feasible or profitable. Consequently, the OFT does not consider that the merger gives rise to a realistic prospect of conglomerate effects through tying.
304. The OFT also considers that mergers between firms producing complements can also give rise to portfolio effects—whereby rivals are foreclosed post-merger—if (i) consumers value product 'variety', (ii) there are large fixed or sunk costs associated with providing product variety and (iii) other firms cannot replicate the merged firm's variety.
305. Set against this, the OFT recognizes that mergers of firms producing complementary products may give rise to pricing efficiencies (known as Cournot effects) as the merged firm is able to internalize the pricing externality between complements to lower the price of all of them when they are supplied together.
306. However, the merger does not appear to give the parties a range of products that cannot be matched by competitors. Consequently, the OFT does not consider that the merger gives rise to a realistic prospect of portfolio conglomerate effects.

XIII EFFICIENCIES

307. There are two ways in which the OFT may take efficiencies into account in its analysis of a merger.⁹³ One is where they are rivalry enhancing such as to mean that a realistic prospect of a substantial lessening of competition is not found despite concentration arising in a market from the merger. The other is if overall customer benefits (delivered via efficiencies) from the transaction outweigh the substantial lessening of competition concerned caused by the merger such that the OFT chooses to exercise its discretion not to make a reference to the Competition Commission.⁹⁴

Rivalry enhancing efficiencies

308. The parties submitted that the transaction will lead to significant cost savings [REDACTED] of Lloyds and HBOS, while creating the largest and most effective retail franchise in the UK, enabling better access and service for customers.

309. Lloyds estimates that the proposed merger will lead to an additional contribution to earnings before tax from cost synergies significantly in excess of [REDACTED], in excess of [REDACTED] per cent of the combined cost base. Five potential sources of cost savings leading to procurement and logistics synergies are put forward:

- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED], and
- [REDACTED].

⁹³ Paragraphs 4.29 to 4.35 of the Guidance.

⁹⁴ Sections 22,(2)(b), 33(2)(c) and 44(4)(e) of the Act. See also OFT *Completed acquisition by Global Radio UK Limited of GCap Media plc* 8 August 2008, for a fuller description of the customer benefits exception, including the OFT's interpretation of the Act that it is not possible under the Act for the OFT to exercise its customer benefits discretion in relation to one particular finding of a substantial lessening of competition (in market X) but then to make a reference in respect of another substantial lessening of competition (in market Y).

310. Although the parties did not specifically argue that these cost savings would result in rivalry enhancing efficiencies, the OFT nevertheless considered whether or not this might be the case.
311. In this regard, the Guidance states that the 'key question is whether the claimed efficiency will enhance rivalry among the remaining players in the market'⁹⁵ and gives the example of where two smaller firms merge to provide more effective competition to a larger rival. The Guidance makes it clear that in all cases 'in order for the OFT to take account of efficiencies that are claimed to enhance rivalry, they must be: (a) demonstrable; (b) merger-specific; and (c) likely to be passed on to customers'.⁹⁶
312. The Guidance also states that 'the OFT is generally sceptical, in the absence of compelling evidence, that efficiency gains will not only arise but will also be passed on to a sufficient extent to customers, especially where there are few remaining competitive constraints on the parties. Accordingly, in these situations, the evidence presented by the parties on efficiencies and their likely impact on rivalry must indeed be compelling'.⁹⁷
313. The type of efficiencies claimed by the parties would appear to be plausible.⁹⁸ However, in light of the relatively limited evidence provided by the parties in the time available, the OFT did not receive sufficiently compelling evidence to be able to conclude confidently that the claimed efficiencies and consequent customer pass-through would occur, and would occur such as to enhance rivalry sufficiently to offset competition concerns that would otherwise arise.

Customer benefits

314. In relation to customer benefits, the parties argue that the benefits which accrue from the increased certainty surrounding the future of the HBOS businesses constituted relevant customer benefits under the Act that more than outweigh any substantial lessening of competition that might arise from the proposed merger.
315. In particular, the parties argue that the transaction reduces the risk of a broader, deeper systemic banking crisis. They submit that continuation and certainty or stability in this context are forms of higher quality of service within section 30(1)(a) of the Act. These benefits accrue immediately and would not do so without a merger of HBOS with another well resourced financial institution. They

⁹⁵ Guidance, paragraph 4.32.

⁹⁶ Guidance, paragraph 4.34.

⁹⁷ Guidance, paragraph 4.35.

⁹⁸ See paragraph 299 above on potential impact of cognisable remedies on incentives to coordinate.

will accrue to HBOS customers (and indeed more widely). Accordingly, the parties argue that the customer benefits outweigh the SLC for the purposes of section 44(4)(e) of the Act.

316. The OFT does not accept the parties' argument. In particular, the OFT does not accept that the benefits being claimed by the parties could only be achieved through the proposed merger. As the parties themselves have argued, it is unrealistic to consider Government would have allowed HBOS to fail. Rather it would, absent the merger, have intervened with some form of rescue package. Such intervention and support would have achieved the same benefits that the parties are claiming through the proposed merger, and so the OFT does not consider that such benefits are merger- specific.

XIV SUMMARY OF VIEWS OF INTERESTED PARTIES ON THE IMPACT OF THE MERGER ON COMPETITION

INTRODUCTION

317. The OFT issued an invitation to comment (ITC) on 25 September 2008 regarding the proposed acquisition of HBOS by Lloyds. In addition to replies to this ITC, a selection of customers and organisations were invited to complete detailed written questionnaires covering, for example, market definition, aspects of competition between market participants and competition concerns.
318. The main topics received from third parties on competition issues are summarised in this section, and comments on the public interest consideration are summarised in the next section. The OFT also received comments that do not relate to competition or to the public interest consideration. In particular, third parties expressed concerns over the job security of Lloyds and HBOS workers and of the implications of branch closures, particularly in rural areas.
319. The OFT has taken into account all competition-related comments that were put to it even though in the assessment sections above it might not refer to the full range of issues raised by third parties.

PCA

320. Third party responses confirmed that the parties overlap in the provision of PCAs, which most third parties considered is a UK-wide market.
321. Several competitors were concerned about the effect of the proposed merger on competition in the PCA market. The high combined market share of the parties was raised as a concern, however, some third party respondents argued that the competitive advantage enjoyed by the merged party would be greater than their combined market share in PCAs would suggest. Indeed, concerns were raised that the extensive database held by the merged entity on a significant number of UK customers would allow it to better target new customers. PCAs were also described as a 'gateway' for banks to sell other financial products to PCA customers. Consequently, it was argued that the high market share the merged party would hold in the PCA market may allow them to create similar positions in other product markets.
322. We also received consumer group concerns about the effect of the anticipated acquisition on competition in the PCA market. Again, the high combined market

share of the merged parties was raised as a key concern. A consumer respondent was also concerned about the 'gateway' effect, and argued that it would also increase barriers to entry in the PCA market.

323. Third party responses indicated that, on average, there is a reasonably low frequency of customer switching between PCA providers. It was suggested by a competitor that switching frequency may be an inadequate indicator of competitive conditions as, for example, consumers may hold multiple PCA accounts. Conversely, one consumer group argued that the low rate of switching resulted from the perceived high costs and low benefits from switching itself. Concern was raised that the merger would result in even less frequent switching, as increased cross-selling would make price comparisons across PCA providers more difficult.
324. Consumer group responses raised concerns about the loss of HBOS as a potential challenger, noting its particularly aggressive competition for PCA customers. Indeed, a number of competitors identified HBOS as the bank to which they lose most of their customers. Fears were also expressed that the extensive branch network of the merged entity may give rise to competition concerns and that local competition may be reduced in terms of branch access.

SMES

325. Third party responses agreed that both parties compete in the supply of banking services to SMEs.
326. A majority of competitor respondents felt that the proposed breakdown of financial services to SMEs into four distinct product groups was appropriate, and that the market is UK-wide.
327. On average, competitors and consumers expressed limited concerns about the consequences of the merger for competition overall. Where there were concerns, the main reason given was the merging parties' high combined market share. Other concerns raised included the aggressive business model of HBOS in the provision of business deposit accounts and loans. Indeed, while views on the prevalence of customer switching varied, to the extent that switching does occur, several competitors told the OFT that HBOS was one of the banks to which they were most likely to lose customers.

MORTGAGES

328. Third party customer comments confirmed that both HBOS and Lloyds are active in the mortgage market, which competitors generally agreed is a UK-wide market.

329. A key concern expressed by third party competitors related to the merged entity's combined market share. Specific concerns raised include the economies of scale that the merged party will achieve, argued to put it at a significant competitive advantage. A concern was also raised that the merged firm's scale and dominance in a range of mortgage markets gives it the ability to dwarf the entire sector.
330. Several third parties were concerned with respect to the merging parties' ability to use their mortgage customer base as a platform to leverage other markets, for example PPI and other insurance products. Some competitors suggested that the merged party will have a dominant position in the new mortgage market (and in the placement of associated sales) once the housing market picks up.
331. Customers expressed similar concerns to competitors with respect to the merger. Mortgages were described as a gateway product, offering point-of-sale advantage and wide-spread cross-selling ability to branch-based banks. It was also claimed that the merged entity's combined market share would seriously weaken its incentives to offer improved price or quality, or implement changes to respond to weaknesses in competition already present across the banking industry.
332. The distinctness of HBOS services in the mortgage market was also raised, particularly their BM Solutions brand which covers specialist products such as buy to let and where HBOS is considered a market leader. Similarly, HBOS's expertise in New Build was noted, in particular in stimulating (and meeting) market demand.
333. Competitors identified a variety of participants active in this market and a level of customer switching. However, there was consumer concern that the cost of mortgage finance could increase as a result of the merger, and it was suggested that if a current supplier increased prices by five to ten per cent, it would be difficult or costly for a customer to switch to another supplier. Although not unanimous, in general, third party customers suggested that there are a very limited number of suitable alternative suppliers for mortgages. Perhaps because of these factors - third party customers feel that while they have some negotiating strength, post-merger this will be significantly reduced. Furthermore, entry and expansion conditions were described as very difficult, to the extent that the opportunity for an effective challenger to the parties is unlikely at present.
334. The size of the merged entity's market share was highlighted as a concern by a consumer body. They suggested that the main driver behind choice of provider is the price of mortgage deals (including fees) with brand reputation a secondary

factor. Consumer research was referenced which suggested that the larger the supplier the poorer the service received by customers.

335. A consumer body called for safeguards to protect against the abuse of dominant positions in advance of the merger being completed. There was also concern that 'over concentration' in the market and consumers' restricted choice of provider would be exacerbated by low levels of activity in the market.

PPI

336. Both parties were considered active in the PPI market, and third party competitors generally considered that the geographic market is UK-wide.
337. The level of competition concerns varied among competitors. Where concerns existed, the aggressive/innovative business model of one of the parties was raised by several respondents as a key factor. Specific concerns raised included PPI being a product that is sold on the back of a main banking product. It was argued the possibility exists that, with the merged party having a dominant position in the main banking products (e.g. mortgage markets), there may be a secondary impact on the volume of PPI sales. In addition, it was suggested that the combined group's customer ownership puts them at a significant advantage when determining where the majority of mortgage related sales of PPI (and other insurance products) will be underwritten, potentially preventing access to other providers.
338. Generally competitors felt that there is switching in the market. However, one suggested that while end-customer switching is rare (and usually driven by a change in the underlying product) there is moderate switching between underwriting across PPI segments.
339. A consumer body was very concerned about competition issues arising from the merger. They noted that there are a very limited number of suitable suppliers of PPI. It was suggested that it would be difficult or costly for consumers to switch to another supplier if their current supplier raised prices. Consumer negotiating strength is considered limited and that it will be reduced post-merger.
340. It was also noted that the CC investigation into PPI found that the point of sale advantage prevents, restricts or distorts competition. The consumer body also notes the complex price structures, resulting from cross-selling (which facilitates bundling), reinforces the inherent weaknesses of consumers.

SAVINGS

341. Third party responses confirm that Lloyds and HBOS compete in the savings market. Generally, third party competitors agree that the geographic market is UK-wide for deposit accounts for personal customers, SMEs and large corporations. However, one respondent suggested that the market for large corporations might be worldwide.
342. The degree of concern among competitors with respect to the market for personal deposits varied. One respondent commented that the market for new funds is particularly competitive. Conversely, the combined share of the merged entity was raised as a concern by other competitors, in particular their 'share of voice' in terms of advertising and footfall. There is also concern that, with recent events, there may be further consolidation in this market. One third party competitor noted that HBOS has been 'innovative with development e.g. high headline fixed rate regular savings product, e- and branch limited products, short-term bonds, FRISA'. Third party competitor concerns were generally more muted with regard to the savings market to SMEs and larger firms.
343. The OFT received comments from consumer groups, SMEs and larger firms on the implications of the merger for the deposit accounts (savings) market. Personal customers were described as having limited negotiating power which would be reduced as a result of the merger. A consumer body suggested that savings products have relatively low switching rates. Nevertheless, switching was considered worthwhile for personal customers in the event of a five to ten per cent price rise and an adequate number of alternate suppliers exist. In relation to personal savings and loans, a consumer body felt that, with falling consumer confidence, consumers will seek to remain with well-known, 'trusted brands' which may weaken the prospect of entry or expansion from internet-based providers⁹⁹. They also state that, as with mortgages, the larger the supplier typically the poorer the service received.
344. SMEs and larger firms generally did not identify any specific concerns with the merger. It was mostly considered fairly easy and inexpensive to switch supplier if prices were raised by five to ten per cent. They generally felt they had negotiating strength which would not change post-merger, and that there was an adequate number of alternative suppliers in the market.

⁹⁹ [The respondent quoted] 'Deposit and Savings Accounts, Finance Intelligence', January 2007, Mintel.

PERSONAL LOANS

345. Third parties commented that Lloyds and HBOS compete strongly in this market and competitors generally agree that the market for personal loans is UK-wide.
346. Most competitor respondents identified a variety of firms participating in this market, but the level of concern among competitors varied. The main issue of concern raised was the high combined market share of the merged entity, which would be significantly higher than the next competitor. The market was characterised by only moderate switching across the market, and switching was unlikely during the loan length.
347. One consumer body noted that customers had limited negotiating strength which would be reduced post-merger. Nevertheless, it was considered that it would be worthwhile customers switching from their current supplier in the event of a five to ten per cent price rise. The considerable benefits to suppliers operating a branch network were also raised, with the suggestion that this is indicated by the weak performance of any internet based bank. They also noted that around two-thirds of customers needing a loan will initially make enquiries with their current account provider.¹⁰⁰
348. As outlined in the preceding section on deposit accounts, it was asserted that, with falling consumer confidence, consumers will seek to remain with well-known, 'trusted brands' which may result in weakening the prospect of entry or expansion from (in particular) internet-based providers¹⁰¹.

CREDIT CARDS

349. Third party responses confirmed that both parties compete in the provision of credit cards. Competitors generally agreed that the geographic market is UK-wide.
350. The level of competition concerns varied among competitors, though the parties' high combined market share was raised as a concern. In addition, as noted in other product markets, there was concern over the parties' ability to use customer data. Nevertheless, competitors were able to identify a variety of active participants in this market, switching was generally considered to be frequent and the issue was raised that customers can hold cards from a number of providers at any one time. It was also suggested that credit cards are

¹⁰⁰ [The respondent quoted] Secured Lending Products, Finance Intelligence, January 2008, Mintel.

¹⁰¹ [The respondent quoted] 'Deposit and Savings Accounts, Finance Intelligence', January 2007, Mintel.

substitutable with other payment mechanisms eg debit cards, store cards and cash.

351. One consumer body suggested that customers have limited negotiating strength in this market, and that it would be further reduced post-merger. Nevertheless, it would be worthwhile to switch from their current supplier if they raised prices by five to ten per cent. As in the PCA market, a consumer body highlighted that prices in this market are not easily comparable and are somewhat opaque. They note that credit card products calculate actual interest charges in a number of ways that make the actual price differ from the headline APR.

GENERAL INSURANCE

352. Overall, both third party competitors and customers perceived customer switching to be reasonably prevalent in the general insurance sector, although less so in the life insurance market. Competitors generally indicated that customers switched between a variety of insurance providers in both the life and general insurance markets. Several competitors indicated that switching of life and household insurance was often linked to switching of other financial products, such as mortgages.
353. Customers and competitors were, on average, only moderately concerned about the effects of the merger on competition in this market, although some insurance providers registered higher levels of concern. The main reason given was the high combined insurance-market share of the parties as a result of the merger. Several competitors also argued that a leading position in the PCA, and in particular the mortgage market, would allow the merged entity to sell insurance products, especially household insurance, to existing customers. Concerns about the large database the merged entity would possess on customers, and thus the possibility of leveraging this information to make further sales, were also lodged in relation to this market. Third parties also raised concerns that, given the volume of distribution of insurance by the merged parties, the underwriting arm might be able to foreclose access to insurance policies to third party distributors, thereby increasing third party costs.

