IN THE COMPETITION APPEAL TRIBUNAL

BETWEEN:

MERGER ACTION GROUP

- and -

SECRETARY OF STATE FOR BUSINESS, ENTERPRISE AND REGULATORY REFORM

- and -

(1) LLOYDS TSB BANK plc
(2) HBOS plc

Interveners

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EXHIBIT DS1
IN THE COMPETITION APPEAL TRIBUNAL

BETWEEN:

MERGER ACTION GROUP

Applicant

and

SECRETARY OF STATE FOR BUSINESS, ENTERPRISE AND REGULATORY REFORM

Respondent

and

(1) LLOYDS TSB BANK plc
(2) HBOS plc

Interveners

WITNESS STATEMENT OF DAVID SAUNDERS

I, DAVID SAUNDERS, Civil Servant of the Department for Business, Enterprise and Regulatory Reform, 1 Victoria Street, London SW1H 0ET, WILL SAY as follows:

Introduction

1. I am a Director at the Department for Business, Enterprise and Regulatory Reform ("BERR"). Until recently, I was head of the Consumer and Competition Policy Directorate ("CCP") which has responsibility for competition law and merger control issues, a post I had held for four years. The role of CCP includes advising the Secretary of State on the use of his powers under the Enterprise Act 2002 ("the Act") to intervene in mergers on public interest grounds. I was responsible for advising John Hutton and then Lord Mandelson on the intervention made in respect of the proposed merger between Lloyds TSB Bank plc ("Lloyds") and HBOS plc ("HBOS"). I am authorised to make this statement
on behalf of the Secretary of State. Except where otherwise stated, the facts and
matters to which I depose are within my own personal knowledge. Where they
are not, they are true to the best of my information and belief. I exhibit to this
statement a bundle of paginated copy documents referred to herein as exhibit
DS1.

2. The Government’s long-standing policy has been to provide for mergers
generally to be considered to be consistent with, or contrary to, the public interest
purely on the basis of their effect on competition in the relevant market (and I
summarise the relevant provisions of the Act below with that in mind). The Act
places a duty on the Office of Fair Trading ("OFT"), as the independent
competition regulator, to refer a merger to the Competition Commission for a full
investigation, into its impact on competition, if certain conditions are satisfied.
The Secretary of State normally has no statutory role in this process.

3. He may, however, intervene if he believes it is or may be the case that a merger
situation has arisen that raises particular concerns relevant to a public interest
consideration that has been, or ought to be, specified in section 58 of the Act.
Where a public interest consideration specified in section 58 "justifies" any anti-
competitive outcome of a merger situation (the term used in section 45(6) of the
Act), the merger situation is not contrary to the public interest for the purposes
of the Act. There are now three considerations specified in section 58: (i) the one
recently introduced concerning the stability of the UK financial system; (ii) the
media public interest considerations (which were introduced by amendment in
2003); and (iii) national security. The Act provides that further public interest
considerations may be added as necessary by making an order which must be
approved by an affirmative resolution of each House of Parliament. It also
provides expressly that an intervention notice may be issued on the basis of such
a new consideration before the consideration has been finalised. This reflects
Parliament’s acknowledgement that such a public interest concern may only
become apparent at the time an actual merger situation arises in respect of which
it is appropriate to intervene and that it is appropriate for such intervention to
proceed in parallel with the making of an order to specify the relevant new
consideration. In such cases, the proposed new consideration must be finalised
as soon as reasonably practicable and must have been specified before any
substantive final decisions may be taken on the basis of it. The need for this
feature of the public interest intervention regime was a matter considered directly
by Parliament during the debate on the Enterprise Act. The relevant Hansard extracts are attached at [DS1 pp. 1-24].

4. Issuing an intervention notice under Section 42 of the Enterprise Act means that, in addition to the OFT examining the competition issues raised by the merger, an investigation is also conducted by the OFT (or Ofcom in the case of a media merger) into whether the merger raises concerns relevant to the public interest consideration specified in the notice. In such cases, the OFT (or Ofcom) report on the matter to the Secretary of State. It then falls to the Secretary of State to decide whether to refer the merger to the Competition Commission for a full investigation either on both competition and public interest grounds or just on public interest grounds. If, at this stage, he decides that the merger is, in fact, not likely to raise concerns affecting the public interest (so that only possible competition concerns remain), he may instead refer the case back to the OFT. At this point the public interest element of the case falls away and the OFT resumes responsibility for the decision on whether to make a reference to the Competition Commission purely on the basis of the competition issues raised by the merger.

5. To date, the power to intervene has been used on seven occasions. Five of these interventions were made on national security grounds and related to proposed mergers involving defence sector companies that were key suppliers to the Ministry of Defence. A further intervention was made on the grounds of media plurality in respect of BSkyB’s acquisition of shares in ITV. And most recently, the Secretary of State intervened in the proposed merger between Lloyds TSB and HBOS on the new ground of stability of the financial system.

6. In reaching the decision to issue an intervention notice under section 42 of the Act, the Secretary of State must have reasonable grounds for suspecting that it is or may be the case that a relevant merger situation has been created and that it is or may be the case that a public interest consideration that has been, or that he considers should be specified in section 58 of the Act, is relevant to a consideration of the relevant merger situation concerned. These thresholds are relatively low requiring only that there is a reasonable basis to suspect that a merger situation may exist to which a specified public interest consideration may be relevant.
7. Having taken the decision that intervention is merited, there is an initial investigation under Section 44 of the Act (or 44A in the case of intervention in media mergers). That investigation provides the Secretary of State with evidence and materials on which to base his decision under section 45 of the Act as to whether it is appropriate to refer the merger to the Competition Commission for a more detailed investigation, including into its effects on the public interest. Accordingly, the report provided under Section 44 of the Act is a crucial step that must occur before the Secretary of State can make a decision under Section 45.

8. In cases where the Secretary of State issues an intervention notice and subsequently decides that there are grounds to refer a merger to the Competition Commission, it becomes open to him instead to accept statutory undertakings in lieu of making such a reference in accordance with paragraph 3 of Schedule 7 to the Enterprise Act. He may do this if he believes that accepting such undertakings would adequately address the public interest issues raised by the merger. This has been the outcome in all the cases where the Secretary of State has intervened on national security grounds in mergers within the defence sector. The only time the Secretary of State has referred a merger to the Competition Commission for a full investigation of the public interest issues raised was in the one media merger case in which an intervention has been made — that being the case of Sky’s purchase of a major shareholding in ITV.

9. Where the Secretary of State decides to make a reference, the Competition Commission investigates and provides a report to the Secretary of State who must then take final decisions under section 54 of the Act on whether or not to make an adverse public interest finding and on appropriate remedies. It is not possible to refer only part of a merger to the Competition Commission. The options available to the Secretary of State are as set out above: (i) not to refer a merger; (ii) to accept statutory undertakings in lieu of referring a merger; or (iii) to refer a merger.

The decision to intervene in the proposed merger

10. On 16 September 2008, a meeting took place between representatives of BERR and HM Treasury to discuss the prospect of intervening on public interest grounds in a possible merger between Lloyds and HBOS On 17 September
2008, further discussions took place at BERR to consider whether it would be appropriate to: (i) issue an intervention notice under section 42 of the Act; and (ii) make an order so as to specify the stability of the UK financial system as a new public interest consideration under section 58 of that Act (which would be the consideration specified in the intervention notice).

11. On 17 September 2008, the Secretary of State received advice from HM Treasury reflecting the views of the other Tripartite Authorities (Financial Services Authority ("FSA") [DS1 pp. 28-31] and the Bank of England [DS1 pp. 32-34]) on the substantive arguments for intervening in the proposed merger on public interest grounds [DS1 pp. 25-28]. A copy of a letter HM Treasury had received from the FSA was attached to HM Treasury's advice. It referred to the letter they had received from the Bank of England. However, in the event, this attachment, was not actually received by BERR before the Secretary of State took his decision on whether to issue an intervention notice. However, BERR officials were satisfied that HM Treasury's advice reflected the content of the Bank of England's letter.

12. During the course of 17 September 2008, BERR officials received confirmation that the Secretary of State believed it was appropriate to make an order and issue an intervention notice in this case. This decision reflected the clear advice he had received from the Tripartite authorities that the merger raised matters relevant to the stability of the UK financial system and the belief that this was a matter of legitimate public interest.

13. The position of the Tripartite authorities was summarised by HM Treasury in paragraph 6 of their advice on the matter [DS1 p.28] which stated: "In light of the extraordinary stress in the financial markets, the systemic importance of HBOS to the UK banking system, the deteriorating position in the position of the firm in recent days and heightened market speculation about the firm with extreme volatility in its share price, the Treasury and other Tripartite authorities have concluded that the proposed merger provides the best route for ensuring the financial stability of the UK economy". Having regard to the views expressed by the Tripartite Authorities, it was clearly necessary for the Secretary of State to make an order and issue an intervention notice so that the procedure by which the Secretary of State could consider the matter would be set in train.
14. We proceeded to make the necessary preparations. On 18 September 2008, the intervention notice was issued [DS1 p. 35] along with an accompanying press statement [DS1 p. 36]. As Parliament was in summer recess, the Secretary of State also wrote to opposition spokesmen and the chairman of the Business & Enterprise Committee informing them of the decision to intervene and that an order would be laid as soon as Parliament reconvened on 6 October 2008 [DS1 pp. 37-41].

15. Around this time, the media reported certain statements by the Chancellor of the Exchequer and the Prime Minister about the proposed merger. I can confirm, however, that both BERR officials and the Secretary of State were at all times fully aware of the Secretary of State’s duty to reach decisions in this case independently and in accordance with the requirements of the relevant sections of the Act, taking into account all relevant considerations.

Making the order

16. On 3 October 2008, Lord Mandelson took over from John Hutton as Secretary of State.

17. On 3 October, officials submitted advice to Ministers on making the necessary order to introduce the proposed new public interest consideration concerning the stability of the UK financial system [DS1 pp. 43-44]. On 6 October 2008, the order [DS1 pp. 45-46] seeking Parliament’s approval for the introduction of the proposed new consideration was signed and BERR issued a press release announcing this [DS1 pp. 47-48]. The order was accompanied by an Explanatory Memorandum which set out the policy background [DS1 pp. 49-51] and an Impact Assessment which set out the policy objectives together with the anticipated impact of the measure [DS1 pp. 52-61]. In fact, it transpired that the order could not be laid in Parliament until the following day, 7 October 2008. The same day, BERR published a statement summarising the reasons for making the order and for issuing an intervention notice in respect of the proposed merger between Lloyds and HBOS [DS1 pp. 62-63].

18. On 8 October 2008, HM Treasury announced a package of measures aimed at ensuring the stability of UK financial institutions. On 13 October HM Treasury announced that it had reached agreement on the recapitalisation of RBS, Lloyds
and HBOS, the recapitalisation of Lloyds and HBOS being conditional on the merger completing.

19. The draft order was debated in the House of Lords on 16 October 2008. The Secretary of State introduced the debate on the order, presenting the arguments as to why the new public interest consideration was appropriate. A number of Lords made contributions to the debate. A copy of the relevant Hansard extract is included in the bundle at [DS1 pp. 64-79]. In his closing speech, Lord Mandelson stated: “The order that we are considering is brought forward to allow for the careful consideration of financial stability as part of our assessment of the proposed merger between Lloyds TSB and HBOS. This debate, therefore, is not about the assessment, which I have yet to undertake. I will do so following receipt by me of the OFT’s recommendations on the competition and public interest issues which are due by 24 October. I have an open mind to both the competition and public interest considerations.” The arguments were further outlined when the draft order was subsequently presented to a House of Commons Delegated Legislation Committee on 20 October 2008 by the Competition Minister, Gareth Thomas. A copy of the Hansard extract detailing this debate is included in the bundle at [DS1 pp. 80-83]. It was made clear in both Lords and Commons debates that decisions on whether or not to make a reference in the Lloyds/HBOS case could only be taken once the Secretary of State had received and considered the OFT report and any other representations he received. The order [DS pp. 45-46] came into force on 24 October 2008.