XV SUMMARY OF VIEWS OF INTERESTED PARTIES ON THE PUBLIC INTEREST CONSIDERATION

354. As required by section 44(3)(b) of the Act, this section provides a summary of representations about the merger that have been received by the OFT and which relate to the stability of the UK financial system (the public interest consideration mentioned in the intervention notice), and which is or may be relevant to the Secretary of State's decision as to whether to make a reference to the CC under section 45 of the Act.
355. The OFT received representations on the public interest from: (i) the merging parties,¹⁰² (ii) the Tripartite Authorities (HMT, FSA and the Bank of England), (iii) seven third parties active in the financial services sector, (iv) two consumer interest groups, (v) the Scotsman newspaper, (vi) Rt Hon Alex Salmond MSP, First Minister of Scotland, and (vii) several members of the public. The representations are summarised below. Those representations in categories (i)-(vi) above are also appended in full in annex 2.¹⁰³

MERGING PARTIES

356. The parties note the position set out in the Impact Assessment attached to the Explanatory Memorandum to Statutory Instrument 2008/2645, which states that 'in instances where a banking failure can be prevented through a soundly structured merger, the economic harm caused by any lessening of competition could be substantially less than the economic harm caused should the merger not go ahead and a bank failure allowed to occur.'¹⁰⁴ They argue that the Lloyds/HBOS merger is such a case, and hence the benefits to the public interest from the merger outweigh any competition concerns the OFT may raise. They therefore maintain that the Secretary of State should not refer the merger to the CC, but rather clear it unconditionally.
357. The parties argue that [REDACTED] HBOS would have been (and would be) traumatic in terms of: a) counter-party exposure due to HBOS' wholesale market exposure; b) depositor exposure; c) investor confidence; and d) general

¹⁰² The parties provided two separate submissions on the public interest consideration, dated 8 October and 24 October.

¹⁰³ Where representations were received as part of a broader submission to the OFT about the merger, those representations have been provided as extracts; where representations were received in a stand-alone submission, the submission is provided in its entirety.

¹⁰⁴ Explanatory Memorandum to the Enterprise Act 2008 (Specification of Additional Section 58 Consideration) Order 2008 No. 2645, page 11.

confidence. They contend that financial stability should be considered from three perspectives:

- The infeasibility of referring the merger to the CC [REDACTED].
- The systemic need to intervene to save HBOS.
- The justification of this transaction as a means by which this systemic need is met.

358. On this third point, the parties argue that the measures announced by Government on the 8 October do not render the transaction unnecessary, and that in the absence of the proposed merger, further intervention or support of HBOS between 18 September and 8 October would likely have been necessary.

TRIPARTITE AUTHORITIES

359. The OFT received submissions from the Bank of England, the FSA and HMT (the Tripartite Authorities), all of whom argue that the necessity of the merger on financial stability grounds outweighs any potential competition concerns, and that the merger should not therefore be referred to the CC. In particular:

360. The Bank of England notes the importance of HBOS as a major UK bank for the stability of the UK financial system as a whole. It contends that the sounder funding base and better quality of assets of Lloyds support the merits of the merger in strengthening financial stability.

361. The FSA also notes the vulnerable position of HBOS leading up to announcement of the merger. It argues that a private sector acquirer of HBOS was and is the best way to promote financial stability in the UK, and that Lloyds was best placed to act quickly in making an offer for HBOS.

362. HMT agrees that the successful passage of the merger is crucial for financial stability. In particular, it argues that the benefits of the transaction for HBOS include increased confidence, an improved business model, a better capital base, a reduced reliance on wholesale funding, an improved credit rating, a broader business base, and the addressing of funding issues. All of these factors, it contends, will promote financial stability in the UK more generally.

THIRD PARTIES IN THE FINANCIAL SECTOR

363. Two competitors ([REDACTED]) hold the view that the merger may be necessary to restore financial stability but have concerns about competition, and are as such not wholly convinced of the case for not referring the merger to the CC.

364. In particular, [a competitor] who competes with the parties in the general and life insurance sector, argues that while the merger may be necessary on the grounds of the public interest, the Secretary of State should not permit a transaction that may be anti-competitive beyond what is strictly necessary to satisfy public interest concerns. In this respect, it argues that the anti-competitive consequences of the merger in relation to the insurance market should not be overridden to safeguard the mortgage market.
365. Two competitors ([REDACTED]) claim that the merger is necessary in the short term to aid the recovery and stability of the financial sector. However, they express concerns that in the medium to long term, competition could be severely hampered as a result of the merger, and argue that safeguards and scrutiny should be in place to prevent such a result.
366. Two respondents ([REDACTED]¹⁰⁵) view the merger as necessary for financial stability and recovery, and do not judge there to be another viable option. As such, they argue that the merger is aligned with the public interest, and do not feel that it should be referred to the CC.
367. Only one respondent ([REDACTED]¹⁰⁶) argues that the merger is completely opposed to the public interest. It points out that [REDACTED].

CONSUMER INTEREST GROUPS

368. The OFT received responses from two consumer interest groups (Consumer Focus and Which?). Broadly speaking, both consumer groups recognise that the merger may be necessary to restore stability to the financial sector, and this may be in the interest of consumers. However, both also express concerns about the longer term implications of the proposed merger for competition in the banking industry. In particular:
369. Consumer Focus notes that in normal times it would fully expect the merger to be referred to the CC; yet, in the current climate, it feels that this would not be in the public interest given the length of time a CC investigation would take. However, it also expresses some concerns in relation to the public interest. First, it does not want the exemption to be seen as diluting the competition regime, and in particular worries that it may set a precedent for exemptions in other sectors. Second, it notes that a preferable solution may have been for Government to have promoted financial stability in the industry through the provision of financial support to HBOS as an independent entity. It argues that

¹⁰⁵ [REDACTED] is a mortgage broker, and [REDACTED] is a pensions and investment provider.

¹⁰⁶ [REDACTED].

this would have maintained a greater degree of competition in the banking sector.

370. Which? also notes that in normal circumstances it would expect the merger to be referred to the CC. However, it recognises that in this case it may be necessary for the Secretary of State not to do so, in order to protect consumers from the risk of instability in the banking sector. Nonetheless, it seeks assurances that healthy competition will be protected and promoted in the industry in the medium to long term, for example through binding undertakings at the time of the merger and/or through ongoing scrutiny of the industry.

OTHER REPRESENTATIONS

371. The Editor of The Scotsman newspaper, Mike Gilson, sent the OFT an open letter noting that competition concerns were likely to be more severe than for the rest of the UK, and that branch divestments should be considered.
372. The First Minister of Scotland, Rt Hon Alex Salmond MSP also sent a letter to the OFT expressing his concerns about the merger for the Scottish public interest. He notes that while the transaction may have appeared necessary at the time of its negotiation on 18 September, conditions in the UK banking industry have subsequently changed, and argues that this should be taken into account.
373. Several individual members of the public also made representations on the public interest considerations of this merger. These were varied and on the whole quite general in the concerns raised. Several respondents felt that the longer term consequences of the merger for competition would be severe and as such the merger should be referred to the CC, in spite of considerations of financial stability. Several Scottish respondents were especially worried about the loss of competition in Scotland as a result of the merger, and argued that the merger would not be in the Scottish public interest once this was taken into account.

XVI REMEDIES – UNDERTAKINGS IN LIEU

RELEVANT PRINCIPLES

374. Where competition concerns have been identified, section 44(4)(f) of the Act requires that the OFT's report includes a 'decision' on whether it believes that it is or may be the case that it would be appropriate to deal with the matter (disregarding any public interest considerations mentioned in the intervention notice concerned) by way of undertakings under paragraph 3 of Schedule 7 to the Act. Namely, whether the OFT considers that instead of making a reference, and for the purpose of remedying, mitigating or preventing the substantial lessening of competition concerned or any adverse effect which may be expected to result from it, the Secretary of State should accept from such of the parties concerned undertakings as he considers appropriate.
375. The Guidance states that 'undertakings in lieu of reference are appropriate only where the competition concerns raised by the merger and the remedies proposed to address them are clear cut, and those remedies are capable of ready implementation'.¹⁰⁷
376. In general, the 'clear cut' standard equates to a preference for structural remedies over behavioural ones, a preference which the OFT has publicly described as being an 'explicit policy' one.¹⁰⁸ This is because of the concerns that behavioural remedies can create, in particular because they treat the consequences rather than the cause.
377. In the present case, Lloyds did not offer any structural or behavioural undertakings in lieu of reference to the CC. On this point, the parties commented that undertakings in lieu would not be appropriate in this case¹⁰⁹ given the uncertainty surrounding how financial markets will operate in future and the fact that remedies might prove a 'distraction' to normalising banking markets as quickly as possible. They noted also that the provision of undertakings might mean that Lloyds' offer for HBOS would not proceed (the offer being conditional on there not being conditions that are unacceptable to it). Finally, they pointed out that commitments given in the context of Government's 13 October package

¹⁰⁷ Paragraph 8.3.

¹⁰⁸ See the OFT's evidence in *Co-operative Group (CWS) Limited v OFT* [2007] CAT 24, paragraph 87.

¹⁰⁹ The parties also noted that the power to accept undertakings in lieu arises only where the Secretary of State concludes that he would "otherwise" intend to make a reference, ie only where the Secretary of State concludes that any "anti-competitive outcome" is not outweighed by financial stability considerations.

meant there would be regulatory oversight over the merged group and that, in any event, competition in the market would be safeguarded by normal competition rules.

378. The OFT notes the arguments above in relation to the markets in question. However, to the extent the parties may be suggesting that 'normal' competition rules governing the conduct of firms (such as the Competition Act 1998) can restore competition lost by a merger, this argument is of course flawed. Ex ante merger control was introduced in the UK, EC and almost every other major jurisdiction precisely because ex post competition rules governing the conduct of merged firms are not sufficient to safeguard against, and remedy, anti-competitive structural changes brought about by a merger, and that the ability to 'prevent' adverse merger effects is superior to attempts to 'cure' them.
379. As to merger remedies themselves, the absence of any offer of remedies makes it inherently difficult, particularly in the time available to the OFT,¹¹⁰ for the OFT to formulate a hypothetical set of undertakings and subsequently test whether they might be appropriate to deal with the competition concerns identified – even assuming that this exercise would be meaningful given that undertakings must be voluntarily offered by the acquiring party.
380. The OFT does not rule out entirely the possibility that, with more time and more willing engagement by the parties, it might have been possible to develop structural remedies, although it accepts that – given the competition concerns – this would certainly have been challenging. However, the OFT notes that in Lloyds/Abbey, even at the end of a Phase II inquiry, the CC did not consider that either structural or behavioural remedies would be sufficient to alleviate its concerns about the competitive effects of that merger.

ASSESSMENT

381. Accordingly, in the absence of an offer of undertakings in lieu of reference from Lloyds, the OFT does not believe that there are possible remedies that would be sufficient to address the competition concerns identified.
382. The OFT therefore advises that it would not be appropriate to deal with the competition concerns arising from the merger situation by way of undertakings under paragraph 3 of Schedule 7 to the Act.

¹¹⁰ Although, even with more time, the absence of any offer of undertakings would still make any such assessment extremely difficult.

XVII ASSESSMENT AND REPORT

ASSESSMENT

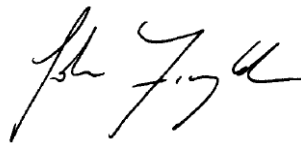
383. As required by sections 44(3) and (4) of the Act the OFT hereby advises and makes the following decisions.

384. The OFT believes that it is, or may be, the case that:

- arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation
- the creation of that merger situation may be expected to result in a substantial lessening of competition (SLC) within a market or markets in the United Kingdom for goods or services, including personal current accounts, banking services to small and medium enterprises, and mortgages, such that further inquiry by the Competition Commission (CC) is warranted
- the markets concerned are of sufficient importance to justify the making of a reference to the CC under section 33 of the Act
- the arrangements are sufficiently far advanced and likely to proceed to justify the making of such a reference
- customer benefits in relation to the creation of the relevant merger situation concerned do not outweigh the SLC and any adverse effects of the SLC, and
- it would not be appropriate to deal with the matter by way of undertakings under paragraph 3 of Schedule 7 to the Act.

ADVICE

385. The OFT accordingly reports and advises the Secretary of State under section 44 of the Act that the test for reference is met on competition grounds.



John Fingleton
Chief Executive
24 October 2008

Lucília Falsarella Pereira	Principal Case Officer, Mergers
Paul Tew	Economist, Mergers
Matt Bowhill	Economist, Infrastructure
Caitlin Wilkinson	Assistant Economist, Mergers
Ruthanne McNeice	Assistant Economist, Mergers
Chris Walters	Assistant Director, Mergers
Alastair Mordaunt	Director, Mergers

ANNEXE 1 – INTERVENTION NOTICE

INTERVENTION NOTICE GIVEN PURSUANT TO SECTION 42 ENTERPRISE ACT 2002

Whereas the Secretary of State has reasonable grounds for suspecting that it is or may be the case that arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation, as defined in section 23 of the Enterprise Act 2002 ('the Act') in that:

- (a) enterprises carried on by or under the control of Lloyds TSB Group plc will cease to be distinct from enterprises carried on by or under the control of HBOS plc, and
- (b) the value of the turnover in the United Kingdom of the enterprise to be taken over exceeds £70million.

Whereas the Secretary of State believes that the stability of the UK financial system ought to be specified as a public interest consideration in section 58 EA 2002 and the Secretary of State believes that the stability of the UK financial system may be relevant to a consideration of the merger situation;

Now, therefore, the Secretary of State in exercise of his powers under section 42(2) of the Act, hereby gives this intervention notice to the Office of Fair Trading and requires it to investigate and report in accordance with section 44 of the Act within the period ending on 24 October 2008.

The Secretary of State proposes to finalise the public interest consideration of the stability of the UK financial system by way of affirmative resolution made by the Secretary of State and laid before Parliament for its approval in the week beginning 6 October, when Parliament resumes after the recess. The exact timetable will depend upon Parliamentary business but the order will be debated in the Commons and the Lords as soon as practicable after it is laid.

18 September 2008

Andrew Rees

An official of the Department for Business Enterprise and Regulatory Reform

ANNEXE 2 – COPIES AND EXTRACTS OF SUBMISSIONS ON THE PUBLIC INTEREST CONSIDERATION

LLOYDS AND HBOS

Submission on Public Interest Consideration

Introduction

- 1** This submission supplements that of 3 October. This submission is confined to the public interest consideration specified in the Intervention Notice of 18 September of the stability of the UK financial system.
- 2** The assessment to be made under the Enterprise Act requires the Secretary of State to determine whether the Transaction may be expected to operate against the public interest, taking account of the OFT's findings on the competition issues and the public interest in ensuring the stability of the UK financial system. In the event that the OFT were to make an SLC finding, the question for the Secretary of State would be whether this is outweighed by the public interest consideration, such that the Transaction may not be expected to operate against the public interest. The parties have argued strongly in their submission of 3 October that the Transaction will not give rise to an SLC. In this submission the parties explain why the Transaction would be overwhelmingly in the public interest, such that a reference to the CC would not be justified.
- 3** Clearly it is Ministers accountable to Parliament who are best placed to assess the public interest and it is the Tripartite Authorities who have best access to information relating to the stability of the UK financial system institutions. Nevertheless this submission sets out the Parties' views.

The condition of financial markets and HBOS

- 4** The circumstances leading up to the Transaction and the position of HBOS were described in the 3 October submission [REDACTED]. Events in the USA and Europe (including Iceland) since the announcement of the Transaction and even since the 3 October submission indicate the progressive and severe strain affecting financial systems, in which the developments affecting the UK and HBOS specifically are inextricably woven.
- 5** A [REDACTED] HBOS which was becoming [REDACTED] in mid September would have been or would be traumatic in terms of:
 - counterparty exposure: it is common knowledge that HBOS has significant wholesale market exposure
 - depositor exposure (since HBOS was the market leader in savings and has a large number of current account customers)
 - investor confidence, and
 - general confidence: [REDACTED].

[Redacted] would have been potentially disastrous in terms of financial stability and therefore not tenable.

Implications for financial stability in the UK

6 The implications for financial stability have to be considered from three aspects:

- the infeasibility of referring the Transaction to the CC for investigation
- the systemic need for intervention to sustain HBOS
- the justification for this Transaction as the means by which that need is met.

All three aspects have to be taken into account by the Secretary of State in the exercise of his discretion under s.45(4), Enterprise Act to make a reference to the CC.

7 A common factor to all three aspects is the critical need for financial authorities to act quickly to address incipient crises: see p31 of the IMF Working Paper at Annex 2.1 to the 3 October submission. As set out in Annex 20.1 to the 3 October submission, not only can individual banks fail quickly and suddenly but this can create a domino effect upon other financial institutions. The development of the present crisis provides stark illustrations of both phenomena and the material referred to in the previous section demonstrates the gravity of that risk in the specific circumstances of HBOS.

Infeasibility of reference to the CC

8 [REDACTED].

The systemic need for intervention to sustain HBOS

9 It is the parties' clear opinion (for the reasons set out in the materials referred to in the previous section) that intervention of some form [REDACTED].

The justification for this Transaction

10 [REDACTED] it may be assumed that some form of intervention would have occurred. The alternate forms of intervention postulated by the [REDACTED] all presuppose some element of Government support. It is clearly a matter for Ministers to decide, in the general public interest, whether it is preferable to advance such support (and to what extent) or to support a private sector solution.

11 The measures announced by the Government on 8 October 2008 designed to support the stability of the UK financial system do not render the Transaction unnecessary. Even though the Government's measures may begin to alleviate some of the strains being experienced by the UK financial services sector (a) but for the announcement of this Transaction it is likely that alternative tripartite intervention or support of the type envisaged [REDACTED] would have been required by HBOS between 18 September and 8 October and (b) even with the benefit of the package of measures announced on 8 October there is a remaining real risk that the "domino effect" (given other bank difficulties that have arisen since 18 September) and issues of equity and debt investor, and customer confidence, would still at best have acted as a material impediment to the ability of HBOS to continue to compete aggressively and, more likely, would have required further intrusive tripartite intervention in due course.

- 12** With completion of the Lloyds TSB/HBOS Transaction customers will see greater continuity of HBOS products, services and brands than would otherwise be the case. Confidence will therefore be higher than would otherwise be the case. This will contribute to the stability of the UK financial system.
- 13** The fact that the fifth largest bank and the largest savings and mortgage provider has [REDACTED] but instead has been subject to a managed solution to its imminent problems can therefore be seen as a vital mechanism to maintain confidence. Confidence is key to maintaining stability in the UK financial system see e.g. Bank of England News Release 1 May 2008: "Confidence is key for Financial Markets".
- 14** Only Lloyds TSB was in a position to move rapidly enough to achieve a private sector solution to the challenges confronting HBOS. That solution has:
- ensured and will ensure a degree of continuation of HBOS business that would not otherwise be achievable
 - preserved a degree of confidence that would not otherwise have been preserved, and therefore contributed to the preservation of stability in the UK financial system.
- 15** In the round therefore the counterfactual means that
- any impact on competition from the Transaction is, at most, limited (see the October 3 submission), and
 - any such impact is justified by the factors described above and the maximisation and preservation of confidence and therefore stability in the UK financial system.
- 16** In conclusion, therefore, the parties consider there are compelling reasons not to refer this Transaction to the CC, and that even if the OFT were to reach an SLC finding, clearance would be overwhelmingly in the public interest.

Lloyds TSB

HBOS

Lloyds TSB/HBOS – Final Public Interest Submission

- 1 This Memorandum updates and summarises the parties' submissions on the public interest issues in this case and in particular why the merger of Lloyds TSB and HBOS should be permitted to proceed without reference to the Competition Commission or undertakings in lieu of such a reference.
- 2 The parties agree with the position set out in the Impact Assessment attached to the Explanatory Memorandum to Statutory Instrument 2008/2645 (page 11) that "in instances where a banking failure can be prevented through a soundly structured merger, the economic harm caused by any lessening of competition resulting from the merger could be substantially less than the economic harm caused should the merger not go ahead and a bank failure allowed to occur". The parties submit that the Lloyds TSB/HBOS merger is such a case.

The Competition Issues

- 3 The parties appreciate that the OFT's conclusions on the competition issues are binding on the Secretary of State. For the reasons set out in their submissions of 3 and 14 October they believe the Transaction cannot be expected substantially to lessen competition. In most markets affected by the Transaction that conclusion is based on the low post merger share and strong levels of post merger competition. But in any event the Transaction cannot reasonably be expected to result in a substantial lessening of competition in any market when account is taken of the "future" HBOS would have but for the merger. [REDACTED]:
 - [REDACTED], and
 - [REDACTED].

Public Interest issue – implications for financial stability in the UK

- 4 In their public interest submission of 8 October the parties said that the implications for financial stability have to be considered from three aspects:
 - the infeasibility of referring the merger to the CC for investigation
 - the systemic need for intervention to sustain HBOS, and
 - the justification for the merger as the means by which that need is met.

Infeasibility of reference

- 5 [Redacted].

The need for intervention

- 6 In the public interest submission of 8 October and the competition submissions of 3 and 14 October the parties described the financial position of HBOS. [REDACTED]. HBOS provided further material orally to OFT on 13 October.
- 7 The central theme of the evidence given by the parties to the OFT in those submissions is [REDACTED]. That was obviously the view of the Government too since the Public Intervention Notice was "considered necessary in view of the urgent need to intervene in

respect of the proposed merger between Lloyds TSB and HBOS and to give wider market clarity about the regulatory process” (Explanatory Memorandum, para 7.1). The Impact Assessment to the Explanatory Memorandum also notes (page 4) that the Chancellor, FSA and Bank of England all endorsed that merger “as important to ensure the financial stability in the UK in the interest of consumers and the wider economy”.

The Justification for this Transaction

- 8** The parties’ submission of 8 October on the public interest issues in this case pre-dated the events of 9-13 October which led to further instability and the Government package of 12-13 October. The parties’ position is that those events and the Government’s package support the parties’ submission that the merger is a critical component of the response to the financial crisis and therefore in the public interest. The reasoning for this conclusion is as follows:
- HBOS is vulnerable to investor, counterparty and customer confidence that has fallen significantly [REDACTED];
 - HBOS has stated publicly that it is important that it be part of a “bigger and stronger group” (Share O’Riordain to the Scotsman, 19.10.08). The merger will achieve that; and
 - The merger will create a stronger and more resilient banking force, better able to sustain and meet the needs of business and retail banking customers, savers and those looking for mortgages. Lloyds TSB’s strong capital position, sustainable funding model and strategy of putting customer relationships at the heart of its strategy make it well placed to achieve a successful merger.
- 9** The parties continue to believe that, given that counterfactual, any impact on competition from the merger is limited and, in any event, justified and more than outweighed by the factors described above and the beneficial effects on stability in the UK financial system.

Undertakings are neither justified nor appropriate

- 10** Finally the parties address the question of undertakings in lieu of a reference. First, the power to accept undertakings in lieu arises only where the Secretary of State concludes that he would “otherwise” intend to make a reference; in other words, the power is triggered only where the Secretary of State concludes that any “anti-competitive outcome” is not outweighed by financial stability considerations. Given the limited effects on competition in this case, no undertakings are warranted and would jeopardise the transaction.
- 11** Second, undertakings would not be appropriate in this case for the following reasons:
- first, it is increasingly obvious that however financial markets are perceived to have operated in recent years it is unclear how they will fare going forward; there has been rapid consolidation in recent weeks even leaving aside the present merger (Santander’s acquisition of Alliance & Leicester and parts of Bradford & Bingley; Nationwide’s acquisition of Derby and Cheshire BS); there has been nationalisation (part of B&B, Northern Rock, RBS); and refinancings. In such an environment neither the OFT nor Secretary of State can anticipate how markets will work and so it would be premature and disproportionate to seek to impose undertakings now to apply to the post merger Lloyds TSB/HBOS;

- second, Lloyds TSB has made its offer for HBOS conditional on there not being conditions that are unacceptable to it and so undertakings may cause it to decide not to proceed with the merger;
- finally, it is clear that significant regulatory oversight will apply to the post merger group (and other banks) going forward; commitments have already been given in the context of the Government's package of 12/13 October; and the OFT has extensive experience of the banking sector and has extensive powers under competition legislation to monitor, review and challenge anti-competitive behaviour should it have concerns.

As a result, the Secretary of State should clear the merger unconditionally.

TRIPARTITE AUTHORITIES

Redacted versions of the submissions from:

- 1. The Bank of England**
- 2. The Financial Services Authority (FSA)**
- 3. Her Majesty's Treasury (HMT)**

EXECUTIVE SUMMARY

- HBoS has a central position in the provision in the UK of residential mortgages, retail savings products and in areas of corporate banking, particularly commercial property lending. The importance of HBoS for the wider stability of the UK banking system explains why it was important to issue the intervention notice on the 17 September.
- The merger of HBoS with a stronger partner would therefore support the maintenance of financial stability: the prospect of merger and the capital raising attached to that transaction helps to substantially strengthen HBoS' capital and liquidity positions and so minimise the risk of a deterioration in sentiment towards the firm re-occurring; and any potential wider loss of confidence would also be reduced.
- More generally, confidence in the consistency and effectiveness of the authorities' intervention has been key to the re-establishment of stability. The unexpected imposition of avoidable delay to closing the merger would risk undermining that confidence. Successful and prompt completion of the merger is likely to strengthen further confidence in the UK banking sector.

HBoS as a systemically important institution

1. The Bank considers that HBoS plays a central role in the UK financial system through direct and indirect channels. Figure 1 (attached) summarises the direct channels. Central to this assessment is HBoS' role in the provision of core banking services to the household and corporate sectors. As Table 1 shows, HBoS' position in a number of core banking markets is significant.

Table 1: Estimated market position of combined Lloyds / HBoS Group

Market Sector	Market Segment – Detailed	Estimated market position
Retail Financial Services	Current Accounts	1
	Mortgages	1
	Savings	1
	Personal Loans & Cards	1
Insurance	Household Insurance	1
	Bancassurance	1
Corporate	Commercial Banking	3
	Mid-corporate Banking	3

Source: Lloyds presentation to investors on the acquisition of HBoS, 18 September 2008.

2. Table 2 illustrates the scale of HBoS' balance sheet. From the asset side, HBoS provides significant capacity for lending to UK households and corporates.

3. From the liability side, HBoS is a major provider of current account services. The bank's membership of the UK's core retail and wholesale payment systems (eg BACS, CHAPS, CREST) supports this position, as does the status of HBoS' Bank of Scotland subsidiary as an issuer of Scottish banknotes.

**Table 2: HBoS' funding structure
(end-June 2008)**

(£bn)	H1 2008	FY 2007
Customer deposits	258.1	243.2
Wholesale deposits	47.0	41.5
MTNs and bonds	72.4	73.8
Other debt sec.	121.0	132.7
Sub. debt	19.4	17.7
Other liabilities	142.4	135.8
Share equity	21.1	22.2
TOTAL	681.4	666.9

Source: Published accounts

Recent events and the case for action

4. On 13 October LTSB announced revised terms of its proposed merger of HBoS, reducing from 0.833 to 0.605 the number of LTSB shares to be exchanged for each HBoS share. This followed announcements by LTSB and HBoS of major capital raisings - £5.5bn and £11.5bn respectively – under the Government’s recently introduced initiative.

5. Announcement of the merger on 17 September truncated the deterioration in sentiment towards HBoS in funding and equity markets, a deterioration which could also have spilled over to other institutions. In this sense, some financial stability benefits from the proposed merger have already been realised. And the prospect of merger and the capital raising attached to that transaction helps to strengthen substantially its capital and liquidity positions and so minimise the risk of such deterioration in sentiment re-occurring.

6. This strengthening would occur through its association with a stronger partner. First, on market indicators Lloyds has been performing better than HBoS (Tables 3 and 4).

7. Second, Lloyds’ customer funding gap¹¹¹ is markedly lower than HBoS’.

Table 3: HBoS market indicators

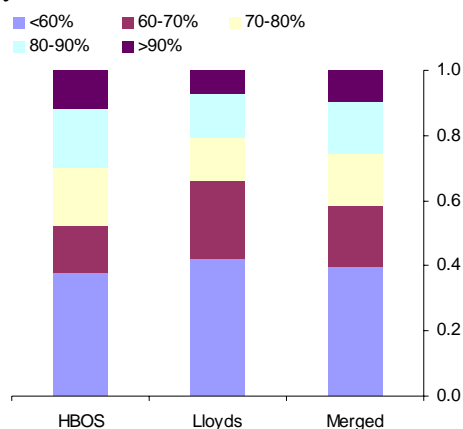
	HBoS		
	02/07/07	09/10/08	Change
Share price	963.3	153.5	-809.8
Market cap (GBP millions)	36,954	8,298	-28,655
CDS premia	10.8	195.3	184.5
P/E ratio	9.0	2.1	-6.9

Table 4: LTSB market indicators

	LTSB		
	02/07/07	09/10/08	Change
Share price	550.0	211.8	-338.2
Market cap (GBP millions)	31,473	12,814	-18,659
CDS premia	6.5	100.0	93.5
P/E ratio	9.9	5.1	-4.8

8. Finally, the quality of Lloyds’ assets is higher. For example, HBoS has a greater proportion of its stock of mortgage loans at high LTVs than LTSB (Chart 1 and Table 5).

Chart 1: Outstanding mortgage balances by LTV bucket: end H1 2008



Source: Published accounts and Bank of England

Table 5: Outstanding mortgage balances by LTV bucket: end H1 2008

LTV bucket	HBoS	LTSB	Merged
<60%	0.38	0.47	0.42
60-70%	0.15	0.27	0.20
70-80%	0.18	0.15	0.17
80-90%	0.18	0.15	0.17
>90%	0.12	0.08	0.10
Mortgages outstanding (£billions)	151	109	260

Source: Published Accounts and Bank of England

¹¹¹ Defined as the excess of lending to customers over deposits from customers and can be viewed as a diagnostic on a bank’s structural reliance on wholesale funding. Customer is defined here as non-bank borrowers and depositors.

9. Looking to the longer term, a successfully combined LTSB and HBoS will be able to realise significant cost synergies and economies of scale. If translated into enhanced profitability, this will enable the group to generate greater quantities of capital internally, enhancing the combined group's financial robustness.

Conclusion

10. HBoS plays a major role in the provision of financial services to the UK household and corporate sectors, both directly and indirectly, underlining the importance for financial stability in the UK of a merger which will strengthen both its liquidity and funding positions. A delay to the merger, or its failure, could also weaken confidence in the effectiveness of HMG's re-capitalisation and funding guarantee programme to re-establish stability. Successful and prompt completion of the merger with a stronger partner should improve and maintain confidence in the UK banking sector and thus support financial stability.

Bank of England
October 2008

The Financial Services Authority (FSA)

To: OFT Date: 16 October 2008
From: FSA cc:
Ref: OFT request for FSA response to competition enquiry

Subject: **Lloyds TSB/HBOS Merger**

1. This note provides the rationale for our recommendation that the Lloyds TSB/HBOS merger be approved for financial stability reasons.

Why was HBOS vulnerable?

2. HBOS has been seeking since the beginning of this crisis to reduce its reliance on wholesale funding and to lengthen the maturity profile of its liabilities. Unfortunately the firm has had only limited success in doing so given the extremely difficult market conditions prevailing since August 2007. As a result, at the end of June 2008 HBOS had a significantly higher loan-to-deposit ratio, and consequently a higher funding gap, than its UK peers.

Metric \ Firm	Barclays plc	HBOS plc	HSBC Holdings plc	Lloyds TSB Group plc	RBS plc
Customer loans/advances	£535,422m	£455,950m	\$1,049,200m	£229,621m	£557,762m
Customer deposits	£466,176m	£258,130m	\$1,161,923m	£178,460m	£432,920m
Loan:Deposit Ratio	115%	177%	90%	129%	129%
Funding Gap	£69,246m	£197,820m	N/A	£51,161m	£124,842m

Source: June 2008 interim results

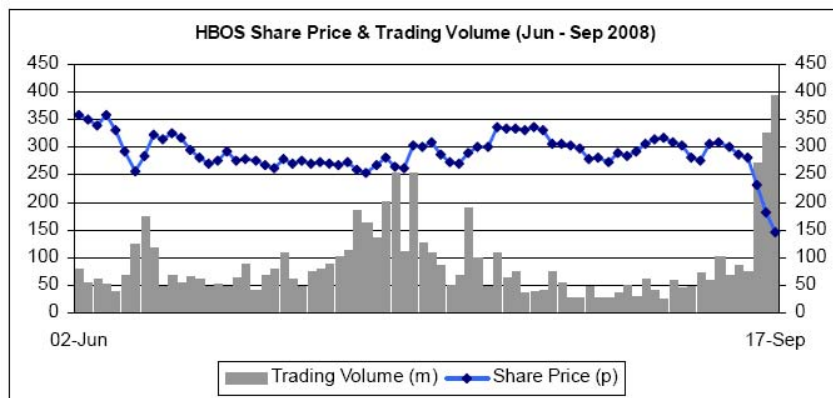
3. HBOS has had a high concentration in UK mortgage lending with approximately 53% of its loans and advances to customers being for UK residential mortgages (as at 30 June 2008). With UK house price indices reporting a fall of 11.5% from October 2007's peak to August 2008¹ and various market expectations of more price falls still to come, HBOS has been, and was viewed by the market as, particularly vulnerable to materially higher loan losses in relation to UK residential mortgages.

¹ http://www.nationwide.co.uk/hpi/historical/Aug_2008.pdf

- In addition to the structural vulnerabilities of its funding model and its high concentration in the UK residential mortgage market, HBOS has also been materially exposed to the UK corporate loan sector. This exposure reached £107 billion as at the end of June 2008, which represents some 23% of its loans and advances. This total included a £66 billion exposure to commercial properties and was thus highly vulnerable to the decline in collateral values. HBOS's broader expansion into the UK corporate credit market has been relatively recent in relation to its large domestic peers', thus contributing to comparatively higher asset risk.