The decision not to refer the merger to the Competition Commission

20. On 24 October 2008, the Secretary of State received the report of the OFT prepared in accordance with section 44 of the Act [DS1 pp. 84-254]. As required under the Act, the report included summaries of the representations the OFT had received on the public interest consideration that may have been relevant to the Secretary of State’s decision as to whether the case should be referred to the Competition Commission, as well as the OFT’s decisions relating to the potential impact on competition of the proposed merger, and annexed the full version of those representations (the annexes were actually received on 27 October 2008).

21. BERR had asked the OFT to extend its deadline for receiving representations on the public interest issues raised in the case until 23 October 2008. This was to
ensure that those representations were able to reflect the most up to date situation. The OFT received a number of representations from parties relating to financial stability. As required under section 44(3)(b) of the Enterprise Act, the OFT summarised these representations in its report. It also annexed to the report the representations it had received from the Tripartite Authorities on 23 October as well as a number of other representations. In view of the requirement on the Secretary of State, in making his decision, to reach his own view on the public interest issues, it was particularly important for the Secretary of State to consider directly the representations annexed to the OFT's report, including the submissions from the Tripartite Authorities whose views would be of particular significance in view of their relevant expertise in assessing financial stability issues across the UK as a whole.

22. Also on 24 October 2008, officials submitted advice to the Secretary of State on the next steps to be taken following receipt of the OFT report, [DS1 pp. 257-259]. The submission explained that the Secretary of State was required to accept the OFT's conclusions about the impact of the merger on competition but must apply his own judgment - drawing on all the available information and representations - as to whether any anti-competitive effects may be justified by the public interest consideration specified in the intervention notice. The Annex to the submission outlined the two alternatives open to the Secretary of State: either to make a reference to the Competition Commission or not to make a reference on the basis that the anti-competitive outcome was justified by the specified public interest consideration (stability of the UK financial system).

23. Also on 24 October 2008, the Secretary of State received a letter from Lloyds TSB making representations about the merger. He had previously received a small number of other representations from interested third parties. All these representations received directly by the Secretary of State are included at [DS1 pp. 260-267].

24. On 28 October 2008, officials submitted further advice to the Secretary of State on the decision he was required to make under section 45 of the Act on whether he believed the creation of the merger situation operated against the public interest and should be referred to the Competition Commission [DS1 pp. 268-276]. In presenting our advice on this matter, we were strongly conscious of the need for the Secretary of State to reach an independent view taking all relevant
considerations into account. The Secretary of State had to have regard to the OFT's decisions on the competition issues specified in its report as well as to the other representations and submissions made by the parties and third parties. In accordance with section 45(6) of the Act, he also had to consider whether any potentially anti-competitive outcomes identified by the OFT might be justified by a relevant public interest consideration.

25. The submission of 28 October to the Secretary of State, included a consideration of the competition concerns that had been identified by the OFT: relating primarily to personal accounts and banking services to small and medium sized enterprises in Scotland, as well as to concerns about impacts in the mortgage market.

26. The submission also considered the representations of third parties concerning the public interest consideration, including those of the Tripartite Authorities (summarised at paragraphs 9-12 of the submission). The Bank of England had sought in particular to emphasise the importance of HBOS for the stability of the UK financial system. They confirmed their position that, irrespective of the re-capitalisation programme, the merger represented the most effective and beneficial outcome and that it should proceed without delay. It was clear that the merger and the other measures taken to ensure financial stability were viewed by the Tripartite Authorities as complementary and not as alternative options and also that they considered neither measure would be as effective without the other.

28. HM Treasury identified a range of benefits resulting from the merger, including: (i) increased confidence; (ii) an improved business model and better capital base for the merged entity; (iii) reduced reliance on wholesale funding; (iv) improved credit rating; and (v) a broader business base. HM Treasury also emphasised that the Government's agreement to provide recapitalisation funding to Lloyds and HBOS was on the basis that the proposed merger completed. It should not be assumed
that capital would be available to the banks as stand alone entities on the same terms as had been approved for the merged entity.

29. Paragraphs 13-15 of the submission set out the officials' assessment of the case. We made reference to the fact that the test applied by the OFT in deciding whether a reference may be warranted on competition grounds was relatively low, requiring only the belief that there exists a realistic prospect of a substantial lessening of competition (under the "is or may be the case" standard). We acknowledged that there were legitimate concerns about the potential market power of the merged enterprise in the medium term and recognised that there would be a need for the competition authorities to keep a close watch on its future behaviour in the market. We concluded that it appeared from the representations of the Tripartite Authorities that the Government's recapitalisation programme was complementary and not alternative to the merger and, accordingly, that it was necessary for the merger to proceed in the interests of ensuring stability in the UK financial system notwithstanding the existence of the recapitalisation programme. In particular, without it the Tripartite Authorities remained clearly of the view that the merger was necessary and should proceed without delay.

30. On 29 October 2008, the Secretary of State received a letter from Alex Salmont, First Minister of Scotland, making representations about the merger [DS1 pp. 277-280]. These representations were considered.

31. On 30 October 2008, the Secretary of State had a telephone conversation with the Chief Executive of the OFT, John Fingleton. As is generally the case in such situations, one of my officials listened in on this discussion. I understand from having myself spoken to that official that Mr Fingleton highlighted to the Secretary of State the main conclusions set out in the OFT report and responded to questions from the Secretary of State. I understand that one of the points made by Mr Fingleton during the discussion related to the preliminary nature of the decisions the OFT was required to take: the OFT's role in considering mergers is limited to deciding whether a more in depth investigation by the Competition Commission may be appropriate and, as explained in the OFT report, the OFT's conclusion that a reference was appropriate in this case did not necessarily mean
that a Competition Commission investigation would find that the merger should be blocked on competition grounds after a more extensive analysis.

32. I understand from having myself spoken to that official that another matter the Secretary of State explored with Mr Fingleton was the scope for the OFT to take action at some future date, should it consider that competition concerns had arisen in a market as a result of the merger. Following this discussion, officials at the OFT sent me some further advice about the OFT’s capacity to take action as appropriate to protect the interests of consumers, businesses and the economy as a whole [DS1 pp. 281-283].

33. On 30 October 2008, the Secretary of State also received a letter from the Chancellor of the Exchequer re-confirming the views of the Tripartite Authorities concerning the public interest issues relevant to the merger [DS1 pp. 284-285].

34. That afternoon, the Secretary of State met with officials to discuss the advice and submissions he had received and to reach a decision. At our request, officials from HM Treasury were also present in case the Secretary of State had any specific further questions about the evidence of the Tripartite Authorities relating to the implications of the merger for financial stability. Having satisfied himself that all the evidence and options had been fully examined, the Secretary of State reached the decision, in line with our recommendation and on the basis of the arguments set out in the submission dated 28 October 2008, not to refer the merger to the Competition Commission.

35. This decision was announced the following day, 31 October 2008, when the Secretary of State published his Decision [DS1 pp. 286-294] along with a press release [DS1 pp. 295-296] and a non-confidential, redacted version of the OFT’s report [Applicant’s bundle tab 23].
36. The Decision speaks for itself. In short, it summarised the reasons for the Secretary of State's decisions in this case by reference to: (i) the major role of HBOS in the provision of financial services to the UK household and corporate sectors; (ii) the importance of the merger for ensuring the stability of the UK financial system; (iii) the fact that a delay to the merger (or its failure) would weaken confidence in the effectiveness of HMG's re-capitalisation and funding guarantee programme in re-establishing stability; and (iv) the belief that the merger would provide a sustainable medium term future for HBOS as a result of an improved business model and reduced reliance on wholesale funding.

37. The same day the Secretary of State wrote to opposition spokesmen and the chairman of the Business and Enterprise Committee as well as certain members of the House of Lords who had made interventions during the Parliamentary debate (DS1 pp297-301).

Statement of truth

38. I believe the facts stated in this witness statement are true.

Signed: [Signature]
(David Saunders)

Dated: 4 December 2008
CONFIDENTIAL

1. Responder
2. D Saunders
3. First
4. "DS1"
5. 04.12.08

Case No: 1107/4/10/08

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(1) LLOYDS TSB BANK plc
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Interveners

_____________________________________

WITNESS STATEMENT OF DAVID SAUNDERS

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Miss Johnson: The balance is difficult to strike, but we think that we have found the right balance in all the measures covered in this clause and the earlier clauses relating to it. The 1973 Act is relevant to this clause, but companies will be required to undertake review by the Competition Commission. They will have to put forward their comments, which will be provisional findings, not conclusions. I trust that I have reassured the hon. Gentleman that we have the balance right.

Question put and agreed to.

Clause 38 ordered to stand part of the Bill.

Clause 39 ordered to stand part of the Bill.

Clause 40

**Intervention by Secretary of State**

in certain public interest cases

Mr. Waterson: I beg to move amendment No. 56, in page 26, line 7, leave out from "56" to end of line 8.

The amendment is quite important and it raises two issues. One is of principle and the other of uncertainty.

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The amendment was raised by the joint committee of the Law Society and the Bar, which was examining the legislation, and it raises wider concerns. As one can tell at a glance, subsection (3) refers to a "public interest consideration". Our next major debate—with your acquiescence, Mr. Conway—will be under clause 56, which is a convenient place to tackle the issues of principle relating to public interest.

The narrow point is in the words following "section 56" in subsection (3):

"or is not so specified but, in the opinion of the Secretary of State, ought to be so specified."

As a matter of principle, we think that it is quite wrong to pass primary legislation that leaves a door wide open for the Secretary of State, should he exercise his power, and perhaps later, to think of some other basis to intervene. If such a door is left even ajar, it would make nonsensical the care that we lavish on Bills in these Committees. In this case, one could drive the proverbial coach and horses through it, if one were so minded.

It is wrong in principle to say that the Secretary of State should have the power to consider public interest considerations that are not listed in the legislation. Given the care and work that has been directed at drafting the Bill, and the extra care that must be attached to anything that has the phrase "public interest" in it, I would be surprised if the draftsmen had not already thought of other possible situations that could have been included. However, as it stands, the Secretary of State will be able to add a new public interest consideration, and will be able to do so in response to a specific or proposed merger, which brings me to my second area of concern.

In essence, a merger could be referred on new grounds that did not exist when the merger was conceived. That is the point about uncertainty. Companies in all good faith will start negotiations to merge their companies and spend a lot of time and money doing so without being sure that the goals set will not be moved at some subsequent date by the Secretary of State. In other words, they could agree to merge on the basis of the provisions in the clause but, after expending a great deal of time, money and effort, discover that the Secretary of State has said that there will be an intervention on public interest grounds on the basis of something not set out in legislation.

I do not want to be repetitive, so I will not get into the definitions of public interest involved—we will come to that under clause 56. We think that the power is a dangerous one to give any Secretary of State, and that such uncertainty is bound to cause problems in the business community. The Under-Secretary has said more than once, in a number of different contexts and quite justifiably, that we need certainty in the way that the provisions are applied. The clause leaves an enormous lacuna in the legislation that can be filled at any time by any Secretary of State, possibly part of the way through a merger. We feel strongly about the provision, and for us to be satisfied, the Under-Secretary is going to need a pretty good justification for it.

Column Number: 341

http://www.publications.parliament.uk/pa/cm200102/cmstand/l/st020430/pm/20430s05.htm 04/12/2008
Mr. Lansley: I want to support my hon. Friend the Member for Eastbourne. The amendment will help us to establish the Government’s intentions and explain how clause 40 is intended to work. It may be helpful if I explain why there might be a problem with clause 40(3). To explain the amendment, I must refer ahead to clause 56, on which I will not dwell because we will come to it later.

National security interests are specified in clause 56. It is clearly intended that the Secretary of State will be able to add to such a consideration, which might give rise to an intervention notice. That would, however, have to be done by order. In doing so, the Secretary of State would not be confined to cases that were about to be considered by the OFT or the Competition Commission. Cases that were already under consideration could be looked into. There is no sense in which the absence of such a consideration already being specified by order under clause 56 would mean that the Secretary of State could not act when presented with a merger situation if he or she felt that a public interest, which had not previously been considered and that we had not put in the legislation, were brought to bear.

As we will discuss later under clause 51, the Secretary of State will be able to wait for up to 24 weeks before finalising a consideration. In that context, finalising means making the order necessary to amend clause 56. That is a problem because if there were a relevant merger situation and the Secretary of State held the opinion under clause 40(3) that a consideration ought to be specified under clause 56, he or she would have 24 weeks in which to decide whether to make an order, which, as we have previously heard, happens to be exactly the same 24 weeks during which the Competition Commission would consider the case under the time limit.

The Secretary of State would have the luxury of having an opinion on whether a consideration ought to be in clause 56. The OFT and the Competition Commission would consider it under an intervention notice all the way through the reference, but at the end of the day the Secretary of State could not have to make the order, in which case that consideration would fall away and the reference would not be made.

The Secretary of State would be able to have his cake and eat it. He would be able to have an opinion about whether a consideration ought to be made under section 56, he could have it tested by reference to the Competition Commission and could get virtually to the last day and it would still be considering it. He could then pull everything away at the last minute and it would never have to go before Parliament.

I dwell on all those matters because if the amendment moved by my hon. Friend the Member for Eastbourne were agreed, the Secretary of State could still intervene. Clause 56, as amended, could be used. The difference is that the Secretary of State would have to bring an order before Parliament and get it to agree that such a consideration ought to be added to the exceptional considerations of national security that were foreshadowed in the legislation.

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On the face of it, there would be ample time in which to do that because 28 days is sufficient time to make and lay an order. There would be no bar under clause 56 for that to relate to considerations for cases that had already occurred. People would not be able to run through a merger situation and secure consent without the Secretary of State having an opportunity to make an intervention notice, because he could amend clause 56 to do it. The legislation is designed not to allow the Secretary of State in wholly exceptional circumstances to issue an intervention notice with the scrutiny of Parliament but to allow the Secretary of State to make an intervention notice and test the issue virtually to completion without the intervention of Parliament.

We could deal with that by following the amendment of my hon. Friend the Member for Eastbourne and getting rid of the part of the clause that allows for the opinion of the Secretary of State, or we could change the time limits in clause 51 so that the Secretary of State must finalise the consideration at an earlier point. I shall not dwell on clause 51. We can quickly refer to it later, if necessary. However, a way of dealing with the issue would be for the Secretary of State not to take the power in clause 40, which allows an opinion about an intervention notice, but to use the proper procedure under clause 56.

5.45 pm

Mr. Djanogly: One of the most significant purposes of the review of competition law is to remove political interference. I do not think that anyone in the Room would dispute that. On the one hand the public interest test has been removed—
extremely curtailed, at least—but on the other, the Secretary of State has a get-out if, in his opinion, something should count as public interest. There is an inconsistency of approach.

When we debated clause 20 at some length, Opposition Members argued that the OFT should have discretion on making referrals. At that time, the Government attacked the suggestion on the basis of a variety of arguments but mainly the concept of uncertainty coming into the legislation and the need for businesses to be able to have certainty. Yet here the tables have been turned, this time in favour of discretion for the Secretary of State. The Government seem to be arguing that the Secretary of State should have discretion to decide when the measure should apply. I would be grateful if the Under-Secretary would justify the inconsistency of approach.

Mr. Field: I entirely agree with the comments of my hon. Friends the Members for Huntingdon and for South-East Cambridgeshire—

Mr. Lansley: South.

Mr. Field: I apologise to my hon. Friend the Member for South Cambridgeshire (Mr. Lansley). Clearly, I do not know the geography of Cambridgeshire as well as that of the centre of London. Perhaps I may be forgiven for that.

We had a long discussion on clause 20 and I openly said that I was uneasy about the idea of taking politics out, not least for the reasons given by my hon. Friend.

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the Member for South Cambridgeshire in relation to those who are not deemed fit to run companies and how the powers to make the sort of inquiry that we had in mind might be taken away from the Secretary of State.

Clause 56 is entirely clear about the ground of national security. Clause 40 tries to undermine or drive a coach and horses through the issue of national security by virtually giving carte blanche to any Minister, notwithstanding national security considerations—I believe that such considerations are entirely acceptable to everyone—effectively, to play to the gallery. In recent years, Ministers have played to the gallery on competition matters in several cases. For example, the rip-off Britain campaign that was run by the then Secretary of State for Trade and Industry in the late 1990s was a deliberate attempt to get at the supermarket chains.

We are concerned that playing to the gallery will undermine the predictability and certainty tests that have been heralded to such a great extent. Subsection (3) gives carte blanche for any Secretary of State to undermine the very ideas of competition and certainty that the Enterprise Bill should be putting in place. I shall be interested to have the Under-Secretary's guidance as to how the clause will operate. Under what circumstances will Ministers invoke their powers and go one step further than what is envisaged in clause 56?

Miss Johnson: Let me be clear; we have no plans to specify new public interest considerations. Merger reform has been the subject of extensive consultation and we have considered thoroughly whether anything beyond national security should be in the Bill. We do not expect to specify further issues in relation to the current scope of the merger control regime.

It would be unwise, however, to ensure that unforeseen circumstances could not be dealt with if there were a compelling case in the public interest. We must ensure that we can meet unforeseen circumstances and other legislation makes similar provision. The European merger control arrangements are focused on competition, but provide that member states can take appropriate measures to protect other legitimate interests. Consideration of whether new issues raised by member states are legitimate interests takes place in parallel with consideration of the case. That is a sensible arrangement and it ensures that a case is not needlessly delayed.

The amendment could stop the Secretary of State claiming an interest where a case raises important issues but the deadline for a reference decision is close. I have already explained why it is sensible to have limited flexibility, but I reassure the Committee that wherever an intervention notice cites a new public interest consideration, subsection (7) will ensure that the Secretary of State must move quickly to make an order specifying that consideration. The subsection states that it must be finalised “as soon as practicable”—[Interruption.] The hon. Member for South Cambridgeshire is laughing, but it is only sensible to include such a provision.

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The Bill also ensures that public interest considerations can be taken into account in making a final decision on a case only if they have been finalised by Parliament. Our proposals ensure that the Secretary of State can intervene to claim an interest in a case, but cannot determine its outcome with regard to any public interest consideration that has not been approved by Parliament. That represents the right balance: we need to ensure that the legislation can deal with unforeseen matters, and provide appropriate safeguards for the use of the Secretary of State's powers, but I emphasise that we have no proposals to use that. We are simply ensuring that if the unforeseen arises, we have some contingencies.
On Government intervention, ministerial involvement will be the exception. The Secretary of State will take decisions only where the case raises certain matters specified by parliamentary agreement. The Secretary of State must serve the intervention notice before the public interest test can be applied. If no intervention notice is served, the case follows the competition-only route.

Of course, companies need certainty. When a case raises wider public interest issues, the Secretary of State needs to claim interest transparently and within a clear deadline. The intervention notice will have to be published and will make it clear that the case is to be decided by the Secretary of State in terms of the public interest test. The Secretary of State will have to give reasons for the intervention. It is important that companies know that non-competition issues must be raised in advance of any possible reference decision.

The Secretary of State will be limited in the matters on which he or she can intervene. They must already have been specified in legislation, or be ones that the Secretary of State thinks should be so specified. There are no plans to extend that beyond national security.
Enterprise Bill

Mr. Lansley: I have indeed seen subsection (7). Given that the Secretary of State will have to set out the grounds for the intervention notice at the time at which it is made, can the Under-Secretary give any reason why an order under clause 56 should not be made within 12 weeks, for example, rather than the 24 that seem to be allowed?

Miss Johnson: When the Secretary of State wishes to intervene on those grounds she will be compelled to bring forward an order and to specify that in legislation. The 24-week period is a long-stop and fits in with a possible time scale for obtaining approval for a new public interest consideration. It was chosen for the order to be laid twice to allow for consultation and discussion, as well as long summer breaks and parliamentary timetables during such breaks. If the consideration is not approved within the deadline, the issue will be disregarded in any case. I assure the hon. Gentleman that we want to ensure that cases are not unduly delayed.

Mr. Lansley: When making an order to amend under clause 56, clause 116(7) provides that periods

"during which Parliament is dissolved or prorogued or during which both Houses are adjourned for more than four days"

will not be counted. I fail to see why a recess should be a relevant consideration. If time is to be allowed for orders to be made simply in a practical way, would it not be better to set an intermediate time limit of, for example, 12 weeks rather than allowing the Secretary of State 24 weeks during which the commission might be working?

Miss Johnson: As I have said, the time scale is a long-stop. It is a maximum and will not necessarily operate. I appreciate the hon. Gentleman’s interest in trying to peg it to a shorter time frame. We would all like that, but the fact is that the summer break involves not only the House, but other parties that may wish to comment. Members of this House may wish to have an input but they may be away on holiday. During the summer, it is difficult for people to contribute fully to discussions unless some of the time scale falls outside the summer period. That is why we chose the time scale. It was not plucked out of the air. It allows for the most extreme case when that length of time may be required. We need that flexibility to cope with the need to obtain parliamentary approval and to make final decisions.

Clause 56 does not affect the limitation that the Secretary of State must intervene before reference and I hope that that clarifies the interaction between the two clauses. I hope that I have persuaded Opposition Members to support the clause unamended because I believe that we have got the balance right.

Mr. Waterson: I am sorry to disabuse the Under-Secretary, but she has not persuaded me. Two issues still worry me. One concerns the principle behind this part of the Bill: to eliminate ministerial involvement. I believe that it is common ground in the Committee—including the Under-Secretary—that any exception should be as narrow as possible. National security is, I hope, about as narrow as one can get. Rather like an elephant, it is difficult to describe but one knows it when one sees it. National security would hit any sensible Secretary of State firmly in the face as and when it arose. I am worried as a matter of principle about any attempt to extend what is being suggested, particularly in this vague way.

What the Under-Secretary said was supposed to reassure me, but it had the opposite effect. More worrying is the fact that, as she has repeated on several occasions, there are no plans whatever to specify any other ground and nothing foreseeable is being considered. That seems to be making the situation worse. If something sufficiently serious arose outwith the imagination of everyone involved with the Bill, including officials who have had a hand in drafting it over a long period, and was sufficiently serious and important, primary legislation could be passed through both Houses very quickly to deal with the matter, rather than going through the order-making procedure. It is very worrying that this might depend on the approach of the individual Secretary of State. We have been told that this Secretary of State cannot foresee any circumstances to be included, although I do not expect that she has spent much time worrying and thinking about it. National security is, apparently, all that we are worried about.

http://www.publications.parliament.uk/pa/cm200102/cmstand/b/st20430/pm20430s07.htm
04/12/2008
Miss Johnson: I can reassure the hon. Gentleman that we have spent time thinking about the matter. After considering it very carefully, we can foresee no further situation that might be included.