What was the catalyst for action?

- On Sunday 14 September, Lehman Brothers Holdings Inc. filed for bankruptcy under Chapter 11 of the US Bankruptcy Code. This event shocked the financial markets and caused investors to re-appraise their risk appetite, resulting in a heightened wariness of lending to banks and a sharp increase in the cost of obtaining such funding.
- The relatively large size of HBOS's funding gap rendered it particularly exposed to this re-appraisal of risk. The market was concerned about the availability and cost of new funding to replace existing liabilities falling due. HBOS's share price fell by 18% on Monday 15 September followed by a further fall of 22% the next day.



Source: <http://uk.finance.yahoo.com>

What action was taken?

- On Wednesday 17 September, the Boards of Lloyds TSB and HBOS agreed to a takeover of the latter by the former with a formal announcement made the following day. Meanwhile, HBOS's share price fell by a further 19%, reinforcing the urgency of this action.

What will be the impact on competition?

- A merger of Lloyds TSB and HBOS could reduce competition within UK banking. However, this effect would vary substantially among various business lines both as a result of the existing market structure and the scope for new entrants. The table below shows the potential competition implications across a selection of product lines:

Firm	Barclays	HBOS	HSBC	Lloyds	RBS	Lloyds/ HBOS	Rest of Market
Current Accounts	14%	13%	14%	17%	17%	30%	25%
Savings Accounts	6%	10%	6%	7%	6%	17%	65%
Residential Mortgages	7.1%	20.4%	4.2%	9.7%	6.8%	30.1%	51.8%
Credit Cards	14%	8%	10%	10%	11%	18%	47%
Unsecured Loans	7%	8%	9%	21%	12%	29%	43%
Business Banking	20.0%	5.6%	15.5%	17.0%	33.8%	22.6%	8.1%

Source: FSA data, GfK FRS Consumer Survey (June 2008), Continental Research/Mintel (June 2006)

9. HBOS currently has the highest market share of the major UK banks in savings accounts and residential mortgages, whilst Lloyds TSB has the highest market share in current accounts and unsecured loans. The merger would consolidate these competitive strengths. However, the combined market share would not exceed c. 30% in any product line – a point worth noting in relation to RBS's existing 33.8% market share in business banking. There is also fierce competition in the market for savings, mortgages, credit cards and unsecured loans as evidenced by the significant size of the rest of market in each of these product lines and the freedom for new entrants to come into the market. It is therefore likely that in time the relative size of various product market shares will fluctuate, especially given UK banks' renewed focus on growing retail funding sources.
10. Arguably the largest concern relates to competition in the current account market, where Lloyds TSB/HBOS would have a 30% market share and competition from outside of the major UK banks is more limited. However, we note that the OFT Market Study into personal current accounts in the UK proposes improvements to competition in this market through increased transparency, reduced complexity of charging structures and simplification of the switching process. These steps would reduce the opportunity for Lloyds TSB/HBOS to exploit its market position, as consumers would be more empowered to compare products offered by different providers.

What alternative action was explored?

11. Full or partial temporary public ownership (e.g. Northern Rock/Bradford & Bingley) could have been considered in the absence of the Lloyds TSB proposal, although EU State Aid rules preclude a government-owned entity from competing aggressively with private sector banks which would likely have caused HBOS's balance sheet to shrink and limited its ability to provide loans and services. Under this scenario, HBOS would not have been able to provide effective competition.
12. The FSA held talks with various potential acquirers for HBOS. This population of firms was limited in number by the capacity to successfully absorb HBOS's substantial balance sheet in the prevailing market conditions.

13. The FSA believes that the proposed Lloyds TSB/HBOS merger affords a means to maintain financial stability and to sustain confidence of HBOS creditors (including retail depositors). In particular, it provides a sustainable medium-term future for HBOS in a way that none of the alternative scenarios does. We consider these benefits to be considerable relative to the competition aspects of the proposed merger, particularly when account is taken of the lack of competition offered under the alternative scenario.



Evidence to the Office of Fair Trading on the proposed Lloyds TSB and HBOS merger

1. On 18 September Lloyds TSB and HBOS announced that they had reached agreement on the terms of a merger. HBOS shareholders were to receive 0.83 Lloyds TSB shares per HBOS share, valuing HBOS at around £12.2billion. This was subject to the approval of Lloyds TSB and HBOS shareholders. On 18 September, the Secretary of State issued an intervention notice on the merger on the grounds of a public interest consideration not yet specified, namely, maintaining the financial stability of the UK.
2. Following additional market turbulence and a significant drop in HBOS's share price, the terms of the merger were renegotiated and announced on 13 October. HBOS shareholders will now receive 0.605 Lloyds TSB shares per HBOS share. The new deal was also accompanied by an agreement with Government on participation of the two firms in the Bank Recapitalisation scheme (subject to completion of the merger). £17billion of capital will be raised, of which £11.5billion (£8.5billion in ordinary shares and £3billion in preference shares) will be raised by HBOS and £5.5billion (£4.5billion in ordinary shares and £1billion in preference shares) will be raised by Lloyds TSB. The Government will do whatever is necessary to maintain financial stability but it should not be assumed that capital will be available to the banks as standalone entities on the same terms as has been proposed for the merger.
3. Further detail of the revised merger terms and recapitalisation can be found in the two firms' regulatory announcements (included at annex A).
4. HM Treasury, drawing on advice from the Bank of England and the Financial Services Authority, believes that the merger will have significant benefits for the financial stability of the UK. Our evidence also comments on the implications of the Bank Recapitalisation Scheme for the effects of the merger on competition.

HM Treasury's objectives

5. The Treasury has three objectives when considering how to respond to difficulties in a financial institution:
 - maintaining financial stability;
 - protecting taxpayers; and
 - safeguarding depositors and consumers.
6. After consultation with the other Tripartite Authorities we have concluded that the private sector merger, accompanied by recapitalisation, represents the best outcome in line with the Treasury's objectives:
 - Maintaining financial stability:
 - Protecting taxpayers:
 - Safeguarding depositors:
7. The alternatives do not meet these objectives as well.

8. This evidence focuses on the objective of maintaining financial stability, since this has been specified as a public interest consideration for the merger between Lloyds and HBOS.

Financial Stability

Background

9. It was right for the Secretary of State to issue an intervention notice immediately (on advice from the Tripartite Authorities) so that the implications for financial stability could be considered alongside the implications for competition.

Recent Developments

10. The rapidly deteriorating situation in global financial markets and further interventions by governments and central banks around the world have changed the context for the merger but its importance for financial stability remains.
11. Since 18 September countries across the world have seen further financial turmoil, more bank failures, unprecedented Government intervention and continued fragility in financial markets. In the UK, this included the sale of the retail business of Bradford & Bingley and the announcement of the Bank Recapitalisation Scheme. A number of countries across the world have made similar announcements, including the US and leading European countries.

Benefits of a Merger for Financial Stability

12. In the view of the Tripartite Authorities the merger remains the best option in terms of financial stability.
13. The Bank of England's evidence recommends that the takeover should proceed without delay
14. The evidence from the Financial Services Authority concludes that the merger affords a means to maintain financial stability and to sustain confidence of HBOS creditors. The merged recapitalised entity will be on a strong footing to withstand further turbulence in the financial markets.
15. We agree with the Bank of England's assessment that the merged entity would be stronger than a standalone HBOS. The benefits of the merger for financial stability include:
- Improved confidence
 - Improved business model
 - Better capital base
 - Reduced reliance on wholesale funding
 - Improved credit rating
 - Broader business base
 - Addressing funding issues

Improved confidence:

16.

Improved business model:

17. One of the key benefits of the merger for financial stability is the opportunity to revise and refocus the HBOS business model. HBOS has been particularly exposed to the recent market turbulence because it expanded at an inopportune moment, relies heavily on wholesale funding and has significant exposure to the mortgage market. A merger will bring the opportunity to

strategically reduce these vulnerabilities, for example through a more diverse funding structure. A change of management and new expertise will help to give a fresh approach to the business of the company. Lloyds TSB are generally regarded as having a conservative model and their approach will be particularly useful for reforming HBOS in the current climate. A new business model is key to improving market, wholesale and retail confidence as well as reducing the firm's vulnerabilities to the immediate financial turmoil.

Better capital base:

- 18. We are advised by the Bank of England that Lloyds TSB has assets of a higher quality than HBOS. It has less exposure, for example, to buy-to-let, self-certified and sub-prime mortgage lending. The merged entity will have a better quality asset base than standalone HBOS.
- 19. The recapitalisation of both banks which will accompany the merger will also of course make a significant contribution to improving the capital base of the merged entity. The merged entity will have over 7% core tier 1 ratio upon merging..

Reduced reliance on wholesale funding:

- 20. The merger will help HBOS to address its wholesale funding gap,.
- 21. The Government expects that the ability of all banks to rollover wholesale funding will be improved by the recently announced credit guarantee scheme.

Improved credit rating:

- 22. The Bank of England's evidence refers to Lloyd's higher credit ratings which allow it to attract cheaper wholesale funding and help maintain the confidence of wholesale and retail depositors. The recapitalisation package, alongside the other benefits of the merger, should mitigate against the risk that the merged entity receives the lower HBOS rating. For example, Moody's have commented that "The new capital levels of the banks are likely to limit any potential downward pressure on the ratings"¹¹²

Lloyds TSB

Agency	Long-term	Short-term
Moody's	Aaa	P-1
Fitch	AA+	F1+
Standard & Poor's	AA	A-1+
DBRS	AA(H)	R-1H

HBOS

Agency	Long-term	Short-term
Moody's	Aa2	P-1

¹¹² Moody's announcement 14 October
<http://www.moodys.com/moodys/cust/research/MDCdocs/14/2007300000539825.asp?search=6&searchQuery=lloyds&click=1&frameOfRef=corporate>

Fitch	AA	FI+
Standard & Poor's	A+	A-I
DBRS	AA(H)	R-IH

Broader business base:

23. Lloyds TSB has a broader business base and so are less exposed to downturns in one particular product. They are importantly significantly less exposed to the residential mortgage and buy-to-let markets. We would expect the merged entity to continue to follow this broad base model, though this is obviously a matter for the management of the merged entity. For example, Lloyds TSB's wider portfolio includes a significant market share in private pensions and small business banking – areas where HBOS has little presence.

Addressing funding issues:

24. These issues are covered in detail in the Bank of England and FSA submissions.

Systemic importance of HBOS

25. The Bank of England and the Financial Services Authority have provided evidence of the systemic importance of HBOS to the UK banking system and its importance for financial stability in the UK. HM Treasury agrees with their views.

Competition

26. It is for the Office of Fair Trading to make a general assessment of the implications of the merger for competition. We comment here only on the specific issue of the relevance of the Government's recapitalisation programme to the competition implications of the Lloyds-HBOS merger.

27. In its decision of 13 October 2008 authorising, inter alia, aid granted under the Bank Recapitalisation Scheme, the European Commission found that the Scheme was necessary, well-targeted and proportionate for the purposes of remedying a serious disturbance of the economy of the UK caused by the financial crisis.

28. If the merger receives the necessary approvals from shareholders and regulators, the Government has agreed to purchase £8.5 billion worth of ordinary shares in HBOS and £4.5 billion worth of ordinary shares in Lloyds TSB. Existing shareholders will have the option to purchase these shares up to their pro rata entitlement. In addition, the Government will purchase £3 billion worth of preference shares in HBOS and £1 billion in Lloyds TSB.

29. If the merger goes ahead and there is no take-up by ordinary shareholders the Government will have a share with an economic value of 44%. The Government intends to create a new arms length body to manage the Government's interest on a professional and wholly commercial basis. Transparent arrangements will be put in place to ensure that any role for the Government in relation to investment decision-making is strictly defined. The new body will be developed to be capable of managing the UK taxpayer's interest along commercial principles, acting at arms length to the Government. An important way to achieve this will be the use of external board appointments.

30. In addition, we recognise the importance of ensuring that the arrangements within Government (who will have stakes in a number of financial institutions) are not anti-competitive. We are

considering measures to, for example, ensure that teams working on each investment project protect confidentiality concerns from individual institutions. We would welcome the opportunity to work with the Competition Authorities as we develop these arrangements in relation to the general implementation of the Recapitalisation Scheme. The Government has also invited the OFT to continue to monitor competition in the banking sector and, if it finds evidence of competition problems that lead to harm to consumers or business customers, appropriate action will be taken to tackle this.

Annex A – Lloyds TSB and HBOS Regulatory Announcements

RNS Number : 6667F
Lloyds TSB Group PLC
13 October 2008

85/08 13 October 2008

NOT FOR RELEASE, PUBLICATION OR DISTRIBUTION IN WHOLE OR IN PART IN, INTO OR FROM ANY JURISDICTION WHERE TO DO SO WOULD CONSTITUTE A VIOLATION OF THE RELEVANT LAWS IN THAT JURISDICTION

31. Lloyds TSB announces revised terms for the acquisition of HBOS and the raising of £5.5 billion of new capital

32. In the context of unprecedented turbulence in global financial markets the Board of Lloyds TSB Group plc (Lloyds TSB) welcomes the action that the UK government has taken over the last week to stabilise the UK banking system for the benefit of deposit holders, shareholders, customers and the UK economy as a whole.

33. The Board of Lloyds TSB has carefully considered the best interests of its shareholders in these circumstances and has had discussions with HM Treasury on the additional capital which the UK Government requires Lloyds TSB to have if it is to access the Government backed provision of liquidity. Based on these discussions, the current market environment and the future prospects of the enlarged group, the Boards of Lloyds TSB and HBOS plc (HBOS) have agreed to proceed with a recommended offer for HBOS on revised terms. The revised terms agreed with HBOS are that HBOS shareholders will receive 0.605 Lloyds TSB shares for every 1 HBOS share. At the same time, an offer will also be made to HM Treasury to exchange HM Treasury preference shares in HBOS for equivalent preference shares in Lloyds TSB.

34. The Board of Lloyds TSB intends to recommend that Lloyds TSB shareholders vote in favour of the necessary resolutions to be proposed to Lloyds TSB shareholders at the Lloyds TSB general meeting. The Board of HBOS has also agreed to recommend these revised terms to its shareholders. The Takeover Panel has given its consent to the revision of terms. In addition, £17 billion of capital will be raised, of which £11.5 billion (£8.5 billion in ordinary shares and £3 billion in preference shares) will be raised by HBOS and £5.5 billion (£4.5 billion in ordinary shares and £1 billion in preference shares) by Lloyds TSB.

35. Lloyds TSB believes that the acquisition of HBOS will create a compelling business combination offering substantial benefits. The enlarged group will have excellent breadth and balance with strong positions in retail, corporate banking, SME business banking and long term savings. The acquisition brings together two of the strongest retailers in UK financial services and accelerates Lloyds TSB's stated strategic aim to build the UK's best financial services group based on growing sustainable earnings streams and on deep customer relationships.

36. Commenting on the developments, Sir Victor Blank, Chairman of Lloyds TSB said:

37. "Today's news is good for investors and customers alike. Lloyds TSB's already robust financial position is further enhanced by today's capital raising which in turn allows us to drive forward with our plans to acquire HBOS. Our trading update underlines that our core business is strong and growing. Our customers can feel confident that their money is secure. Lloyds TSB is and remains a great place to bank."

38. Revised terms and capital raising

39. The equity capital raising by Lloyds TSB comprises a subscription by HM Treasury of approximately 2.6 billion new ordinary shares at 173.3 pence per share, representing an 8.5 per cent discount to Lloyds TSB's closing price on 10 October 2008 and raising circa £4.5 billion in aggregate. Lloyds TSB shareholders will be given the opportunity to claw back their proportionate entitlement to these new Lloyds TSB shares through an open offer, the timing of which will be announced later. In addition, HM Treasury will subscribe for £1.0 billion of Lloyds TSB preference shares. The preference shares will carry an annual coupon of 12% (non tax deductible), and will be callable after a period of five years. The equity capital raising by Lloyds TSB is conditional on the passing of various resolutions including those relating to the acquisition of HBOS at the Lloyds TSB general meeting.

40. Under the terms of the preference shares, the enlarged Group will be precluded from paying a cash dividend on its ordinary shares whilst any of the preference shares remain outstanding.

41. The revised terms and the £8.5 billion equity capital raising by HBOS will result in the issue by Lloyds TSB of 7.80 billion new ordinary shares in respect of the acquisition.

42. If the acquisition were not completed HM Treasury would expect to take appropriate action to address the position in the light of the policy objectives set out in its announcement of 8 October 2008 on Financial Support to the Banking Industry.

43. Upon completion of the transaction, if neither Lloyds TSB's nor HBOS's shareholders participate in the claw back, existing Lloyds TSB shareholders will own 36.5 per cent, with existing HBOS shareholders owning 20.0 per cent of the ordinary capital of the enlarged Group. In these circumstances, the remaining 43.5 per cent will be owned by HM Treasury.