Mr. Waterson: I take that point. I am not trying to denigrate the amount of time that the Secretary of State has spent on the matter. From that point of view, it is reassuring that she and other Ministers, however much time they have spent on it, have not come up with the remotest possibility of any other heading to put in primary legislation. However, suppose a different Secretary of State were to take over during what remains of the life of this Government—someone with a much more interventionist approach, who wanted to intervene before breakfast, before lunch and before dinner, to coin a phrase. This would be a wonderful section through which they could do that, by coming up with a whole range of different grounds.

Last the Under-Secretary should think that fanciful, let her look ahead to amendment No. 262, which we shall debate very shortly, under clause 56. It is a workmanlike attempt by some of her old Labour colleagues in the House to do just that—open up a great hole in the legislation through which such interventionist policy could be enforced.

There is a problem about certainty. If the Under-Secretary wanted to go halfway towards allaying the concerns of the business community, she might agree to go away and consider later amendments to exclude any changes affecting mergers or investigations of mergers already afoot. That would take a lot of steam out of the business community’s concerns. We are not happy with the explanations. I am not saying for a moment that the Under-Secretary has not tried hard and been absolutely open about the thinking behind the provision. However, given the Department’s current thinking, it is precisely the mystery of why on earth we need to leave that gap in the legislation that still causes me concern. We might wish to return to the subject later. I beg to ask leave to withdraw the amendment.

Amendment, by leave, withdrawn.

Clause 40 ordered to stand part of the Bill.

Clause 41 ordered to stand part of the Bill.

Clause 42

Investigation and report by OFT

Amendment made: No. 178, in page 28, line 43, after "outweigh", insert

"the substantial lessening of competition and".—[Miss Melanie Johnson.]

Clause 42, as amended, ordered to stand part of the Bill.

Clause 43

Power of Secretary of State to

refer matter to Commission

Question proposed, That the clause stand part of the Bill.

Mr. Lansley: I do not wish to detain the Committee, but I want to be sure that I understand the purpose of the clause accurately. I would be grateful for the Under-Secretary’s confirmation, as the clause seems to be designed to allow the Secretary of State to refer a merger situation to the Competition Commission after having made an intervention notice, whether or not the OFT has determined that there is a substantial lessening of competition. Further, under clause 42, the OFT will have provided advice and recommendations in relation to a public interest consideration raised by the Secretary of State under the intervention notice. The implication in clause 43—although it is not set out in detail—is that the Secretary of State will be able to make a reference to the Competition Commission whether or not the OFT has decided that that public interest consideration is well founded and should give rise to a reference.

In effect, if I understand the provision accurately, the Secretary of State is proposing to be able to ignore the OFT. The Competition Commission will be able to make a determination and the Secretary of State cannot sustain an intervention
(11) No more than one extension is possible under subsection (1).—[Miss Melanie Johnson.]

Clause 31
Supplementary provision for purposes of sections 24 and 30

Amendment made: No. 226, in page 19, line 13, leave out "or (6)" and insert ", (6) or (7A)".—[Miss Melanie Johnson.]

Clause 39
Section 38: supplementary

Amendment made: No. 227, in page 24, line 29, at end insert—

'(4A) Where a period within which a report under section 37 is to be prepared and published is extended or further extended under section 38(3) or (4), the period as extended or (as the case may be) further extended shall, subject to subsections (4B) and (4C), be calculated by taking the period being extended and adding to it the period of the extension (whether or not those periods overlap in time).

(4B) Subsection (4C) applies where—

(a) the period within which the report under section 37 is to be prepared and published is further extended;

(b) the further extension and at least one previous extension is made under section 38(4); and

(c) the same days or fractions of days are included in or comprise the further extension and are included in or comprise at least one such previous extension.

(4C) In calculating the period of the further extension, any days or fractions of days of the kind mentioned in subsection (4B)(c) shall be disregarded.'.—[Miss Melanie Johnson.]

Clause 41
Intervention by Secretary of State in certain public interest cases

Mr. Waterson: I beg to move amendment No. 63, in page 26, line 28, leave out from "57" to end of line 29.
Madam Deputy Speaker (Sylvia Heal): With this it will be convenient to discuss the following: Government amendment No. 229.

Amendment No. 142, in clause 45, page 31, line 36, at end insert—

'(5A) The Secretary of State shall not make a reference under section 44(3) or (5) when a relevant public interest consideration which is mentioned in the intervention notice has not been finalised.'.

Government amendment No. 234.

Amendment No. 304, in clause 57, page 40, line 15, after "of" insert "(a)"

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Amendment No. 305, in page 40, line 15, after "security" insert—

'(b) maintaining and promoting the balanced distribution of industry and employment in the United Kingdom;

(c) maintaining and promoting competitive activity in markets outside the United Kingdom on the part of producers of goods, and of suppliers of goods and services, in the United Kingdom.'.

Amendment No. 197, in page 40, line 15, at end insert—

'(1A) The interests of plurality in newspaper ownership are specified in this section.'.

Amendment No. 198, in page 40, line 18, at end insert—

'(2A) In subsection (1A) "newspaper" shall have the same meaning as in section 57(1)(a) of the 1973 Act; and in this subsection "plurality" means a diversity of ownership that is sufficient to ensure that the public have access to the accurate presentation of news and free expression of opinion.

(2B) In applying the interests specified in subsection (1A) no account should be taken of plurality in newspaper ownership if the relevant merger situation concerns the transfer of a newspaper or newspaper assets to a newspaper proprietor whose newspapers have an average circulation per day of publication amounting, together with that of the newspaper concerned in the transfer, of fewer than 500,000 copies.

(2C) In subsection (2B), "newspaper proprietor" shall have the same meaning as section 57(1)(b) of the 1973 Act; and the calculation of circulation per day shall be by such means as the OFT or (as the case may be) the Commission shall determine.'.
Amendment No. 143, in page 40, line 19, leave out subsections (3) and (4).

Government amendments Nos. 243 to 245.

Mr. Waterson: As this may be the last group of amendments that we can deal with before 7 pm under the guillotine procedure, it may be helpful if I point out that we intend to press amendment No. 63 to a Division, as we feel strongly about it. The group deals with public interest and mergers, but there will be some echoes from topics that we discussed in the debate on the previous group.

At present, the only definition of public interest appears in clause 57. The clause defines public security in the terms set out in the European merger regulations. We had a significant number of debates on these matters in Committee. Our starting point is that the provision is crucial, so it is right that it should be firmly stated in the Bill. Our approach is rather different from that of the hon. Member for North-East Derbyshire (Mr. Barnes), and our concern is that it should not be open to the Government to add a new ground of public interest when they feel like it.

When we pressed the issue in Committee, the Minister was wedded to the power to extend the definition, but she was wholly unable to say—in fairness, she said the same this afternoon—what possible category she might have in mind to add to the definition in the Bill. Nevertheless, the Government's position seems to be that it is imperative to include the power.

The effect of amendment No. 63 would be to remove the Secretary of State's ability to consider public interest considerations not listed in the legislation. We debated a similar amendment in Committee. As the Bill stands, the Secretary of State could simply add a new public interest consideration, or more than one such consideration, in response to a specific merger or proposed merger, as it arose.

Apart from anything else, that could involve enormous uncertainty for those in the business sector. When embarking on a merger, they would not know whether the goalposts would be moved in due course by the addition of a new public interest ground because the Secretary of State had decided to change the rules. That is another good reason why any other public interest consideration—whether media plurality, which we shall come to in a moment, prudential rules or anything of that sort—should be identified in the primary legislation.

If it is not possible to identify those considerations now and they arise later, it should be possible to add them to the Act, as it will then be, by primary legislation. If something arose that was so important and so unforeseeable that no one can even imagine what it would be, any Government ought to be able, possibly with cross-party agreement and—who knows?—possibly even with the agreement of their Back Benchers, to put through the House the necessary primary legislation, and quite quickly, if needs must.

There is also a side issue. If we leave open this great loophole, it merely returns us to what I am sure the Minister would regard as the bad old days of political involvement in such matters.

I shall touch briefly on amendments Nos. 142, 197 and 198 tabled by my hon. Friend the Member for South Cambridgeshire (Mr. Lansley), who will develop the arguments in detail. Amendment No. 142 relates to the Secretary of State's power to make merger references arising from a public interest intervention notice. My hon. Friend will develop the reasons for the amendment. Amendments Nos. 197 and 198 deal with the plurality of newspaper ownership. The effect of amendment No. 143 echoes that of amendment No. 63.

It is impossible to consider what the Government have in mind in changing the law on mergers and takeovers without considering how those matters have been dealt with up till now.

We argued in Committee—with some justification, I think—that all we are doing in the Bill is regularising what has been practice for a considerable time. Under the so-called Tebbit guidelines, there has been a kind of self-denying ordinance among successive Secretaries of State of both parties that they would look narrowly at competition issues when reaching their decisions. It is fair to say that there is an element of cross-party consensus that seeming political involvement brings the system into disrepute. The average member of the public finds it difficult to distinguish between a politician making a decision on non-political grounds and one making a decision on political grounds.

6.30 pm

Fast-forwarding from the Tebbit doctrine, we come to 26 October 2002, when the then Secretary of State, the right hon. Member for Tynedale, North (Mr. Byers)—a familiar name in the House—anounced that Ministers would accept the advice of the Director General of Fair Trading on takeover matters, save in exceptional circumstances.

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Enter stage left the figure of Mr. Richard Desmond, whose Northern and Shell media group on 22 November of that year paid £125 million for Express Newspapers Group. Mr. Desmond had a busy week, because only four days later, on 26 November, he had a half-hour chat at No. 10 with the Prime Minister.
Mr. Desmond has forced himself into the consciousness of many of us recently through the titles of some of the magazines that he publishes, as well as through his newspaper activities. The list of publications is very long; I was going to say that it is impressive, but it is long. There are titles such as *Ward Sex Special*—[Interuption.] That is obviously familiar to the hon. Member for Wolverhampton, North-East (Mr. Purchase).

Titles include *Horny Housewives*, *Mega Books*, and for the real enthusiast, *The Very Best of Mega Books*. There is also a magazine called *Mothers-in-Law*. I could go on; I probably will. *Asian Babes* is another title that is not unfamiliar. In fairness, Mr. Desmond also publishes magazines such as *Worldwide Golf*, which as far as I can tell has nothing to it other than an interest in the game of golf.

In any event, the issue arose whether the then Secretary of State would refer the takeover of Express Newspapers. Events had moved on by that stage. During the new year celebrations of 2001, Mr. Desmond had told senior Labour figures that he was willing to offer them free advertising in the run-up to the election.

January was a busy month; Mr. Desmond's editor at *The Express* resigned, and on 7 February, the then Secretary of State announced that he would not refer the takeover of *The Express* to the Competition Commission. Only eight days later, on 15 February, it is understood that the Labour party banked Mr. Desmond's cheque for £100,000. To show that relations were particularly cordial and fraternal, Mr. Alistair Campbell attended Mr. Desmond's 50th birthday party in December.

**Mr. McWalter:** Does the hon. Gentleman accept that his remarks seem to be rather tenuously linked to any arguments that might encourage us to support amendment No. 63?

**Mr. Waterson:** That is more a matter for the Chair, although I do not accept the proposition for a moment. We are discussing public interest in mergers. The hon. Member for North-East Derbyshire, who has strong views about almost everything, although he puts his arguments with a certain charm, has strong views about whether Ministers of the Crown should be able to intervene in employment matters. He made a powerful case on that in the previous debate. However, some people and certainly some members of the Labour party have similar views about the activities of the party's donors, such as Mr. Desmond.

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Mr. Ken Purchase (Wolverhampton, North-East): Does the hon. Gentleman accept that many Labour Members believe that Mr. Desmond’s activities, so long as they are legal, are a matter for him and his shareholders? However, many of us would not take a penny-piece from a man who is nothing but a pornographer.

Mr. Waterson: I am not sure what the hon. Gentleman’s point is. That is his description of the gentleman involved, not mine. However, the Labour party has taken £100,000 in penny-pieces.

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Is interesting that when the Prime Minister was interviewed by Jeremy Paxman, who also reeled off a list of names of magazines, the Prime Minister seemed to invert the issue—

Madam Deputy Speaker: Order. I hope that the hon. Gentleman will be a little more concise and address his remarks to the amendment.

Mr. Waterson: Let me bring events forward to the present day and to the revelations that appeared in The Sunday Telegraph last Sunday. It reported:

"The Department of Trade and Industry conceded yesterday that there had been no scrutiny of Mr. Desmond’s on-line services which allowed paying customers to ask models to perform live sex acts."

I shall not go into any more detail than that, Madam Deputy Speaker, because I am sure that you would not wish me to. However, the criteria to be applied in the case of a major takeover—for example, of a newspaper—are extremely interesting and are relevant to the competition provisions in the Bill.

We are told that the Bill will put into legislation what has become the practice and that, under the Tebbit doctrine and the position as stated most recently by the then Secretary of State in 2000, the broader issues will not be taken into account. It is important to consider what has been happening and whether the provision is necessary.

When these issues came into the public domain, the attitude of the former Secretary of State was that he had merely followed the advice of officials. I assume that that is what will happen by law if we pass these provisions in the Bill. However, when the report of the Director General of Fair Trading saw the light of day, a different picture emerged. The director general had advised the Secretary of State that, on the competition issues, he could see no reason to refer the bid, but he pointed out that what he described as the non-competition issues were a matter for the Secretary of State. That is a subtle and rather important difference from what the former Secretary of State had told us earlier.

It emerges that the Home Office had been asked to advise, as had the Department for Culture, Media and Sport, about Mr. Desmond and his activities. The Home Office tetchily concluded that, as he was not breaking the law, it had no further comment to make.

However, as The Sunday Telegraph has now revealed, neither it nor anyone else was asked to consider the websites operated by the companies controlled by Mr. Desmond.

It is important to quote the hon. Member for Calder Valley (Chris McCafferty), who is reported as saying:

"I am astonished. It takes my breath away that the Government failed to examine the very worst side of Desmond’s empire. There should have been a thorough investigation at the time. The Government should make amends by launching a thorough investigation now."

Other Labour Members expressed similar concerns.

We must examine how the matter was dealt with, as there are major questions about how the DTI chose to conduct its investigation into the takeover of Express Newspapers. It would be, at the very least, surprising if Mr. Desmond’s colourful websites were not taken...
into account. We need to be told the precise criteria on which the former Secretary of State based his ultimate decision.

not to refer the bid, especially as the decision was followed only a few days later by a large donation to the Labour party.

Miss Melanie Johnson: The hon. Gentleman is inviting me to comment on what happened. It is hard to understand the relevance of his case to amendments Nos. 197 and 198—[ Interruption. ] I am seeking Madam Deputy Speaker's guidance. In light of the hon. Gentleman's concerns about pressure on time, it is hard to understand how his argument relates to the amendments.

Madam Deputy Speaker: I have drawn the hon. Gentleman's attention to the fact that he must speak more directly to the amendments, and I do so once again.

Mr. Waterson: I have made my points on that issue. I was not aware when I gave way to the hon. Lady that she wanted to make a point of order.

It is necessary to give the provisions careful consideration. Some of the amendments are new, in particular those that relate to newspapers, on which my hon. Friend the Member for South Cambridgeshire may wish to comment. Others are familiar from our deliberations in Committee.

We are worried that the Secretary of State will reserve not only powers to act in the public interest, but the power to add to the criteria they relate to the public interest. We do not know what the Government have in mind, which is understandable because they do not know what they have in mind. We feel strongly about the matter and intend to press the amendment to a Division. If the Government have nothing in mind, and I am sure that they are being open and honest with the House, they should leave the public interest definition as it is, without the power to add to it by regulation.

Mr. Lansley: Before I comment on the amendments, I want to explain why Mr. Desmond and the handling of his case by the then Secretary of State is relevant.

As Mr. Desmond was not a newspaper proprietor, his acquisition was not considered under the special newspaper transfer regime, as set up by the Fair Trading Act 1973. Instead, he was considered under the normal merger regime. As my hon. Friend the Member for Eastbourne (Mr. Waterson) made clear, the possible threat to the public interest by the acquisition of Express Newspapers by Northern and Shell could have been considered by the OFT. However, because it put competition as a primary duty, it chose to have no view and referred the problem to the Secretary of State who, although recognising that he had a responsibility, chose not to exercise it. My hon. Friend took us through the conjecture and speculation on why he chose not to consider the wider issues of public interest. We should not count out the fact that they exist, however.

The hon. Member for Wolverhampton, North-East (Mr. Purchase) and others, including the Prime Minister, seem to suggest that what is legal is by definition okay, and what is done legally must therefore be in the public interest. There is no mention of a subset of activities in relation to the ownership of newspapers under existing legislation that are legal but could adversely affect the public interest. I am afraid that the evidence points to the opposite.

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6.45 pm

In 1990, the Monopolies and Mergers Commission made a report on Mr. David Sullivan and his acquisition of the Bristol Evening Post. I will not quote at great length, but paragraph 6.13 of the report says:

"Were someone of Mr. Sullivan's business background and interests—

it may be recalled that Mr. Sullivan owned the Sunday Sport and other related newspapers—

"seen to have a significant influence in their affairs",

that is, the affairs of the Bristol Evening Post and Western Daily Press,

"their reputation could well be seen as compromised, particularly where the reporting of events with sexual aspects was involved. Were he to have acquired effective management control these effects could be expected to be more pronounced."
Essentially, the Monopolies and Mergers Commission was applying a test in relation to the accurate presentation of news and free expression of opinion.

The issue, therefore, is this. If at that time the consent to a transfer of a newspaper title was refused under the special newspaper transfer regime by reference to that test of the public interest—interestingly, we understand that the Government intend at some point to introduce a test of the public interest in relation to the plurality of newspaper ownership—surely the two things are related. The question whether the Government believe that there is a public interest in the ownership of newspapers and the consequences that flow from that for the accurate presentation of news or for free expression of opinion must be of the essence in relation to the amendments. I hope that I have demonstrated why the handling of Mr. Desmond's case is relevant to their consideration.

I shall deal first with amendments Nos. 197 and 198, which relate specifically to newspapers. On a number of occasions—interestingly, she even managed to do it earlier this afternoon—the Minister has asserted to the Committee and to the House that the Government have no intention of adding additional public interest, to be specified under clause 57. However, in paragraph 9.7.4 of the document published as a policy narrative to accompany the draft Communications Bill, the Government express their future intention in relation to that Bill, and, on newspaper ownership, state:

"the Secretary of State will retain the power to refer transfers for wider investigation by the Competition Commission by an extension of the provisions in the Enterprise Bill dealing with 'exceptional public interest'... cases."

Therefore, unless the Minister tells me something to the contrary, it is clearly the Government's intention, subject to consultation and scrutiny of the Bill, to bring newspaper ownership under clause 57 by way of an additional specification of national interest, but apparently we are not to debate that at this stage.

Before the Minister intervenes to say that amendments Nos. 197 and 198 do not do all that is required, I understand that subsequently clause 66 would need to be deleted and schedule 26 concerning repeals of the 1973 Act amended. One would have to remove the existing special newspaper transfer regime, but it is important, if we are legislating for what is to be in the Bill, that we do it now and have a clear indication of the circumstances in which Ministers would wish to specify an additional public interest. Plurality of newspaper ownership is one that has been suggested.

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Two sets of amendments seek to do slightly different things. That is why they are slightly testing the Minister. Amendment No. 143 would remove from the Secretary of State the ability to specify additional public interest considerations. My personal inclination is that relying on the general merger regime and competition considerations should be sufficient. I accept the argument that national security and what flows from it is an exception, but that should be the only exception. If I were pressed, I would say that amendment No. 143 should be pursued. I would similarly support amendment No. 53. It is likewise designed to remove from the Secretary of State what might otherwise become a politically motivated opportunity to inject additional public interest considerations that are not transparent in advance and not transparent to the marketplace for those who are contemplating or executing mergers.

If we are to have any additional forms of public interest, we should be told what they will be. My purpose in tabling amendments Nos. 197 and 198 is to ensure that we can know precisely, by way of the Government's response in due course—there might be one—what kind of newspaper ownership regime is contemplated. If, until now, a special newspaper transfer regime has operated on the basis of confining itself particularly to the accurate presentation of news and the protection of free expression of opinion, I believe that that is a sufficient basis upon which to undertake an examination of plurality of newspaper ownership. Those can be the factors for which we look. Is the diversity of newspaper ownership sufficient to deliver that?

To whom should that test be applied? Clearly, the merger regime has its own test in terms of market share and turnover. However, we have discovered over years past that where newspapers are concerned—I quote from the Government's "Consultation on Media Ownership Rules"—

"This regime has imposed significant costs on the industry and yet, out of 172 cases considered by the Secretary of State since 1990, only three have been refused and five given approval subject to conditions."

It is important that we structure a regime that is more deregulatory than that which went before it. We should not merely replicate the special newspaper transfer regime in new legislation.

It is interesting that the Government's consultation goes on to state:

"In no case has the Competition Commission found that the acquisition of purely local newspaper titles would be against the public interest on freedom of expression grounds."

Ministers and the Competition Commission have often found that quite high local concentrations of newspaper ownership are consistent with a continuing plurality of voice in the sense of free expression of
opinion. To respond to customers in those areas, newspapers often find that they must be responsive in that way. The opportunities for concentration of local newspaper titles throughout the country, although that has happened in recent years, has not necessarily led to centralised editorial opinion imposed on local newspapers from the controlling interest.

One of the consequences that flow from that is that the newspaper ownership regime could be structured in a way that excluded local newspaper titles. For these purposes, as a proxy, I have adopted the threshold of a circulation of 500,000 newspapers a day. That is a limit above which transfers of newspaper titles could be considered.

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Whether that approach should apply to existing newspaper proprietors or transfers of ownership in any circumstances is a difficult question. It is difficult to argue that maintaining plurality of newspaper ownership could mean that someone would be barred from the acquisition of a newspaper if he or she was not already a newspaper proprietor and there was no concentration of newspaper ownership.

The only circumstances in which that could be done would be if one were to reintroduce some test of whether someone acquiring a newspaper was a fit and proper person to do so. As the Minister said in Committee, and in her subsequent letter, it is difficult to envisage circumstances where someone could be excluded, on competition grounds, from owning a newspaper or acquiring an enterprise on the basis of whether he or she was a fit and proper person. That should be considered on the basis of disqualifications under the Companies Acts. However, with newspapers, a further question could arise about whether someone is seeking to limit the free expression of opinion or the accurate presentation of views by acquiring a newspaper. It is therefore important to find out more about what the Government are seeking to achieve by extending clause 57, contrary to their previously stated intention.

Amendment No. 143 would make competition the sole factor to be considered in the operation of merger policy, with the exception of national security. Amendment No. 142 is more technical; it will not be immediately obvious to people who are not as familiar with the Bill as Committee members that in clause 44, after the Secretary of State has given a public interest intervention notice and a reference back to him or her has been made by the Competition Commission, he or she has four options for subsequent decisions, two of which can be made in circumstances in which there is a finding of a substantial lessening of competition if a merger is completed or is being contemplated. The two remaining circumstances, given in clause 44(3) and (5), are ones in which there is no finding of a substantial lessening of competition, and the Secretary of State can take account only of public interest considerations.