44. Full details with regard to the arrangements surrounding HM Treasury's ownership of a substantial part of the enlarged group, which include remuneration, corporate governance and public lending, are in Appendix I. Lloyds TSB expects that HM Treasury will act as a value-orientated shareholder with regard to the strategic development of the enlarged group and the implementation of cost synergies which remain forecast to be significantly in excess of £1 billion per annum by 2011. Lloyds TSB expects that the acquisition will be completed early in 2009.

45. Further, as agreed at the time of the initial announcement, the enlarged entity will continue to use The Mound as its Scottish Headquarters, will continue to hold its AGM in Scotland and will continue to print Bank of Scotland notes.

46. Following the actions announced today, the equity placing completed on 19 September 2008 and the inclusion of the HBOS acquisition on a pro forma basis at 30 June 2008, the enlarged group had a pro forma core Tier I ratio in excess of 8.5 per cent.

47. Revised conditions to the proposed acquisition are set out in Appendix II.

48. Interim Management Statement and Current Trading

49. Lloyds TSB continues to trade well and deliver good growth in its relationship banking businesses in this immensely challenging period for financial services companies. UK Retail Banking has continued to capture market share in a number of key areas, whilst improving product margins, and has delivered revenue growth in excess of cost growth and a double-digit percentage increase in profit before tax.

50. In Insurance and Investments, excluding the impact of insurance volatility, good growth in bancassurance sales has continued and the division has again delivered good revenue growth and lower costs, and a double-digit increase in profit before tax. The turbulence in fixed income

markets and lower equity markets contributed to adverse volatility of £504 million relating to the insurance business in the third quarter of the year, excluding policyholder interests volatility.

51. In Wholesale and International Banking, profits were lower, reflecting the impact of market dislocation of £384 million in the third quarter of 2008. The division's relationship banking businesses continued to perform well and, excluding the impact of this market dislocation, also achieved double-digit growth in profit before tax.

52. The Group remains well positioned to deliver a strong performance over the coming years.

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Merrill Lynch and UBS are acting as joint financial advisers to Lloyds TSB. Merrill Lynch, UBS and Citi are joint bookrunners and sponsors of the placing and open offer. Citi have also provided financial advice to Lloyds TSB.

53. Appendix I - Arrangements in relation to Government's equity participation

54. Remuneration

55. Remuneration of Board Directors

56. Although they will be entitled to take cash as an alternative, Lloyds TSB will ask executive directors to receive their 2008 bonus entitlement in Lloyds TSB shares. These will be subject to a restriction on sale until December 2009.

57. Going forward, for the merged group, in addition to complying with the ABI industry best practice code, remuneration will reflect long term value creation and take account of risk. Reward for Board Members will take into account internal relative compensation packages and perceived fairness in the current economic climate.

58. No rewards for failure: where a Board Member loses the confidence of the Board, they should be able to be dismissed at a cost that is reasonable and perceived as fair.

59. Commitment to FSA Code on Risk Based Remuneration

60. Corporate Governance

61. Government will work with the Board on its appointment of two new independent directors. Should the Government's holding of the combined entity fall below 25%, the Government would only expect to be consulted on the appointment of one independent director.

62. Lending

63. Mortgages

64. A commitment to maintain the availability and active marketing of competitively priced mortgage lending (other than in the non-conforming market) over the next three years at a level at least equivalent to that of 2007.

65. Make available a sum to be agreed for the next twelve months for shared equity/shared ownership schemes to help people struggling with mortgage payments to stay in their homes, either through individual bank schemes or paid into a central fund run by industry.

66. Make available a sum to be agreed for the next twelve months to support ongoing expansion of financial capability initiatives.

67. SMEs

68. A commitment to maintain the availability and active marketing of competitively priced lending to SMEs at a level at least equivalent to that of 2007, over the coming three years.

69. Publish an annual report on:

70. Overall lending to SMEs

71. Overdraft facilities and loans to SMEs: volumes, value and rates

72. Foreclosures of debt finance to SMEs

73. Appropriate lending of Small Firms Loan Guarantee Scheme

74. Application and use of EIB global loan facility to secure additional liquidity specifically for SME lending

75. To satisfy EU state aid requirements, the aggregate growth in balance sheet volumes of banks accessing the government schemes will be limited to the higher of the annual growth rate of growth of UK nominal GDP in the preceding year or the average historical growth of the balance sheets in the UK banking sector during the period 1987 - 2007, unless there is evidence that the thresholds are exceeded for reasons unrelated to the schemes.

•

76. Other

77. As agreed at the time of the initial announcement, the enlarged entity will continue to use The Mound as its Scottish Headquarters, will continue to hold its AGM in Scotland and will continue to print Bank of Scotland notes.

• **APPENDIX II - Conditions to the Implementation of the Scheme and the Acquisition**

The Acquisition will be conditional upon the Scheme becoming effective by not later than 28 February 2009 or such later date (if any) as, subject to the requirements of the City Code, HBOS and Lloyds TSB may agree and, if required, the Court may allow.

The Scheme will be conditional upon:

approval of the Scheme by a majority in number representing three-fourths or more in value of the holders of HBOS Shares (or the relevant class or classes thereof), present and voting, either in person or by proxy, at the Court Meeting and at any separate class meeting which may be required by the Court or at any adjournment of any such meeting;

the resolution(s) required to approve and implement the Scheme being duly passed by the requisite majority at the HBOS Extraordinary General Meeting or any adjournment of that meeting;

the sanction (with or without modification, but subject to each such modification being acceptable to Lloyds TSB) of the Scheme and the confirmation of any reduction of capital involved therein by the Court and an office copy of the Court Order and the minute of such reduction attached thereto being delivered for registration to the Registrar of Companies in Edinburgh and in relation to the reduction of capital, being registered; and

the passing at the Lloyds TSB Extraordinary General Meeting (or at any adjournment of such meeting) of such resolution or resolutions as may be necessary to approve, effect and implement the Acquisition and the implementation of the Scheme (as such resolutions may be set out in the Lloyds TSB Shareholder Circular), including a resolution or resolutions to (i) approve the terms of the Acquisition, (ii) authorise and permit the creation and allotment of New Lloyds TSB Shares, the making of any offer, proposal or other arrangement to holders of options under the HBOS Share Option Schemes and any necessary authorities and permissions for the creation and allotment of Lloyds TSB Shares in relation thereto; and (iii) disapply any requirements under Rule 9 of the City Code for any general offer to be made by HMT.

In addition, HBOS and Lloyds TSB have agreed that, subject as stated in paragraph 4 below, the Acquisition will also be conditional upon the following matters, and, accordingly, the necessary actions to make the Scheme effective will not be taken unless such Conditions (as amended if appropriate) have been satisfied or waived:

Admission becoming effective in accordance with the Listing Rules and the Admission and Disclosure Standards or, if Lloyds TSB and HBOS so determine and subject to the consent of the Panel (if required), the UK Listing Authority agreeing to admit the New Lloyds TSB Shares to the Official List and the London Stock Exchange agreeing to admit such shares to trading on its main market for listed securities subject only to (i) the allotment of such shares and/or (ii) the Acquisition becoming effective;

the Financial Services Authority (the "FSA") indicating pursuant to section 184(1) of the Financial Services and Markets Act 2000 (as amended) ("FSMA"), in terms reasonably satisfactory to Lloyds TSB, that it approves any acquisition of:

control over any UK authorised person;
(if applicable) any additional kind of control over any UK authorised person; or
(if applicable) any increase in a relevant kind of control which is already held over any UK authorised person,

in each case within the meaning of Part XII of FSMA which would take place as a result of the Acquisition or its implementation, or the FSA being treated as having given such approval under section 184(2) of FSMA;

each Relevant Regulator having, to the extent necessary, approved or is deemed to have approved, in terms reasonably satisfactory to Lloyds TSB, the acquisition by Lloyds TSB of control over HBOS and any member of the Wider HBOS Group which is authorised

or regulated by any Relevant Regulator, either unconditionally or subject to the fulfilment of certain conditions or obligations acceptable to Lloyds TSB;

it being established in terms satisfactory to Lloyds TSB, that it is not the intention of the Office of Fair Trading or the Secretary of State to refer the proposed acquisition of HBOS by Lloyds TSB or any matter arising therefrom or related thereto to the Competition Commission; and (ii) if clause (i) is satisfied, either the period specified in Rule 26 of the Competition Appeal Tribunal Rules 2003 for making an application under section 120 of the Enterprise Act for the review of a decision in relation to the Acquisition having expired without any such application being made or, where any such application has been made, the Competition Appeal Tribunal having dismissed such application;

all necessary or appropriate notifications, applications and/or filings having been made in connection with the Acquisition and all necessary waiting periods (including any extensions thereof) in connection therewith under any applicable legislation or regulation of any jurisdiction having expired, lapsed or been terminated (as appropriate) and all statutory and regulatory obligations in any jurisdiction having been complied with in connection with the Scheme and all Authorisations necessary or reasonably deemed appropriate by Lloyds TSB in any jurisdiction for or in respect of the Acquisition and the acquisition or the proposed acquisition of any shares or other securities in, or control of, HBOS by any member of the Wider Lloyds TSB Group having been obtained in terms and in a form reasonably satisfactory to Lloyds TSB from all appropriate Third Parties or (without prejudice to the generality of the foregoing) from any person or bodies with whom any member of the Wider HBOS Group or the Wider Lloyds TSB Group has entered into contractual arrangements and all such Authorisations necessary or reasonably deemed appropriate by Lloyds TSB to carry on the business of any member of the Wider HBOS Group in any jurisdiction having been obtained, in each case where a failure to make such notification or filing or to wait for the expiry, termination or lapsing of any such waiting period or to comply with such obligation or obtain such Authorisation would be material to the Wider HBOS Group taken as a whole and all such Authorisations remaining in full force and effect at the Effective Date and there being no notice or intimation of an intention to revoke, suspend, restrict, modify or not to renew such Authorisations;

Lloyds TSB reserves the right to waive in whole or in part all or any of the Conditions except Condition 2. Lloyds TSB will be under no obligation to waive or treat as satisfied any of the conditions in Condition 3 notwithstanding that the other Conditions may have been waived or satisfied and that there are no circumstances indicating that the relevant condition may not be capable of satisfaction.

The Acquisition will lapse and the Scheme will not proceed if, before the date of the Court Meeting, there is a reference to the UK Competition Commission.

Subject to the consent of the Panel, Lloyds TSB reserves the right to elect to implement the Acquisition by way of a contractual offer. In such event, such offer will be implemented on the same terms (subject to any revisions appropriate amendments, including (without limitation) an acceptance condition set at 90 per cent. (or such lesser percentage (not being less than 50 per cent.) as Lloyds TSB may decide) of the shares to which such offer relates), so far as applicable, as those which would apply to the Scheme.

If Lloyds TSB is required by the Panel to make an offer for HBOS Shares under the provisions of Rule 9 of the City Code, then Lloyds TSB may make such alterations to any of the above conditions as are necessary to comply with the provisions of that Rule.

The Acquisition and the Scheme will be governed by Scottish law and be subject to the jurisdiction of the Scottish courts. The Acquisition will comply with the applicable rules and regulations of the UK Listing Authority, the London Stock Exchange and the City Code and any other applicable laws or regulations.

Terms used but not defined in this announcement shall have the meanings given to them in the announcement of the Recommended Acquisition of HBOS dated 18 September 2008.

Citi, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting exclusively for Lloyds TSB and for no-one else as joint sponsor and joint bookrunner in relation to the Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Offer on the Official List and their admission to trading on the London Stock Exchange's main market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of Citi nor for providing advice in connection with the proposed Placing and Open Offer or the Offer, proposed listing or admission to trading or contents of this announcement or any other matters referred to in this announcement.

Merrill Lynch International, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting exclusively for Lloyds TSB and for no-one else as joint sponsor, joint financial adviser and joint bookrunner in relation to the Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Offer on the Official List and their admission to trading on the London Stock Exchange's main market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of Merrill Lynch International nor for providing advice in connection with the proposed Placing and Open Offer or the Offer, proposed listing or admission to trading or contents of this announcement or any other matters referred to in this announcement.

UBS Limited, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting exclusively for Lloyds TSB and for no-one else as joint sponsor, joint financial adviser and joint bookrunner in relation to the Open Offer and the listing of the securities to be issued pursuant to the Placing and Open Offer and the Offer on the Official List and their admission to trading on the London Stock Exchange's market for listed securities, and will not be responsible to any other person for providing the protections afforded to clients of UBS Limited nor for providing advice in connection with the proposed Placing and Open Offer or the Offer, proposed listing or admission to trading or contents of this announcement or any other matters referred to in this announcement.

This announcement does not constitute an offer to sell or issue or the solicitation of an offer to buy or acquire any Lloyds TSB or HBOS securities in the United States, Canada, Australia or Japan or any jurisdiction in which such an offer or solicitation is illegal. All Lloyds TSB and HBOS securities referred to in this announcement have not been and will not be registered under the Securities Act and may not be offered, sold or transferred in or into the United States absent registration or an exemption from registration.

The distribution of this announcement in jurisdictions other than the United Kingdom and the United States may be restricted by law and therefore persons into whose possession this announcement comes should inform themselves about, and observe, such restrictions. Any

failure to comply with the restrictions may constitute a violation of the securities laws of any such jurisdiction.

This announcement has been prepared for the purposes of complying with Scottish law, the Listing Rules, the rules of the London Stock Exchange and the City Code and the information disclosed may not be the same as that which would have been disclosed if this announcement had been prepared in accordance with the laws and regulations of any jurisdiction outside of the United Kingdom.

The New Lloyds TSB Shares and New Lloyds TSB ADRs to be received by HBOS Shareholders and holders of HBOS ADRs, respectively under the Scheme have not been, and will not be, registered under the Securities Act or under the securities laws of any state, district or other jurisdiction of the United States, or of Canada, Australia or Japan and no regulatory clearances in respect of the registration of New Lloyds TSB Shares have been, or will be, applied for in any such jurisdiction. It is expected that the New Lloyds TSB Shares and New Lloyds TSB ADRs will be issued in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 3(a)(10) thereof. This transaction has not been and will not be approved or disapproved by the SEC, nor has the SEC or any US state securities commission passed upon the merits or fairness of the transaction nor upon the adequacy or accuracy of the information contained in this document. Any representation to the contrary is a criminal offence in the United States. Under applicable US securities laws, HBOS Shareholders holders of HBOS ADRs who are or will be "affiliates" of Lloyds TSB prior to or after the Effective Date will be subject to certain transfer restrictions relating to the New Lloyds TSB Shares and New Lloyds TSB ADRs received in connection with the Scheme.

Lloyds TSB strongly advises Lloyds TSB Shareholders to read the formal documentation relating to the Acquisition when it becomes available because it will contain important information relating to the Acquisition. Any response in relation to the Acquisition should be made only on the basis of the information contained in the formal documentation relating to the Acquisition. This announcement does not constitute a prospectus or prospectus equivalent document.

This document includes certain "forward looking statements" with respect to the business, strategy and plans of Lloyds TSB Group and HBOS and their respective expectations relating to the Acquisition and their future financial condition and performance. Statements that are not historical facts, including statements about Lloyds TSB Group's or HBOS's or their respective management's beliefs and expectations, are forward looking statements. Words such as "believes", "anticipates", "estimates", "expects", "intends", "aims", "potential", "will", "would", "could", "considered", "likely", "estimate" and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon future circumstances that may or may not occur.

Examples of such forward looking statements include, but are not limited to, statements about expected benefits and risks associated with the Acquisition, projections or expectations of profit attributable to shareholders, anticipated provisions or write-downs, economic profit, dividends, capital structure or any other financial items or ratios; statements of plans, objectives or goals of Lloyds TSB, HBOS or the combined business following the Acquisition; statements about the future trends in interest rates, liquidity, foreign exchange rates, stock market levels and demographic trends and any impact that those matters may have on Lloyds TSB, HBOS or the

combined company following the Acquisition; statements concerning any future UK, US or other economic environment or performance; statements about strategic goals, competition, regulation, regulatory approvals, dispositions and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by Lloyds TSB or HBOS or on their behalf include, but are not limited to, general economic conditions in the United Kingdom, the United States or elsewhere; regulatory scrutiny, legal proceedings or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the ability to secure new customers and develop more business from existing customers; the Acquisition not being completed or not being completed as currently envisaged; additional unanticipated costs associated with the Acquisition or the operating of the combined company; or an inability to implement the strategy of the combined company or achieve the Acquisition benefits set out herein. Additional factors that could cause actual results to differ materially from forward looking statements are set out in the most recent annual reports and accounts of the Lloyds TSB Group and HBOS, including Lloyds TSB Group's most recent annual report on Form 20-F filed with the SEC.

Under Rule 9 of the City Code any person, or group of persons acting in concert, which acquires an interest in shares which, when taken together with an interest in shares already held by him or an interest in shares held or acquired by persons acting in concert with him, carry 30 per cent. or more of the voting rights of a company which is subject to the City Code, that person is normally obliged to make a general offer in cash to all shareholders at the highest price paid by him, or any person acting in concert with him, within the preceding 12 months.

On completion of the Acquisition and the capital raisings described in this announcement, the Commissioners of HM Treasury or its nominee ("HMT") (taken together with those persons with whom HMT is acting in concert for the purposes of Rule 9 of the City Code, if any) may be interested in shares in Lloyds TSB in excess of the 30 per cent. threshold in Rule 9 of the City Code. The Panel on Takeovers and Mergers (the "Panel") has confirmed that, subject to the independent shareholders of Lloyds TSB voting in favour of a resolution to that effect, the Panel will disapply the requirement to make a general offer under the terms of Rule 9 of the City Code. An appropriate resolution will be put to Lloyds TSB shareholders at the Lloyds TSB General Meeting to approve the capital increase involved in the Acquisition and capital raisings described herein. HMT's commitment to subscribe for the Lloyds TSB Shares will be conditional on the disapplication of the requirements for a general offer under Rule 9 of the City Code being approved.

Under the provisions of Rule 8.3 of the City Code, if any person is, or becomes, "interested" (directly or indirectly) in one per cent. or more of any class of "relevant securities" of Lloyds TSB or HBOS, all "dealings" in any "relevant securities" of that company (including by means of an option in respect of, or a derivative referenced to, any such "relevant securities") must be publicly disclosed by no later than 3.30 pm (London time) on the London business day following the date of the relevant transaction. This requirement will continue until the date on which the Scheme becomes effective, or on which the "offer period" for the purposes of the City Code otherwise ends. If two or more persons act together pursuant to an agreement or understanding, whether formal or informal, to acquire an "interest" in "relevant securities" of Lloyds TSB or HBOS, they will be deemed to be a single person for the purpose of Rule 8.3.

Under the provisions of Rule 8.1 of the City Code, all "dealings" in "relevant securities" of Lloyds TSB or HBOS by Lloyds TSB or HBOS, or by any of their respective "associates", must be disclosed by no later than 12.00 noon (London time) on the London business day following the date of the relevant transaction.

A disclosure table, giving details of the companies in whose "relevant securities" "dealings" should be disclosed, and the number of such securities in issue, can be found on the Panel's website at www.thetakeoverpanel.org.uk.

"Interests in securities" arise, in summary, when a person has long economic exposure, whether conditional or absolute, to changes in the price of securities. In particular, a person will be treated as having an "interest" by virtue of the ownership or control of securities, or by virtue of any option in respect of, or derivative referenced to, securities.

Terms in quotation marks are defined in the Code, which can also be found on the Panel's website. If you are in any doubt as to whether or not you are required to disclose a "dealing" under Rule 8, you should consult the Panel.

This information is provided by RNS
The company news service from the London Stock Exchange

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HBOS PLC
13 October 2008

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Proposed acquisition of HBOS by Lloyds TSB, capital increase and access to guaranteed wholesale funding

HBOS reaffirms its confidence in the substantial benefits for shareholders that will arise from its proposed acquisition by Lloyds TSB. Revised terms are to be recommended to shareholders reflecting today's announcement in respect of capital raisings by both companies and the impact of significant disruption in financial markets. The resulting capital and funding position for the proposed combination establishes a strong platform from which the enlarged Group can create value in the long term.

Following the UK Government's announcement on 8 October 2008 and as part of a co-ordinated package of capital and funding measures for the UK banking sector, HBOS announces the proposed placing of £8.5bn of ordinary shares with the UK Government at 113.6p per share (representing a discount of 8.5%, prior to commissions payable, to the HBOS closing share price on Friday 10 October 2008), subject to clawback of pro-rata entitlements by HBOS shareholders following approval of the issue expected in early December.

In addition, HBOS will place £3bn of preference shares with the UK Government, callable at par after 5 years and included in Tier 1 capital throughout the period. The annual coupon will be 12% for the first five years and three month LIBOR plus 700 bps thereafter. Under the terms of

the preference shares, no dividend can be paid on ordinary shares whilst any preference shares issued to HM Treasury remain outstanding.

As a result of the decision to strengthen further the Group's capital ratios, HBOS has secured with immediate effect, access to the UK Government guarantee for short and medium term debt issuance. This provides significant additional funding strength which enhances the Group's business and prospects.

Whilst the Group's existing capital ratios are capable of sustaining the business through economic cycles, the substantial increase in Tier I capital resources is designed to ensure higher capital ratios in more extreme stressed scenarios over a prolonged period.

HBOS capital ratios before and after the above Tier I issuance based on June 2008 pro forma figures are shown below:-

	Proforma1,3	Proforma2,3
	%	%
Tier I Capital Ratio	8.6	12.0
Core Tier I ratio	6.5	9.0
Total Capital ratio	12.2	15.6
Tier I gearing	24.1	24.7

Proforma includes the proceeds of the rights issue received on 25 July 2008

Proforma includes both the proceeds of the rights issue and the £8.5bn equity placing and £3bn preference shares issue announced today

Proformas exclude the impact of the sale of BankWest and St Andrews as announced on 7 October 2008

Access to guaranteed wholesale funds, underpinned by substantially higher capital ratios, provides strong support for HBOS to resume a greater level of lending to homebuyers and SME business customers, whilst pursuing its strategy to reduce its loan to deposit ratio. HBOS will continue to de-risk other parts of its business, notably in the Treasury and Corporate Banking areas.

Since the announcement of the Interim Results for the six months ended 30 June 2008, market conditions have deteriorated significantly. Underlying profitability is therefore now being impacted by a significant deterioration in credit conditions and falling property prices with associated increased provisioning in both the Retail and Corporate businesses. In addition, profitability is expected to be adversely affected by fair value adjustments and impairments to the Treasury portfolio and by the impact of increased funding costs.

HBOS now expects these factors to impact substantially on the management's expectations of the underlying results for 2008. In addition, as previously announced HBOS will report a loss of £690m on the sale of BankWest.

Notwithstanding the current difficult market conditions, HBOS's Insurance & Investment business is performing satisfactorily and is expected to continue to benefit from its close affiliation to the UK Retail savings business.

A full trading update will be provided in the Interim Management Statement to be released shortly before publication of the prospectus relating to the equity placing.

Amendment to terms of Lloyds TSB Offer

Following confirmation by the Board of Lloyds TSB that in the light of the scale of disruption in the financial markets it was no longer prepared to recommend to its shareholders the Offer announced on 18 September, agreement has been reached to revised terms on the basis of 0.605 Lloyds TSB share for each HBOS share.

These revised terms also reflect the combined impact of the capital raising announced by HBOS referred to above and the £5.5bn capital raising (£4.5bn ordinary shares and £1bn preference shares) by Lloyds TSB announced today.

Lloyds TSB has also restated the conditions to the implementation of the acquisition and the restated conditions are set out in Appendix 2.

The revised terms provide HBOS shareholders with the opportunity to acquire a stake in the merged group with substantial capital strength which will enjoy a strong franchise and the scope to generate significant synergies.

The Board has concluded that shareholder prospects in the enlarged group are more attractive than on a standalone basis.

Accordingly, the Board intends to recommend to shareholders to vote in favour of the proposals at the General Meeting to be convened.

Board Changes

Upon completion of the proposed acquisition of HBOS by Lloyds TSB, Andy Hornby and Dennis Stevenson, Chief Executive and Chairman respectively, will leave the Group.

Details of the Share Issue

HBOS intends to raise approximately £8.5bn in a Placing and Open Offer underwritten by HM Treasury.

Under the Placing and Open Offer, HBOS intends to issue 7.5bn New Shares at the Issue Price of 113.6p per New Share, raising approximately £8.5 billion. The New Shares will be subject to clawback to the extent they are taken up under the Open Offer. To the extent not placed or taken up under the Open Offer, HM Treasury has agreed to subscribe for the New Shares under the relevant Subscription Agreements.

Subject to the terms and conditions of the Open Offer, Qualifying Shareholders will be given the opportunity under the Open Offer to apply for any number of New Shares at the Issue Price up to a maximum of their pro rata entitlement.

HBOS will seek approval from its shareholders in respect of the Placing and Open Offer at a General Meeting ("GM") to be held in early December 2008. A prospectus in connection with the Placing and Open Offer is expected to be published in mid November 2008.

Upon completion of the Placing and Open Offer, the New Shares will represent approximately 58.1% of the Enlarged Issued Share Capital and the Existing Ordinary Shares will represent approximately 41.9% of the Enlarged Issued Share Capital.

Upon completion of the transaction, if neither Lloyds TSB's nor HBOS's shareholders participate in the clawback, existing Lloyds TSB shareholders will own 36.5%, with existing HBOS shareholders owning 20.0% of the ordinary share capital of the enlarged group. The remaining 43.5% will be owned by HM Treasury.

HM Treasury's obligations in respect of the Placing and Open Offer and the issue of the preference shares assume completion of the merger between HBOS and Lloyds TSB. If the acquisition were not completed, HM Treasury would expect to take appropriate action to address the position in the light of the policy objectives set out in its announcement of 8 October 2008 on Financial Support to the Banking Industry.

Full details with regard to the commitments surrounding HM Treasury's ownership of a substantial part of the enlarged group which include remuneration, corporate governance and public lending, are attached in Appendix I.

Change of Control and the City Code

The capital increase gives rise to certain considerations under the City Code on Takeovers and Mergers (the "City Code"). Under Rule 9 of the City Code any person, or group of persons acting in concert, which acquires an interest in shares which, when taken together with an interest in shares already held by him or an interest in shares held or acquired by persons acting in concert with him, carry 30 per cent. or more of the voting rights of a company which is subject to the City Code, that person is normally obliged to make a general offer in cash to all shareholders at the highest price paid by him, or any person acting in concert with him, within the preceding 12 months.

On completion of the capital increase, HM Treasury (taken together with those persons with whom HM Treasury is acting in concert for the purposes of Rule 9 of the City Code, if any) may be interested in shares in HBOS in excess of the 30 per cent threshold in Rule 9 of the City Code. The Panel on Takeovers and Mergers (the "Panel") has confirmed that, subject to the independent shareholders of HBOS voting in favour of a resolution to that effect, the Panel will disapply the requirement to make a general offer under the terms of Rule 9 of the City Code. An appropriate resolution will be put to HBOS shareholders at the General Meeting to approve the capital increase involved in the Placing and Open Offer. HM Treasury's commitment to subscribe for the new shares is conditional on the disapplication of the requirements for a general offer under Rule 9 of the City Code being approved.

Terms used but not defined in this announcement shall have the meanings given to them in the announcement of the Recommended Acquisition of HBOS dated 18 September 2008.

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THIS ANNOUNCEMENT DOES NOT CONSTITUTE AN OFFER TO SELL, OR AN INVITATION TO SUBSCRIBE FOR OR PURCHASE, ANY SECURITIES OR THE SOLICITATION OF ANY APPROVAL IN ANY JURISDICTION, NOR SHALL THERE BE ANY SALE, ISSUANCE OR TRANSFER OF THE SECURITIES REFERRED TO IN THIS ANNOUNCEMENT IN ANY JURISDICTION IN CONTRAVENTION OF APPLICABLE LAW.

The distribution of this announcement in jurisdictions other than the United Kingdom and the United States may be restricted by law and therefore persons into whose possession this announcement comes should inform themselves about, and observe, such restrictions. Any failure to comply with the restrictions may constitute a violation of the securities laws of any such jurisdiction.

This announcement has been prepared for the purposes of complying with Scottish law, the Listing Rules, the rules of the London Stock Exchange and the City Code and the information disclosed may not be the same as that which would have been disclosed if this announcement had been prepared in accordance with the laws and regulations of any jurisdiction outside of the United Kingdom.

The New Lloyds TSB Shares and New Lloyds TSB ADRs to be received by HBOS Shareholders and ADR holders, respectively, under the Scheme have not been, and will not be, registered under the Securities Act or under the securities laws of any state, district or other jurisdiction of the United States, or of Canada, Australia or Japan and no regulatory clearances in respect of the registration of New Lloyds TSB Shares have been, or will be, applied for in any such jurisdiction. It is expected that the New Lloyds TSB Shares and New Lloyds TSB ADRs will be issued in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 3(a)(10) thereof. This transaction has not been and will not be approved or disapproved by the SEC, nor has the SEC or any US state securities commission passed upon the merits or fairness of the transaction nor upon the adequacy or accuracy of the information contained in this document. Any representation to the contrary is a criminal offence in the United States.

Under applicable US securities laws, HBOS Shareholders who are or will be "affiliates" of HBOS or Lloyds TSB prior to, or of Lloyds TSB after, the Effective Date will be subject to certain transfer restrictions relating to the New Lloyds TSB Shares received in connection with the Scheme.

Lloyds TSB and HBOS strongly advise Lloyds TSB Shareholders and HBOS Shareholders to read carefully the formal documentation relating to the Acquisition when it becomes available because it will contain important information relating to the Acquisition. Any response in relation to the Acquisition should be made only on the basis of the information contained in the formal documentation relating to the Acquisition. This announcement does not constitute a prospectus or prospectus equivalent document.

Morgan Stanley is acting for HBOS as financial adviser and no one else in connection with the Acquisition and will not be responsible to anyone other than HBOS for providing the protections afforded to customers of Morgan Stanley nor for providing advice in relation to the Acquisition, or any matter referred to herein.

Dresdner Kleinwort Limited, which is authorised and regulated by the Financial Services Authority, is acting for HBOS as financial adviser and for no one else in connection with the Offer and will not be responsible to anyone other than HBOS for providing the protections afforded to clients of Dresdner Kleinwort Limited or for affording advice in relation to the Offer or any other matters referred to in this announcement.

Dealing Disclosure Requirements

Under the provisions of Rule 8.3 of the City Code, if any person is, or becomes, “interested” (directly or indirectly) in one per cent. or more of any class of “relevant securities” of Lloyds TSB or HBOS, all “dealings” in any “relevant securities” of that company (including by means of an option in respect of, or a derivative referenced to, any such “relevant securities”) must be publicly disclosed by no later than 3.30 pm (London time) on the London business day following the date of the relevant transaction.

This requirement will continue until the date on which the Scheme becomes effective, or on which the “offer period” for the purposes of the City Code otherwise ends. If two or more persons act together pursuant to an agreement or understanding, whether formal or informal, to acquire an “interest” in “relevant securities” of Lloyds TSB or HBOS, they will be deemed to be a single person for the purpose of Rule 8.3. Under the provisions of Rule 8.1 of the City Code, all “dealings” in “relevant securities” of Lloyds TSB or HBOS by Lloyds TSB or HBOS, or by any of their respective “associates”, must be disclosed by no later than 12.00 noon (London time) on the London business day following the date of the relevant transaction.

A disclosure table, giving details of the companies in whose “relevant securities” “dealings” should be disclosed, and the number of such securities in issue, can be found on the Panel's website at www.thetakeoverpanel.org.uk. “Interests in securities” arise, in summary, when a person has long economic exposure, whether conditional or absolute, to changes in the price of securities. In particular, a person will be treated as having an “interest” by virtue of the ownership or control of securities, or by virtue of any option in respect of, or derivative referenced to, securities.

Terms in quotation marks are defined in the Code, which can also be found on the Panel's website. If you are in any doubt as to whether or not you are required to disclose a “dealing” under Rule 8, you should consult the Panel.

Forward Looking Statements

This document includes certain “forward looking statements” with respect to the business, strategy and plans of Lloyds TSB Group and HBOS and their respective expectations relating to the Acquisition and their future financial condition and performance. Statements that are not historical facts, including statements about Lloyds TSB Group's or HBOS's or their respective management's beliefs and expectations, are forward looking statements. Words such as “believes”, “anticipates”, “estimates”, “expects”, “intends”, “aims”, “potential”, “will”, “would”, “could”, “considered”, “likely”, “estimate” and variations of these words and similar future or conditional expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend upon future circumstances that may or may not occur.

Examples of such forward looking statements include, but are not limited to, statements about expected benefits and risks associated with the Acquisition, projections or expectations of profit attributable to shareholders, anticipated provisions or write-downs, economic profit, dividends, capital structure or any other financial items or ratios; statements of plans, objectives or goals of

Lloyds TSB, HBOS or the combined business following the Acquisition; statements about the future trends in interest rates, liquidity, foreign exchange rates, stock market levels and demographic trends and any impact that those matters may have on Lloyds TSB, HBOS or the combined company following the Acquisition; statements concerning any future UK, US or other economic environment or performance; statements about strategic goals, competition, regulation, regulatory approvals, dispositions and consolidation or technological developments in the financial services industry; and statements of assumptions underlying such statements.