Ministers have an obligation not to make a reference in or after the period of 24 weeks during which the Secretary of State is allowed to try to resolve the question of public interest by laying an order before Parliament and securing parliamentary approval; they will not make a reference after 24 weeks, and disregard any public interest consideration that has not been finalised. By contrast, the Secretary of State can make a reference before the 24 weeks have elapsed when there is a substantial lessening of competition. A loophole has therefore been created. Curiously, before the expiry of the 24-week period, there is nothing to stop the Secretary of State from making a reference to the Competition Commission on the ground that public interest considerations have not been finalised, and when there is no substantial lessening of competition.

One of the most undesirable circumstances in which a reference could be made is as follows. The Secretary of State has devised a public interest consideration, published an intervention notice, failed to come to the House to secure its approval to finalise the public interest, yet goes ahead and makes a reference to the Competition Commission. That loophole should be closed.

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In addition, in clause 45, for reasons that escape me, the Government say that when making a reference during or after the 24-week period the Secretary of State should specify

"the public consideration or considerations... in the intervention notice concerned which the Secretary of State is not under a duty to disregard".

Government amendment No. 234 deals with the same issue. However, if a reference is made before the end of the 24-week period and before a consideration is finalised, as outlined in clause 44(2) and (4), the Secretary of State is not required to disregard the public interest consideration; for completeness, clause 44 (3) should also be specified. It is astonishing that the Minister has gone down that route.

It being Seven o'clock, Madam Deputy Speaker, pursuant to Order [this day], put forthwith the Question already proposed from the Chair.

The House divided: Ayes 126, Noes 255.
House of Commons Hansard Debates for 13 Jun 2002 (pt 37)

Division No. 274

AYES

Ainsworth, Peter (E Surrey)
Allan, Richard
Hames, David
Bath, Rt Hon James
Atkinson, David (Bour'myth E)
Atkinson, Peter (Hexham)
Bacon, Richard
Baldry, Tony
Baron, John
Barrett, John
Bellingham, Henry
Bercow, John
Blunt, Crispin
Boswell, Tim
Bottomley, Rt Hon Virginia
Brady, Graham
Brezzi, Julian
Browning, Mrs Angela
Burns, Simon
Burnside, David
Burt, Alistair
Butterfield, John
Cable, Dr Vincent
Cameron, David
Carmichael, Alistair
Cash, William
Chapman, Sir Sydney
'Chipping Barnet
Chope, Christopher
Clappison, James
Clifton-Brown, Geoffrey
Collins, Tim
Cormack, Sir Patrick
Cran, James
Davey, Edward (Kingston)
Duncan, Alan (Rutland & Melton)
Duncan Smith, Rt Hon Iain
Evans, Nigel
Ewing, Annabelle
Fabian, Michael
Field, Mark (Cities of London)
Flight, Howard
Flonk, Adrian
Forth, Rt Hon Eric
Foster, Don (Bath)
Gale, Roger
Garnier, Edward
Gibb, Nick
Gidley, Sandra
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Grayling, Chris
Green, Damian (Ashford)
Grieve, Dominic
Gummer, Rt Hon John
Hawkins, Nick
Hayes, John

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Key, Robert
Kirkbride, Miss Julie
Laing, Mrs Eleanor
Lait, Mrs Jacqui
Lamb, Norman
Lansley, Andrew
Laws, David
Leigh, Edward
Liddell-Grainger, Ian
Lidington, David
Lilley, Rt Hon Peter
Loughton, Tim
Luff, Peter
McIntosh, Miss Anne
MacKay, Rt Hon Andrew
Maclean, Rt Hon David
Mates, Michael
Mawhinney, Rt Hon Sir Brian
May, Mrs Theresa
Mercer, Patrick
Moss, Malcolm
M'shane, George (Tatton)
M'tawey, Richard
Page, Richard
Paice, James
Patterson, Owen
Pickles, Eric
Portillo, Rt Hon Michael
Prisk, Mark
Pugh, Dr John
Redwood, Rt Hon John
Robathan, Andrew
Robertson, Hugh (Faversham)
Roe, Mrs Marion
Rosindell, Andrew
Ruffley, David
Russell, Bob (Colchester)
Sayeed, Jonathan
Selous, Andrew
Simmonds, Mark
Simpson, Keith (Mid-Norfolk)
Spicer, Sir Michael
Stanley, Rt Hon Sir John
Steen, Anthony
Swayne, Desmond
Swire, Hugo
Syme, Robert
Tappell, Sir Peter
Taylor, Ian (Esher & Walton)
Taylor, John (Solihull)
Taylor, Sir Teddy
Thurso, John
Tredinnick, David
Tyrie, Andrew
Viggers, Peter
Walter, Robert
Waterson, Nigel
Watkinson, Angela
Whittingdale, John
Widdecombe, Rt Hon Miss Ann
Wiggin, Bill
Wilkinson, John
Willis, Phil
Wilshere, David
Winter, Nicholas (Macclesfield)
Yeo, Tim

Tellers for the Ayes:

Mrs. Cheryl Gillan and
Mr. Laurence Robertson.
NOES

Adams, Mrs Irene (Paisley N)
Ainsworth, Bob (Cov'try NE)
Allen, Graham
Anderson, Rt Hon Donald
(Swansea E)
Anderson, Janet (Rossendale)
Armstrong, Rt Hon Ms Hilary
Atkins, Charlotte
Austin, John
Banks, Tony
Barnes, Harry
Barron, Kevin
Bayley, Hugh
Bennett, Andrew
Benton, Joe
Berry, Roger
Blackman, Liz
Blizard, Bob
Brennan, Kevin
Browne, Desmond
Buck, Ms Karen
Burden, Richard
Burn, Colin
Cairns, David
Campbell, Alan (Tynemouth)
Campbell, Mrs Anne (C'bridge)
Campbell, Ronnie (Blyth V)
Casale, Roger
Caton, Martin
Cawsey, Ian
Challen, Colin
Chapman, Ben (Wirral S)
Chaytor, David
Clapham, Michael
Clark, Dr Lynda
(Edinburgh Pentlands)
Clark, Paul (Gillingham)
Clarke, Rt Hon Tom (Coatbridge)
Clwyd, Ann
Cocker, Vernon
Coffey, Ms Ann
Cohen, Harry
Coleman, Iain
Colman, Tony
Connor, Michael
Cook, Frank (Stockton N)
Cooper, Yvette
Cox, Tom
Cranston, Ross
Crausby, David
Cruddas, Jon
Cryer, John (Hornchurch)
Cummings, John
Cunningham, Jim (Cov'try S)
Dalyell, Tam
Davey, Valerie (Bristol W)
David, Wayne
Davidson, Ian

Davies, Gerald (Croydon C)
Davis, Rt Hon Terry
(B'Ham Hodge H)
Dawson, Hilton
Dean, Mrs Janet
Dhanda, Parmjit
Dobbin, Jim
Donohoe, Brian H
Dowd, Jim
Drew, David
Drown, Ms Julia
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Eagle, Maria (L'pool Garston)
Ellman, Mrs Louise
Ennis, Jeff
Field, Rt Hon Frank (Birkenhead)
Fitzpatrick, Jim

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Todd, Mark
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Truswell, Paul
Turner, Dennis (Wolverhampton SE)
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Turner, Neil (Wigan)
Twigg, Stephen (Enfield)
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Vis, Dr Rudolf
Ward, Ms Claire
Wareing, Robert N
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Whitehead, Dr Alan
Williams, Rt Hon Alan
(Swansea W)
Winnick, David
Winterton, Ms Rosie (Doncaster C)
Wood, Mike
Woodward, Shaun
Woollas, Phil
Worthington, Tony
Wright, Anthony D (Gt Yarmouth)
Wright, David (Telford)
Wright, Tony (Cannock)
Wyatt, Derek

Tellers for the Noes:

Derek Twigg and
Mr. Nick Ahnger.

Question accordingly negatived.

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Remaining Government amendments agreed to.

Bill, as amended in the Standing Committee, to be further considered tomorrow.
The noble Lord said: This group comprises a number of minor and technical amendments which all relate to the enforcement provisions of the merger regime. I do not believe that they raise any issues of substance. Members of the Committee will have received a letter setting out briefly the purpose and nature of the amendments. However, if it is helpful to the Committee I shall provide further details of the amendments we are tabling.

Amendments Nos. 120, 126, 132, 142 to 144 and 150 clarify what happens where a merger referred to as an anticipated merger becomes a completed merger during the course of an investigation or vice versa. That will happen only rarely. Amendments to Clauses 36, 48, 63, 104 and 125 provide that undertakings or orders that were accepted on one basis continue to have effect where the nature of the merger reference changes. The automatic restrictions on certain dealings in Clauses 74 and 75 will also apply as if the merger reference had been made on the relevant basis at the outset.

Amendments Nos. 127 to 129 and 139 make clear that the normal enforcement provisions contained in Clauses 74 to 78 apply to public interest cases where the public interest claim is withdrawn and the case is passed back to the Competition Commission to be investigated purely on competition grounds.

Amendments Nos. 135 and 135 are minor technical corrections to Clause 75 which take out references to Clauses 68 and 69, orders and undertakings. These are concerned only with completed mergers and are therefore not relevant in the context of anticipated mergers.

Amendments Nos. 137 to 140 make clear that if a replacement order is made under Clause 80, it is only specified undertakings which fall away. An order under Clause 80 will be brought when undertakings are not being fulfilled. It would not be desirable to penalise all parties where only one is in breach of its undertaking.

Amendments Nos. 165 and 166 are technical amendments to improve internal drafting consistency by aligning references to airport operators with language used elsewhere in Schedule 5. I beg to move.

On Question, amendment agreed to.

Clause 36, as amended, agreed to.

Clause 37 agreed to.

Clause 38 [Time-limits for investigations and reports]:

[Amendments Nos. 121 and 122 not moved.]

Clause 38 agreed to.

Clause 39 agreed to.

Clause 40 [Duty to remedy effects of completed or anticipated mergers]:

[Amendment No. 123 not moved.]

Clause 40 agreed to.

7.15 p.m.

Clause 41 [Intervention by Secretary of State in certain public interest cases]:

Baroness Turner of Camden moved Amendment No. 124:

Page 26, line 39, at end insert—

"( ) "Public interest consideration" in subsection (2) shall include possible social consequences, including the effect on employment."

The noble Baroness said: Amendment No. 124 stands in my name and that of my noble friend. It is clear that the Government want to hand over responsibility in merger and takeover situations to the OFT and the commission, and the sole criterion, as we heard this
evening, appears to be competitiveness.

There is a clause about public interest but it seems clear that government intervention is only envisaged in the most extreme circumstances. I believe that to be wrong. It is surely clear that many mergers and takeovers have considerable social consequences, and only governments can deal with those. Indeed, they may have to if the consequences involve high unemployment in a particular region.

The TUC is concerned about that. It says in briefing:

"The danger for the Government is that removing Ministers from competition decisions will not prevent politically damaging situations arising, but will curb their ability to act when they do".

If a company is a major employer, local communities and other local firms may be hit; regional development may be interrupted or brought to an end altogether. In other words, a large merger or takeover could affect adversely many thousands of people and not only those in the immediate environment.

We have recently been witnesses, as I said on the earlier amendment, to another round of mergers and takeovers—referred to as "merger mania". A recent newspaper article said that many of the deals were done when share prices were roaring. So the predators overpaid for their targets and are now having to write down huge amounts of money in their accounts to reflect the subsequent slump in value. That is the reason, perhaps, why Vodafone is nursing the biggest loss in Britain's corporate history.

Norwich Union and the CGU merged to become Aviva. But that lovely new name has not prevented a halving of the share price in 18 months. So it is not only employees in the relevant companies that suffer—often through job loss or demotion—shareholders suffer too, and of course pension funds. We have heard a great deal about a pensions crisis in recent weeks. The catastrophic drop in the stock market is cited as one of the reasons for the disappearance of defined benefit schemes. There may of course be other reasons as well, but a drop in share values clearly has made a major impact. So mergers and takeovers are not just about competitiveness.

Those are some of the reasons why the Trades Union Congress is saying that it does not agree that decisions as to whether mergers and takeovers should proceed should be made only on the basis of competition. The TUC believes that mergers and takeovers should be regulated in the public interest and that the impact on employment should be taken into account.

Our amendment is very simple; indeed it is modest. We are seeking to introduce it in the part of the Bill dealing with the public interest. We define that as possible social consequences, including the effect on employment. In those circumstances we believe the Government should be able to intervene. I urge my noble friend the Minister to accept the amendment. I beg to move.

Lord Hoylak: I support Amendment No. 124 in the name of my noble friend Lady Turner and myself. Again, I echo what my noble friend said. The Government are trying, in their words, to escape from political decisions; but what they cannot escape from are the consequences of those decisions. To remain on one side, or to pretend to do so, and simply rely on competition when social consequences are taking place is a decision they will regret in the longer term.

Perhaps I may give the media as one example. News International, owned by Rupert Murdoch, has newspapers read by 70 per cent of adults in this country. That is almost a monopolistic position yet the draft Communication Bill does not rule out a further take-over by that group. Of that 70 per cent, The Times is the best-selling "heavy". The Sun sells 4 million copies daily. Quite apart from The Sunday Times there is the News of the World which is the largest-selling Sunday paper.

I am not in favour of or against or get too excited about the euro, but there is something to be said as regards Rupert Murdoch. He has already determined that before any referendum takes place his media interests will be opposed to the euro. That is a very dangerous position. Any further decision must have social consequences. I cannot see any Government, particularly one whom I support, backing away from taking that into account.

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There is also the question of employment. Not very long ago it appeared that Rover was in a difficult situation which would have had grave consequences for the whole of the West Midlands. Given that situation, the Minister put together a rescue package because of the consequences which would have affected not only the company but all the suppliers in the area. There would also have been a devastating effect on the whole of the region.

What would happen if there were another bid for Rover? Could any Government, Minister or Secretary of State escape from the social and employment consequences? Given some of the circumstances, it is totally unrealistic to rely on competition. I hope that the Minister will look a little further. He realised that he did not satisfy us on the previous occasion. We are speaking here about public interest which can have tremendous social and employment consequences for the whole of the region and, as regards the media, for the whole nation. I ask him to accept this modest amendment, particularly having regard to the social consequences of a merger.
Lord Sainsbury of Turville: The amendment seeks to indicate a further public interest consideration, that the Secretary of State could intervene on decisions about mergers. I say to my noble friend Lord Hoyle that when we consider newspapers a different set of considerations are taken into account. The plurality of the press is covered by the Fair Trading Act and will be updated by the Communication Bill. A different set of considerations apply in that case. I shall be talking about other companies.

As the Bill stands, the competition authorities will take decisions on mergers on the basis of a focused competition test. The Secretary of State has power to intervene in a case that raises a public interest issue, which she believes should be specified in legislation. At present we foresee a need for ministerial intervention on national security grounds only. That is the only consideration specified in the Bill.

The Government have considered the case for specifying further matters, but we do not anticipate that Ministers will need to intervene in any other matters. That is why the Bill does not mention social effects or the effects on employment.

Switching away from the current public interest test to a competition test for assessing mergers has involved hard thinking and tough choices. It is a focused policy. We believe that in the vast majority of cases the economy is best served if mergers are assessed solely on the basis of their effect on competition and that these decisions are best taken by the expert competition authorities operating independently of Ministers.

Merger regulation is best aimed at safeguarding the competitive intensity in the economy. Competition provides the spur for businesses to be more productive, innovative and efficient, better able to provide long-term, sustainable employment and better products and services for consumers.

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Adding social and employment factors to the test for mergers would create barriers to market restructuring. We believe that it is wrong to create such barriers unless there are significant and competitive effects. Restructuring must be possible if companies and markets are to remain dynamic and competitive.

I recognise, of course, that mergers can have adverse social and employment impacts in the short term, but I do not believe that the answer is to indicate that Ministers should step in on such grounds. That way lies uncertainty and unpredictability with political lobbying creeping back into the whole process.

The task for the Government is to make sure that the economy as a whole is strong and to help people who are affected to adapt, retrain and get new jobs. We have a good record for creating the conditions for a dynamic economy which can adjust to change. We have the lowest unemployment rate since the 1970s, the lowest rate of inflation and the lowest interest rates since the 1960s. We have record numbers of people in work because private sector employment has increased by 1.25 million over the past five years. We remain the number one destination for foreign, direct investment into Europe.

I should like to make a further important point. It is to set the reforms to the merger regime in the context of the existing fair trading legislation and how it has operated. In practice, competition has been the principal factor in the UK merger policy for many years. In 1984, the then Secretary of State for Trade and Industry, the noble Lord, Lord Tebbit, announced that references would be made primarily on competition grounds. That has been a pursued by every subsequent Secretary of State. When one looks at the reports of the Competition Commission on mergers one finds that the employment effects and other non-competition effects of mergers, other than national security issues, are not matters that have determined decisions in recent years. Legislating for a focused competition test is not something which will make a large difference in practice to the way in which mergers are currently regulated.

Finally, I mention the mechanism of the Bill which provides for factors other than competition and national security being considered, should this prove necessary in the future. I shall explore that in more detail in a moment as regards Amendment No. 131. It is worth noting in relation to this amendment that the power in Clause 57(3), together with the power of intervention set out in Clause 41, represent a careful balance. This amendment would tip that balance. As we have said before, we have no current plans to specify new public interest considerations. We have built in appropriate checks on the use of this power, which we believe are essential to preserve the predictability of the new regime. However, we also believe that the mechanism provides an important safety valve which will ensure that the very exceptional case can be dealt with appropriately. In the light of this explanation, I invite the noble Baroness to withdraw the amendment.

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Baroness Turner of Camden: I thank the Minister for that explanation. He will not be surprised to learn that I find it disappointing
because it has always been the case that competitiveness has been the sole criterion since the Tebbit test. That does not necessarily mean that it has always been right or that people have not suffered as a result of it being applied. In fact, we know of cases where that has happened. The policy that my noble friend has enunciated will not prevent the Government being lobbied when people believe that they are being disadvantaged. Quite obviously, people will make a fuss if they feel that they are being harmed as a result of decisions made within the criteria laid down in this Bill.

However, I do not intend to press the matter further now. I should like to think about it and then decide what further action I might wish to take at Report stage. I beg leave to withdraw the amendment.

Amendment, by leave, withdrawn.

Lord Davies of Oldham: I beg to move that the House do now resume. In moving the Motion, I suggest that we return to this business not before 8.30.

Moved accordingly, and, on Question, Motion agreed to.

House resumed.

Regulation of Investigatory Powers (Maintenance of Interception Capability) Order 2002

7.30 p.m.

The Parliamentary Under-Secretary of State, Home Office (Lord Filkin) rose to move, That the draft order laid before the House on 22nd May be approved (31st Report from the Joint Committee).

The noble Lord said: My Lords, this order has been made in exercise of the powers conferred on the Secretary of State by Section 12(1), (2) and (5) and Section 78(5) of the Regulation of Investigatory Powers Act 2000 (RIPA).

Part I of Chapter I of RIPA updates the previous law in the UK governing the interception of communications. It provides for and regulates powers to allow lawful interception of communications by law enforcement, security and intelligence agencies, consistent with the Human Rights Act 1998. It also creates a system of safeguards reflecting the requirements of Article 8 of the European Convention on Human Rights.

In the United Kingdom, interception is only conducted under warrants authorised personally by the Secretary of State and where it is deemed necessary in the interests of national security for the purpose of preventing or detecting serious crime, or for safeguarding the economic well-being of the UK.

In short, the order under the Act gives the Secretary of State the authority to require communications service providers, which could be a telephone company or a postal service, to put in place an infrastructure capable of intercepting communications when a warrant is issued.

18 Jul 2002: Column 1468

with proper authority for them to do so. So the order is not about the actual interception, but the putting in place of an interception capability, as the title implies.

The schedule to the order lists those obligation which appear to the Secretary of State reasonable to impose on communications service providers for the purpose of securing the information required. The obligations under Part I provide for public postal services and public telecommunication services being required to respond.

There has been lengthy consultation on the order. Also RIPA established a Technical Advisory Board. As the House may well know, it is a non-departmental public body, with the right and the role to comment on draft orders or draft notices made under the Act and to give advice to the Secretary of State. If approved by the House, the order will take effect on 1st August 2002. The Secretary of State’s power to impose the obligations in the order shall be exercised through a notice issued to specific communications service providers. So it is order, then notices and then—if the provision is in place—in future times, warrants to undertake interceptions.

The Government intend that a notice given to a CSP will, wherever possible, be the product of prior dialogue and agreement between the Government’s representatives and the CSP in question. However, should a CSP consider that a notice given to it is unreasonable, it is able to make reference to the Technical Advisory Board, as I indicated.

Clearly, there are issues of financial burdens imposed on CSPs in setting up such an infrastructure or responding to specific warrants. Therefore, the Act imposed a requirement on the Secretary of State to make a fair contribution to the costs incurred as a consequence of those obligations. For example, last year alone, CSPs received some £14 million from the Government. But there is under way a fuller consultation process with the industry about trying to develop the costing regime and the compensation framework to compensate for it.

Without more ado, I commend the order to the House. I beg to move.
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 £70 million;

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 24th 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

Andrew Rees
An official of the Department for Business Enterprise and Regulatory Reform
GOVERNMENT ACTS ON HBOS - LLOYDS TSB MERGER PROPOSALS

The Secretary of State for Business and Enterprise John Hutton today announced his intention to issue an intervention notice in the proposed merger of HBOS and Lloyds TSB on public interest grounds to ensure the stability of the UK financial system.

Under Section 42 of the Enterprise Act 2002 the Secretary of State can extend public interest grounds. The Secretary of State will lay the necessary affirmative Order in Parliament when the House returns after Summer recess. Currently public interest grounds cover only plurality of media ownership and national security. His decision follows advice from the UK Tripartite Authorities (HM Treasury, Bank of England and the Financial Services Authority).

Note to Editors:

1. The Department for Business Enterprise and Regulatory Reform helps UK business succeed in an increasingly competitive world. It promotes business growth and a strong enterprise economy, leads the better regulation agenda and champions free and fair markets. It is the shareholder in a number of Government-owned assets and it works to secure, clean and competitively priced energy supplies.
Alan Duncan MP  
House of Commons  
London SW1A 0AA  

17 September 2008

Dear Alan,

I am writing to inform you that I have today issued an intervention notice under Section 42 of the Enterprise Act 2002 in relation to the anticipated merger between [Lloyds Bank Group plc] with [HBOS plc]. I enclose a copy of the intervention notice.

The intervention notice cites a new public interest consideration concerning "the stability of the UK financial system". I now need to obtain Parliament's approval for this new public interest consideration to be specified under Section 58 of the Enterprise Act 2002. This involves making an order that is subject to the affirmative resolution procedure and, therefore, must be debated in both Houses of Parliament. I intend to lay a suitable order as soon as Parliament reconvenes on 6 October.

I have placed a copy of this letter and the intervention notice in the libraries of the House.

Yours faithfully,

JOHN HUTTON

1 Victoria Street, London SW1H 0ET
www.berr.gov.uk
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 24th October 2008.

The Secretary of State proposes to finalise this 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
Sarah Tether MP
House of Commons
London SW1A 0AA

17 September 2008

Dear Sarah,

I am writing to inform you that I have today issued an intervention notice under Section 42 of the Enterprise Act 2002 in relation to the anticipated merger between [Lloyds Bank Group plc] with [HBOS plc]. I enclose a copy of the intervention notice.