Factors that could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward looking statements made by Lloyds TSB or HBOS or on their behalf include, but are not limited to, general economic conditions in the United Kingdom, the United States or elsewhere; regulatory scrutiny, legal proceedings or complaints; changes in competition and pricing environments; the inability to hedge certain risks economically; the adequacy of loss reserves; the ability to secure new customers and develop more business from existing customers; the Acquisition not being completed or not being completed as currently envisaged; additional unanticipated costs associated with the Acquisition or the operating of the combined company; or an inability to implement the strategy of the combined company or achieve the Acquisition benefits set out herein. Additional factors that could cause actual results to differ materially from forward looking statements are set out in the most recent annual reports and accounts of the Lloyds TSB Group and HBOS, including Lloyds TSB Group's most recent annual report on Form 20-F filed with the SEC.

Forward-looking statements only speak as of the date on which they are made, and the events discussed herein may not occur. Subject to compliance with applicable law and regulation, neither Lloyds TSB nor HBOS undertakes any obligation to update publicly or revise forward looking statements, whether as a result of new information, future events or otherwise.

No statement in this announcement is intended to constitute a profit forecast for any period, nor should any statements be interpreted to mean that earnings or earnings per share will necessarily be greater or lesser than those for the relevant preceding financial periods for either Lloyds TSB or HBOS as appropriate.²

Appendix I

Arrangements in relation to Government's equity participation

Remuneration

- Remuneration of Board Directors;
 - For HBOS there will be no cash bonus for 2008;
 - Lloyds TSB will ask executive directors to receive restricted stock for their 2008 bonus entitlement;
 - Going forward, for the merged group, in addition to complying with the ABI industry best practice code, remuneration will reflect long term value creation and take account of risk. Reward for Board Members will take into account internal relative compensation packages and perceived fairness in the current economic climate;
 - No rewards for failure: where a Board Member loses the confidence of the Board, they should be able to be dismissed at a cost that is reasonable and perceived as fair;

- Commitment to FSA Code on Risk Based Remuneration.

Corporate Governance

Government will work with the Board on its appointment of two new independent directors. Should the Government's holding of the combined entity fall below 25%, the Government would only expect to be consulted on the appointment of one independent director.

Lending

Mortgages

A commitment to immediately restore and maintain the availability and active marketing of competitively priced mortgage lending (other than in the non-conforming market) over the next three years at a level at least equivalent to that of 2007;

General commitment to participate in industry initiatives and to comply with Government codes/guidance;

Make available a sum to be agreed for the next twelve months for shared equity/shared ownership schemes to help people struggling with mortgage payments to stay in their homes, either through individual bank schemes or paid into a central fund run by industry;

Make available a sum to be agreed for the next twelve months to support ongoing expansion of financial capability initiatives.

SMEs

A commitment to immediately restore and maintain the availability and active marketing of competitively priced lending to SMEs at a level at least equivalent to that of 2007;

Publish an annual report on:

Overall lending to SMEs;

Overdraft facilities and loans to SMEs: volumes, value and rates;

Foreclosures of debt finance to SMEs;

Appropriate lending of Small Firms Loan Guarantee Scheme;

Application and use of EIB global loan facility to secure additional liquidity specifically for SME lending.

Other

As agreed at the time of the initial announcement, the enlarged entity will continue to use The Mound as its Scottish Headquarters, will continue to hold its AGM in Scotland and will continue to print Bank of Scotland notes.

Appendix 2

Conditions to the Implementation of the Scheme and the Acquisition

The Acquisition will be conditional upon the Scheme becoming effective by not later than 28 February 2009 or such later date (if any) as, subject to the requirements of the City Code, HBOS and Lloyds TSB may agree and, if required, the Court may allow.

The Scheme will be conditional upon:

approval of the Scheme by a majority in number representing three-fourths or more in value of the holders of HBOS Shares (or the relevant class or classes thereof), present and voting, either in person or by proxy, at the Court Meeting and at any separate class

meeting which may be required by the Court or at any adjournment of any such meeting;

the resolution(s) required to approve and implement the Scheme being duly passed by the requisite majority at the HBOS General Meeting or any adjournment of that meeting;

the sanction (with or without modification, but subject to each such modification being acceptable to Lloyds TSB of the Scheme and the confirmation of any reduction of capital involved therein by the Court and an office copy of the Court Order and the minute of such reduction attached thereto being delivered for registration to the Registrar of Companies in Edinburgh and in relation to the reduction of capital, being registered; and

the passing at the Lloyds TSB General Meeting (or at any adjournment of such meeting) of such resolution or resolutions as may be necessary to approve, effect and implement the Acquisition and the implementation of the Scheme (as such resolutions may be set out in the HBOS Shareholder Circular, including a resolution or resolutions to (i) approve the terms of the Acquisition, and (ii) authorise and permit the creation and allotment of New Lloyds TSB Shares), the making of any offer, proposal or other arrangement to holders of options under the HBOS Share Option Schemes and any necessary authorities and permissions for the creation and allotment of Lloyds TSB Shares in relation thereto.

In addition, HBOS and Lloyds TSB have agreed that, subject as stated in paragraph 4 below, the Acquisition will also be conditional upon the following matters, and, accordingly, the necessary actions to make the Scheme effective will not be taken unless such Conditions (as amended if appropriate) have been satisfied or waived:

Admission becoming effective in accordance with the Listing Rules and the Admission and Disclosure Standards or, if Lloyds TSB and HBOS so determine and subject to the consent of the Panel (if required), the UK Listing Authority agreeing to admit the New Lloyds TSB Shares to the Official List and the London Stock Exchange agreeing to admit such shares to trading on its main market for listed securities subject only to (i) the allotment of such shares and/or (ii) the Acquisition becoming effective;

the Financial Services Authority (the "FSA") indicating pursuant to section 184(1) of the Financial Services and Markets Act 2000 (as amended) ("FSMA"), in terms reasonably satisfactory to Lloyds TSB, that it approves any acquisition of:

control over any UK authorised person;
(if applicable) any additional kind of control over any UK authorised person; or
(if applicable) any increase in a relevant kind of control which is already held over any UK authorised person;

in each case within the meaning of Part XII of FSMA which would take place as a result of the Acquisition or its implementation, or the FSA being treated as having given such approval under section 184(2) of FSMA;

each Relevant Regulator having, to the extent necessary, approved or is deemed to have approved, in terms reasonably satisfactory to Lloyds TSB, the acquisition by Lloyds TSB of control over HBOS and any member of the Wider HBOS Group which is authorised or regulated by any Relevant Regulator, either unconditionally or subject to the fulfilment of certain conditions or obligations acceptable to Lloyds TSB;

it being established in terms satisfactory to Lloyds TSB, that it is not the intention of the Office of Fair Trading or the Secretary of State to refer the proposed acquisition of HBOS by Lloyds TSB or any matter arising from or related thereto to the Competition Commission; and (ii) if clause (i) is satisfied, either the period specified in Rule 26 of the Competition Appeal Tribunal Rules 2003 for making an application under section 120 of the Enterprise Act for the review of a decision in relation to the Acquisition having expired without any such application being made or, where any such application has been made, the Competition Appeal Tribunal having dismissed such application;

all necessary or appropriate notifications, applications and/or filings having been made in connection with the Acquisition and all necessary waiting periods (including any extensions thereof) in connection therewith under any applicable legislation or regulation of any jurisdiction having expired, lapsed or been terminated (as appropriate) and all statutory and regulatory obligations in any jurisdiction having been complied with in connection with the Scheme and all Authorisations necessary or reasonably deemed appropriate by Lloyds TSB in any jurisdiction for or in respect of the Acquisition and the acquisition or the proposed acquisition of any shares or other securities in, or control of, HBOS by any member of the Wider Lloyds TSB Group having been obtained in terms and in a form reasonably satisfactory to Lloyds TSB from all appropriate Third Parties or (without prejudice to the generality of the foregoing) from any person or bodies with whom any member of the Wider HBOS Group or the Wider Lloyds TSB Group has entered into contractual arrangements and all such Authorisations necessary or reasonably deemed appropriate by Lloyds TSB to carry on the business of any member of the Wider HBOS Group in any jurisdiction having been obtained, in each case where a failure to make such notification or filing or to wait for the expiry, termination or lapsing of any such waiting period or to comply with such obligation or obtain such Authorisation would be material to the Wider HBOS Group taken as a whole and all such Authorisations remaining in full force and effect at the Effective Date and there being no notice or intimation of an intention to revoke, suspend, restrict, modify or not to renew such Authorisations;

Lloyds TSB reserves the right to waive in whole or in part all or any of the Conditions except Condition 2. Lloyds TSB will be under no obligation to waive or treat as satisfied any of the conditions in Condition 3 notwithstanding that the other Conditions may have been waived or satisfied and that there are no circumstances indicating that the relevant condition may not be capable of satisfaction.

The Acquisition will lapse and the Scheme will not proceed if, before the date of the Court Meeting, there is a reference to the UK Competition Commission.

Subject to the consent of the Panel, Lloyds TSB reserves the right to elect to implement the Acquisition by way of a contractual offer. In such event, such offer will be implemented on the same terms (subject to any revisions appropriate amendments, including (without limitation) an acceptance condition set at 90 per cent. (or such lesser percentage (not being less than 50 per cent.) as Lloyds TSB may decide) of the shares to which such offer relates), so far as applicable, as those which would apply to the Scheme.

If Lloyds TSB is required by the Panel to make an offer for HBOS Shares under the provisions of Rule 9 of the City Code, then Lloyds TSB may make such alterations to any of the above conditions as are necessary to comply with the provisions of that Rule.

Other than any Lloyds TSB Shares purchased and cancelled pursuant to any existing Lloyds TSB repurchase facility or any Lloyds TSB Shares issued pursuant to Lloyds TSB share option schemes or following the conversion of currently outstanding securities convertible into Lloyds TSB Shares or pursuant to the Lloyds TSB capital raising announced today, if any changes are

made to Lloyds TSB's share capital or Lloyds TSB makes an extraordinary distribution (but excluding for the avoidance of doubt any dividends made in the ordinary course) in cash or specie other than in exchange for fair value in cash or specie (the "Lloyds TSB Share Capital Change") in either case, after the date of this announcement but before the Effective Date, such adjustments shall be made to the Exchange Ratio as Merrill Lynch and Morgan Stanley agree are fair and reasonable such that the Exchange Ratio is what it would have been had it been calculated immediately prior to the release of this announcement had the relevant Lloyds TSB Share Capital Change already occurred.

Other than any HBOS Shares issued pursuant to the HBOS Share Option Schemes or shares to be issued pursuant to the capitalisation issue being implemented in lieu of its 2008 interim dividend or pursuant to the Placing and Open Offer, if any changes are made to HBOS's share capital or HBOS makes any distribution whether in cash or otherwise (the "HBOS Share Capital Change") after the date of this announcement but before the Effective Date, such adjustments shall be made to the Exchange Ratio as Merrill Lynch and Morgan Stanley agree are fair and reasonable such that the Exchange Ratio is what it would have been had it been calculated immediately prior to the release of this announcement had the relevant HBOS Share Capital Change already occurred.

9. The Acquisition and the Scheme will be governed by Scottish law and be subject to the jurisdiction of the Scottish courts. The Acquisition will comply with the applicable rules and regulations of the UK Listing Authority, the London Stock Exchange and the City Code and any other applicable laws or regulations.

This information is provided by RNS
The company news service from the London Stock Exchange

THIRD PARTIES ACTIVE IN THE FINANCIAL SECTOR

Submissions from:

1. [REDACTED]
2. Alexander Hall
3. [REDACTED]
4. [REDACTED]
5. [REDACTED]
6. [REDACTED]
7. Virgin Money Group

1. [REDACTED]

[REDACTED] wrote:

'Thank you for the opportunity to provide information in relation to the proposed acquisition by Lloyds TSB plc of HBOS plc. We feel that the merger achieves a degree of stability in the UK financial markets which outweighs any local competitive issues that may exist for our business.'

2. Alexander Hall

Alexander Hall wrote:

'In summary, we have some serious concerns about the merger in competition terms but in the circumstances there does not appear to be a viable alternative.'

3. [REDACTED]

[REDACTED] wrote:

'We would like to start by saying that we are fully supportive of all moves designed to bring stability to the UK and global financial system and to protect UK employees, businesses and banking customers.

Although we are a subsidiary of [] our area of direct concern relates to the relatively small UK corporate vehicle leasing industry which is effected as a by-product of the overall acquisition.

The above parties each operate vehicle leasing and management companies which are currently the first and second largest players in the market. Merging the two companies creates a competitor that is so far bigger than all other competitors that in our view the market place will inevitably be altered to the detriment of UK employees and businesses.'

4. [REDACTED]

[REDACTED] wrote:

'we do have significant concerns about this combination. Overall under the Enterprise Act whilst we might be satisfied that a genuine public interest issue arises such that on public interest grounds the combination of these two businesses should be permitted, that notice does not permit as a matter of law a transaction that is anti competitive beyond what is strictly necessary to obtain that public interest purpose. Therefore, in the market of GI and Life insurance, concerns that we and others will have about this combination and the resulting concentration in those insurance markets should not be overridden to safeguard the mortgage market.'

5. [REDACTED]

[REDACTED]

6. [REDACTED]

[REDACTED] wrote:

'[REDACTED] accepts that the LTSB takeover of HBOS is essential to the short term recovery of the UK financial system and we recognise the consequences that would ensue if the deal were to fail. As such, [] does not oppose the deal in its current form.

However, the deal raises issues for the longer term nature of the UK PFS [personal financial services] industry and poses threats to the competitive health of the markets. Despite offering our support for the deal, there are a number of areas on which we would expect competition authorities to focus attention to ensure competition is not unduly hindered, in both the immediate future and in the longer term.'

7. Virgin Money Group

Virgin Money Group wrote:

'At this time of turmoil in the global financial markets we understand and support the Secretary of State for Business and Enterprise in this intervention, promoting market stability, which is of overriding importance.

However, at Virgin Money we believe that a healthy competitive environment promotes transparency, fair pricing, choice and innovation for the consumer and would be concerned to see any long term deterioration in competitive pressures in the banking and financial services sectors. As such we would want to see appropriate action taken in the medium term to correct any anti-competitive positions arising from the acquisition by Lloyds TSB plc of HBOS plc.

Virgin Money will continue to offer the UK consumer highly visible, transparent and competitive retail financial services products from our existing product base and we fully intend to expand that product base in the near future.'

CONSUMER INTEREST GROUPS AND OTHER RESPONSES

Submissions from:

- 1. Consumer Focus**
- 2. Which?**
- 3. The Scotsman**
- 4. First Minister of Scotland, Rt Hon Alex Salmond MSP**

1. Consumer Focus



14 October 2008

John Fingleton
Chief Executive
Office of Fair Trading
Fleet Bank House
2-6 Salisbury Square
London
EC4Y 8JX

Proposed merger of HBOS and Lloyds TSB – the consumer interest

I am writing to you in connection with the proposed acquisition of HBOS by Lloyds TSB. As you know, the Secretary of State for Business, Enterprise and Regulatory Reform has issued an intervention notice in anticipation of the merger on public interest grounds to ensure the stability of the UK financial system.

The Secretary of State will make the final decision on whether the transaction should be referred to the Competition Commission, taking account of both competition and public interest issues. As we discussed this afternoon, the Office of Fair Trading is completing its competition investigation and will report to the Secretary of State in accordance with the Enterprise Act 2002.

Consumer Focus fully recognises and supports the decision of the Secretary of State to consider the stability of the financial system as a public interest consideration, as set out in Section 58 of the Enterprise Act 2002. The stability of the financial system is paramount.

Normally, we would strongly recommend that the merger of the two groups be referred to the Competition Commission because of clear concerns about competition and consumer impact which would merit detailed investigation. However, these are not normal times and we conclude that it would not be in the public interest for the Secretary of State to refer the merger to the Competition Commission. The time taken for the Competition Commission to investigate the matter would be likely to undermine the Government's effort to promote financial stability. We agree that financial stability is a pre-requisite for consumer confidence and protection.

We do not, however, want the exemption to be seen as diluting the competition regime. If taken as a precedent for exemptions in other sectors, or a policy of 'national champions', then the independence and the rigour of the UK's competition regime will be in jeopardy. When times are tight, the need for rigorous consumer protection and rules of competition is more important rather than less. We strongly urge Government to apply a sunset clause to the intervention in the form of a commitment to revoking the order within three months.

We also note that an alternative solution might have been for Government to maintain stability in the financial system through the provision of financial support for HBOS as an independent entity. This could have achieved the primary objective of maintaining financial stability, but would have also maintained a much greater degree of competition and choice in the market. That said, if the merger proceeds, then we would welcome all efforts to address potential consumer detriment that may arise in relation to a lessening of competition and restricted choice in financial services. Consumer Focus has particular concerns about market surveillance and the consumer interest, the mortgage market, regulation and local markets.

Market Surveillance – consumer interests come first, not competitor interests

We would welcome active surveillance by the Office of Fair Trading of the financial services markets that are affected by the merger – including: mortgages, which we comment on below; consideration of whether the current remedies under consideration in relation to personal current accounts need to be accelerated or a Competition Commission investigation brought forward; and consideration of persistent concerns since the Cruickshank report about the competitiveness of the market for SMEs as consumers.

We want surveillance by regulators to put consumers first. There is a risk that action to encourage a level playing field is captured by competitors, who, by gaming the regulatory system, seek to impose controls on competitors rather than offering a better deal than them. It seems inappropriate, at a time of financial turmoil, for example for consumers to have faced restrictions on opening accounts with Northern Rock. We urge you to focus exclusively on consumer harm and not competitor harm (except insofar as this leads to consumer harm) and will encourage Government to confirm the clarity of this mandate.

Mortgage Market

Although we support the merger of HBOS and Lloyds TSB in the public interest, it is important that the OFT rigorously evaluates the potential impact on competition and choice in the UK mortgage market. We would like to see the Government incorporate safeguards to protect against the abuse of dominant positions in advance of the merger being completed, although we understand that on legal grounds these may need, in the short term, to be voluntary undertakings.

HBOS is the biggest mortgage lender in the UK with a reported 20% share of mortgage market while Lloyds TSB is ranked fourth with an 8 per cent share of the market. The combined group would have close to 30% of the market, which raises concerns about overconcentration in the market. Under normal market conditions consumers would have some degree of comfort from competitive activity which might have ensured that the combined HBOS/ Lloyds TSB operation had to remain competitive to attract new business and/ or retain existing business by offering competitive rates.

However, it is clear that activity in the mortgage market has been seriously curtailed. According to the latest Bank of England statistics gross lending in August 2008 totalled £19.2 billion, compared with £30.2 billion in August 2007. The August 2008 figures were the lowest figures since August 2002. 32,000 loans were approved for house purchase - 70% lower than a year ago, while remortgage approvals at 64,000 represented a fall of 36% from August 2007. We welcome indications that the Government will encourage banks to promote access to credit and we understand that the market, and prices, will need to adjust to the implications of a less highly leveraged business model of mortgage provision – in short, possibly higher prices. But in the short to medium term, we anticipate that borrowers looking for new mortgages or to remortgage may face severely restricted choice of mortgage provider – this restriction in choice will be exacerbated due to the low levels of activity in the market. Consumers in the mortgage market are clearly at risk from market abuse by such a dominant force in the market.

Therefore, it is important that the Government incorporates robust safeguards to protect consumers the adverse consequences of restricted competition. There are a number of alternative mechanisms for protecting consumers.

We do not, for example, believe that the exemption in relation to the merger should suggest that the merged entity can expect to operate outside the limits of normal competition policy interventions (which, without prejudging the findings, could after all lead to structural remedies down the line that would have been more straightforward to implement at the point of merger). At the same time, we recognise that there is a need for a short period in which the new business can form, financial stability can be secured and in which the markets it operates in can settle.

In order for the UK competition regime to be ready to act in case of consumer detriment, I would ask that the Office of Fair Trading include in its forthcoming draft Annual Plan a commitment to conduct a full market investigation into the mortgage market and that it consider the case for similar investigations and / or referrals to the Competition Commission in relation to other markets Lloyds TSB / HBOS will operate in, including the SME market, savings products, insurance and loans / credit offers.

Regulation – and the case for a Consumer Panel for the merged bank

In meeting with Ian Larkin, Managing Director of Lloyds TSB yesterday, I was struck with the extent to which there may be consensus on the need to revisit the regulation of retail banking. This is a policy matter for Government, but clearly the OFT, with its functions on credit and expertise on personal current accounts, would be an important contributor to the consideration of options on this:

- How can we make a step change forward in transparency for consumers in the industry?
- In terms of promoting access and inclusion, can we learn from the public accountability reporting introduced in the USA under the Home Mortgage Disclosure Act and subsequent legislation?

- Is there a need to give a wider mandate to the Financial Services Authority, or indeed to see a new arrangement?
- Should the Banking Code be brought under co- or direct regulatory supervision?

We will propose to Government that consideration be given to the introduction of a public interest Consumer Panel, with a link to the Board, for Lloyds TSB / HBOS, perhaps in connection with the non-executive directors appointed in consultation with Government.

Local Markets – the case for a map of branch overlap and local competition concerns

We are conscious from work on the consumer interest across Great Britain that a consideration of competition and consumer issues need to look at local markets across England, Scotland and Wales (and, indeed, Northern Ireland) and not just the aggregate picture. In terms of bank branches, we believe that there is a risk of lessening of competition in relation to local access through the branch network. We believe that over the coming months it will be important to pull together a national map of branch overlap and local competition (or rather where there is an absence of local competition), in order to assess this risk. This may suggest towns or villages in which the responsible step would be for the newly merged bank to offer, or be required to offer, branches to sell to its competitors. We respect the fact that Lloyds TSB is a company that takes its wider responsibilities seriously and we hope that this work could inform its actions on a voluntary basis.

This could be a task for either Treasury or the Office of Fair Trading, and we would ask for liaison and action by the appropriate body on this point.

I would like to acknowledge the way in which the Office of Fair Trading is responding, along with other regulators, to the current exceptional circumstances and to welcome the work it is doing on retail banking more widely in relation to personal current accounts.

Lord Whitty and I are writing to the Secretary of State today on the issue of the merger and I will, of course, let you have a copy of this.

Yours sincerely,



Ed Mayo
Chief Executive
Consumer Focus

Cc: Sarah Chambers, BERR

John Kingman, HM Treasury
Lord Lipsey, Financial Services Consumer Panel
Ian Larkin and Jo Lewis, Lloyds TSB
Alistair Mordaunt, Office of Fair Trading
Hector Sants, Financial Services Authority

2. Which?

Which? wrote:

'Which? understands that the Secretary of State shall make the decision on both competition and public interest grounds of whether to allow the merger to proceed, whether to ask the OFT to seek binding undertakings or refer to the Competition Commission.

In the normal course of events Which? fully expects that this proposed merger would be referred to the Competition Commission for further investigation. However, there are exceptional circumstances that Which? recognises means that this merger may be necessary to protect the interest of consumers now from the risk of instability in the banking system.

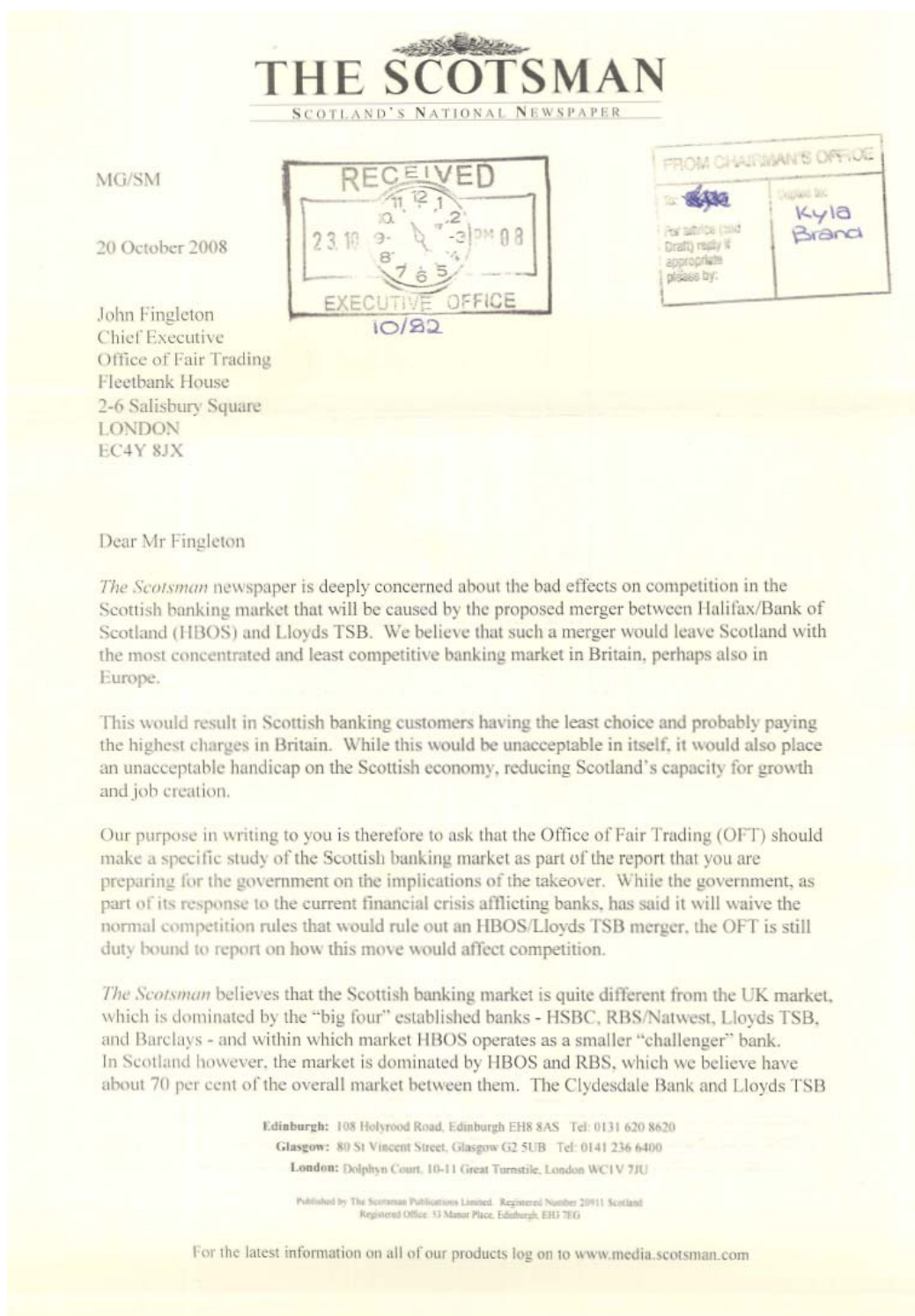
However, the evidence clearly indicates that serious medium-long term implications for the health of competition and the outcomes for consumers are likely. Any concentrations created now will have a long-term impact upon market structure and conditions of entry. The relative weakness of consumers means that post-merger, the concentrated market structure is likely to become entrenched.

Which? seeks specific assurances that special measures will be taken by the Secretary of State to prevent the merged parties engaging in abusive behaviour that harms competition and consumers. This reflects the exceptional nature of this merger.

Measures may take the form of appropriate binding undertakings as condition for the merger, or ongoing scrutiny of the merged firms' conduct with powers to intervene to ensure competitiveness of UK banking is not further undermined.

In the coming months ahead, as business as usual returns, Which? expects that further measures will be required to address the weakening of competition in retail banking caused by the succession of recent economic shocks. Which? will engage with government to seek the necessary actions at the appropriate time.'

3. The Scotsman



share most of the remaining 30 per cent, while HSBC and Barclays have made little inroads, concentrating only on winning some of the larger business customers.

This quite different market structure, *The Scotsman* believes, makes a compelling argument for the OFT to produce a separate report on Scotland.

There is, unfortunately, very little information about competition within the Scottish market. The main banks, obviously, have that information, but they have declined to make it available. But what information is available supports the case that there is limited competition already and that the merger will reduce competition even further.

One indicator we can use is the number of branches that each bank has. While not a perfect match for the actual share of the retail banking market (it ignores internet banks such as Intelligent Finance, also owned by HBOS, and banks run by supermarket firms such as Sainsbury's), it does give a rough approximation.

It shows that the retail banking market is dominated by RBS and HBOS, with Clydesdale and Lloyds TSB having relatively small shares. If Lloyds TSB takes over HBOS, the market will become even more concentrated in the hands of two big banks.

This would be a virtual duopoly. We know just how unacceptable this is because we can use a standard economic tool, used by the OFT and others, to judge the degree of market concentration. This tool, called the Herfindahl-Hirschman Index (HHI) gives a good idea of when a market has become too dominated by big firms.

When applied to the market share of the banks in Scotland as estimated by the number of branches they have, the index turns out to be 2530. This is well in excess of the HHI figure for the UK personal account banking market of 1410 reported in your July 2008 report on UK banking. In our view this justifies a separate investigation into the Scottish banking market. The change in the index which would be caused by an HBOS/Lloyds TSB takeover, an increase of 1043 points, is more than 20 times the increase cited in your guidelines (50) which would raise competition concerns. And the index figure which would be created by the merger – 3593 - points to an unacceptably concentrated market.

These figures can be criticised as being based on a rough-and-ready estimate of market share. But *The Scotsman* believes they are in the right ballpark. The only other publicly available information on the Scottish banking market we have been able to find is in the Cruickshank report, commissioned by the Treasury and published in 2000.

It contains some information on the banking market for small and medium-sized companies. It shows the same pattern as portrayed by the bank's branch networks: a market dominated by RBS and HBOS with Clydesdale and Lloyds TSB some way behind. A Lloyds

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TSB takeover of HBOS would distort the market still further, creating, in effect, an unacceptable duopoly.

The HHI for this banking market emphasises the point. Before any takeover, it is at 2780, which is a high degree of market concentration. Indeed, the Cruickshank report found that Scotland had the most concentrated business market of any part of the UK. A combined Lloyds TSB/HBOS bank would see the HHI shoot up to 3868 and leave Scottish businesses with the least competitive business banking service in the UK.

The Cruickshank report estimated that the cost to UK consumers, in terms of charges being higher than they should be in a properly competitive market, was between £3-5 billion. Allowing for inflation, and Scotland's share of the UK economy, it means that Scottish customers were being over-charged between £300-490 million by their banks. In an even less competitive market post-takeover, that cost is bound to rise further.

It is open to you, we understand, to advise Lord Mandelson, the Secretary of State for Business and Enterprise, that the merger should not proceed if it creates unacceptable competition concerns. We also understand that the government may well authorise the merger as the best way to ensure stability in the British banking system. If so, it is also open to you to advise that a de-merger of part of the HBOS/Lloyds TSB bank, perhaps the Bank of Scotland portion, should be considered in order to improve competition. *The Scotsman* believes, in view of the evidence we have compiled, that this should be considered.

In any event, *The Scotsman* hopes you will agree that there is compelling evidence to warrant conducting a particular examination of the Scottish banking market as part of the report on how this takeover will affect UK banking.

We look forward to hearing from you.

Yours sincerely



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Editor

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4. First Minister of Scotland, Rt Hon Alex Salmond MSP

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First Minister of Scotland

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Mr John Fingleton
Chief Executive
Office of Fair Trading
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23 October 2008

Dear Mr Fingleton

I am aware that the Secretary of State for Business, Enterprise and Regulatory Reform will consider the anticipated merger between Lloyds TSB and HBOS under the UK merger regime established by the Enterprise Act 2002. I am also aware that the Office of Fair Trading (OFT) must report to the Secretary of State and that the report must include a summary of any representations about the case which have been received and which relate to any public interest consideration mentioned in the intervention note (issued on 18 September) in this case, the stability of the UK financial system.

Since the initial proposal on this merger was announced the international financial landscape has changed dramatically. Given these changes, it is legitimate to consider whether the proposed merger, even if it appeared the best option under the old financial order, remains the best under the new, particularly when public interest considerations are taken into account.

As you are probably aware, there is significant concern across Scotland about this proposed merger and I will be writing to the UK Government to bring to its attention three issues about which the Scottish Government is particularly concerned.

You will no doubt understand that uppermost in many people's minds is the real anxiety that any merger of this type will bring with it a level of rationalisation. The loss of a large number of jobs in Scotland goes well beyond the calamitous impact felt by individuals and their families and reaches right across other businesses and services in Scotland. The impact this can have on our economy is therefore of concern. We will be asking the Secretary of State to take this on board in deciding upon what constitutes the national interest.

While we have had an extremely open and positive engagement with the officials working on the proposed merger and we are pleased with the public commitments given in Lloyds TSB's acquisition document to use The Mound as the Scottish Headquarters of the enlarged entity; that the AGM will be held in Scotland and that the issuance of Bank of Scotland notes will continue, we have major concerns around the potential loss of key decision making functions

to Scotland. This goes beyond the loss of "high quality" jobs in Scotland and may impact on the wider business community should they be unable to access the investment teams with the knowledge of the Scottish business community and markets. This could have a severe impact on Scotland's ability to grow our economy and create jobs and wealth which all of our people can share.

Finally, and for you most importantly, the impact of the proposed merger on the competitiveness of Scotland's banking sector is now of major concern. This will impact on the choice available to Scottish consumers, both retail and wholesale, and a reduction in the number of products available to them, but you will have seen from analyses undertaken already that the concentration of market power in the hands of one or two banks must raise serious concerns for the future operation of the market in Scotland. This may also have an impact on Scotland's international reputation as a financial centre. Lack of specific information on market share of each of the current two organisations makes it difficult to assess the potential impact of the new merged organisation. I am pleased, therefore, that the OFT is undertaking this investigation and will bring all of these issues to the attention of the UK Government. We hope that this will identify the potential market concentration in Scotland of the proposed merger. It will be essential that the Secretary of State has this information along with any proposed remedies in advance of any decision.

While I am confident that the OFT will give full consideration to all of the relevant issues, I would urge you to ensure that that all Scottish specific interests are separately and distinctly considered and reported upon.

I look forward to seeing the results of your considerations on this matter.

Y f Scotland
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ALEX SALMOND