The intervention notice cites a new public interest consideration concerning "the stability of the UK financial system". I now need to obtain Parliament's approval for this new public interest consideration to be specified under Section 58 of the Enterprise Act 2002. This involves making an order that is subject to the affirmative resolution procedure and, therefore, must be debated in both Houses of Parliament. I intend to lay a suitable order as soon as Parliament reconvenes on 6 October.

I have placed a copy of this letter and the intervention notice in the libraries of the House.

Yours,

John Hutton

JOHN HUTTON

I Victoria Street, London SW1H 0ET
www.berr.gov.uk

Enquiries +44 (0) 20 7215 5000 | Minicom +44 (0) 20 7215 5740 | Email berr.correspondence@berr.gsi.gov.uk
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 24th 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
Dearest Peter,

I am writing to inform you that I have today issued an intervention notice under Section 42 of the Enterprise Act 2002 in relation to the anticipated merger between [Lloyds Bank Group plc] with [HBOS plc]. I enclose a copy of the intervention notice.

The intervention notice cites a new public interest consideration concerning "the stability of the UK financial system". I now need to obtain Parliament's approval for this new public interest consideration to be specified under Section 58 of the Enterprise Act 2002. This involves making an order that is subject to the affirmative resolution procedure and, therefore, must be debated in both Houses of Parliament. I intend to lay a suitable order as soon as Parliament reconvenes on 6 October.

I have placed a copy of this letter and the intervention notice in the libraries of the House.

Yours sincerely,

John Hutton

JOHN HUTTON

1 Victoria Street, London SW1H 0ET
www.berr.gov.uk
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 £70 million;

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 24th 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
Submission: Creation of a new Public Interest Specification for Merger Intervention Powers

Issue

1. The previous Secretary of State issued an intervention notice in relation to the Lloyds TSB Group merger with HBOS plc on the 18 September. He also announced that he would lay an Order in Parliament when it reconvenes from its recess to seek a new public interest consideration under Section 58 of the Enterprise Act 2002 on the grounds of "stability of the UK financial system".

Recommendation

2. That you:

   • Approve and sign the draft Order, Explanatory Memorandum and Impact Analysis to be laid in Parliament.

   • Decide whether it would be helpful if a Treasury Minister be made available for the House of Commons Select Committee on 16 October and if possible, a relevant Lord representing HMT at the Lords Chamber (Lord Bach is the Treasury Whip)

Timing

3. Immediate. We need to lay the Order and supporting documentation in Parliament by close of play 6 October at the very latest.

Presentation

4. We will issue a brief Press Notice noting that the Order has been laid, giving reasons for the intervention. We will provide a draft shortly.
5. Following the announcement that Lloyds TSB Group and HBOS plc are to merge on 17 September, the previous Secretary of State agreed to a request from HMT to issue an Intervention Notice to the OFT and to lay an Order in Parliament to seek a new public interest consideration citing "stability in the UK financial system". The purpose of the intervention is to allow the Secretary of State to make the final decisions in the merger taking into account the new public interest consideration, alongside the competition analysis. The OFT has been instructed to deliver its reports by the 24 October, by which time we expect the Order to be passed and entered into the Statute, allowing the Secretary of State to make use of the power to make the final decisions in this merger case.

6. Section 58 of the Enterprise Act allows the Secretary of State to introduce a new public interest consideration by Order through the affirmative resolution procedure. This means that the order must pass through both Houses of Parliament. I attach suitable draft Order, Explanatory Memorandum and Impact Analysis (and the legal certificates for Parliamentary Unit) for your approval and signature.

7. In order to speed the process and having checked with the Secretary of State's office, we have already given draft copies of the Order and supporting documentation to the Joint Committee for Statutory Instruments (JCSI) and the House of Lords Committee for Statutory Instruments. The JCSI will review the Order at its next meeting on the 15 Oct and the Lords Committee will review it at its first meeting on 14 October.

8. The Commons will take the Order in Committee, planned for the 16 October at 08.55 which Malcolm Wicks had agreed to be lead Minister as Gareth Thomas will be overseas. However, the Government changes announced today mean that Parliamentary Unit will need to arrange for another Minister to take the Order to Committee. HMT have offered to also make a Treasury Minister available to cover the wider financial issues. The House of Lords will debate the Order in the Chamber also on the 16 October 1.30 and you have agreed to be the lead Minister. We could request that HM Treasury make available Lord Bach (HM Treasury Whip) if you felt that would be helpful. We will prepare suitable briefing for those Ministers taking the order through the parliamentary process.

Paul Bannister
Order made by the Secretary of State, laid before Parliament under section 124(7) of the Enterprise Act 2002, for approval by resolution of each House of Parliament within twenty-eight days beginning with the day on which the Order was made, subject to extension for periods of dissolution, prorogation or adjournment for more than four days.

STATUTORY INSTRUMENTS

2008 No. 2645

COMPETITION

The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008

Made 6th October 2008
Laid before Parliament 7th October 2008
Coming into force 24th October 2008

In exercise of the powers conferred by sections 58(3) and 58(4) and 124(2) and 124(4) of the Enterprise Act 2002(1), the Secretary of State makes the following Order:

Citation, commencement and transitional provision

1.—(1) This Order may be cited as the Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008 and shall come into force on 24th October 2008.

(2) This Order shall apply in relation to cases under consideration by the OFT, OFCOM, the Commission or the Secretary of State before the making of this Order as well as cases under consideration on or after the making of this Order.

Amendment of section 58 of the Enterprise Act 2002

2. In section 58 of the Enterprise Act 2002 (specified considerations), after subsection (2C) insert—

"(2D) The interest of maintaining the stability of the UK financial system is specified in this section (other than for the purposes of sections 67 and 68 or references made, or deemed to be made, by the European Commission to the OFT under article 4(4) or 9 of the EC Merger Regulation)."

Amendment of sections 129 and 130 of the Enterprise Act 2002

3.—(1) In section 129(1) of that Act (definitions), after the definition of "supply" and before the word "and" which follows it insert—

"the UK financial system" means the financial system in the United Kingdom;="

(2) In section 130 of that Act (index of defined expressions), in the table, after the entry for "The turnover in the United Kingdom of an enterprise" insert the following entry—

(a) in the first column, "The UK financial system", and

(b) in the second column "Section 129(1)".

Amendment of Schedule 8 to the Enterprise Act 2002

4. In Schedule 8 of that Act (provision that may be contained in certain enforcement orders), after paragraph 20A insert—

"Maintaining the stability of the UK financial system"
20B.—(1) This paragraph applies for the purposes of a relevant order under paragraph 5, 10 or 11 of Schedule 7 (enforcement orders in cases relating to the stability of the UK financial system) but not for any other purposes of Part 3 or 4 or any other enactment.

(2) The order may make such provision as the person making the order considers to be appropriate in the interest of maintaining the stability of the UK financial system.

(3) Such provision may, in particular, include provision requiring a person to do, or not to do, particular things.

(4) This paragraph is without prejudice to the operation of the other paragraphs of this Schedule in relation to the order.

(5) In this paragraph "relevant order" means an order—

(a) which is to be made following the giving of an intervention notice or special intervention notice which mentions the consideration specified in section 58(2D) (including, in the case of a notice given before the consideration was so specified, an intervention notice which mentions the consideration as a consideration which ought to be specified in section 58); and

(b) to which the consideration is still relevant.

Baroness Vadera
Parliamentary Under Secretary of State for Business and Competitiveness
Department for Business, Enterprise and Regulatory Reform

6th October 2008

EXPLANATORY NOTE
(This note is not part of the Order)

Where a relevant merger situation has been created or arrangements are in progress 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"), the Secretary of State has the power to give a notice to the Office of Fair Trading if he believes that it is or may be the case that one or more than one public interest consideration is relevant to a consideration of the relevant merger situation. Section 59 provides the Secretary of State with a similar power to issue an intervention notice in a special merger situation, as defined in section 58(3) of the Act.

A public interest consideration is defined as one which, at the time of the giving of the intervention notice, is specified in section 58 of the Act or is not so specified but, in the opinion of the Secretary of State, ought to be so specified. The Secretary of State has the power, under section 58(3), to modify section 58 for the purpose of specifying a new consideration.

This Order also inserts a new paragraph 20B into Schedule 8 to the Act. Paragraph 20B gives the Secretary of State the power to use orders to specify the new public interest consideration of the interest of maintaining the stability of the UK financial system. The new public interest consideration will be available in the case of a relevant merger but not in the case of a concentration with a Community dimension. The Secretary of State will have the power, under paragraph 20B of Schedule 8 to the Act, to use orders made under paragraph 5, 10 or 11 of Schedule 7 to the Act to make such provision as he considers to be appropriate in the interest of maintaining the stability of the UK financial system. Paragraph 5 enables the Secretary of State to make an order where undertakings, which have been accepted by him, are not being fulfilled and paragraphs 10 and 11 enable the Secretary of State to make final orders.

A full impact assessment of the effect this Order will have on the costs and benefits for business has been prepared by the Department for Business, Enterprise and Regulatory Reform and is available from the Consumer and Competition Policy Directorate, 1 Victoria Street, London SW1H 0ET and can also be found at http://www.berr.gov.uk/ccp/topics2/pdf2/pomccria.pdf.

(1) 2002 c. 40; section 58 and Schedule 20 were amended by the Communications Act 2003 (c. 21), section 375(1) and 387. Back [1]
GOVERNMENT ACTS TO ENSURE FINANCIAL STABILITY

The Department for Business today laid an Order in Parliament to enable Ministers to intervene and make decisions on mergers that may impact on the UK’s financial stability.

The Government announced it would be seeking Parliamentary approval for this change on 18 September, at the same time as it issued an intervention notice in relation to the proposed merger of Lloyds TSB Group plc with HBOS plc.

Minister for Economic Competitiveness and Small Business, Shriti Vadera, said today:

"The Government took swift action in relation to the proposed merger of Lloyds and HBOS to support the UK financial system.

"In the present economic climate it is vital that financial stability can be considered alongside competition questions."

The Order must now be passed by both Houses of Parliament.

ENDS

Notes to Editors:
1. Section 42 of the Enterprise Act gives the Secretary of State the power to issue an intervention notice to the Office of Fair Trading where he suspects that a merger or a proposed merger may raise issues that relate to a public interest consideration that has been specified under Section 58 of that Act.
2. Section 58 of the Enterprise Act currently specifies two considerations as being matters of public interest namely, national security and plurality of media ownership. Section 58 also provides
for the Secretary of State to specify new public interest
considerations by Order.
3. The Office of Fair Trading issued an Invitation for Comments on the
18 September inviting submissions on the proposed Lloyds TSB –
HBOS merger. The OFT must deliver its report to the Secretary of
State by the 24 October 2008.
EXPLANATORY MEMORANDUM TO

THE ENTERPRISE ACT 2002 (SPECIFICATION OF ADDITIONAL SECTION 58 CONSIDERATION) ORDER 2008

2008 No.

1. This Explanatory Memorandum has been prepared by the Department for Business Enterprise and Regulatory Reform and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 This Order specifies maintaining the stability of the UK financial system as a public interest consideration under Section 58 of the Enterprise Act 2002 ("the Act") enabling the Secretary of State to intervene on this basis in a relevant merger as defined in section 23 Enterprise Act 2002.

2.2 This Order is being proposed in light of the extraordinary stress in the financial markets and, specifically in the case of the proposed Lloyds TSB Group plc/HBOS plc merger, to provide for careful and urgent consideration of financial stability as part of the overall public interest assessment relating to the proposed transaction. The timing is urgent as the Secretary of State is unable to make decisions on the proposed Lloyds TSB/HBOS merger until Parliamentary approval is received for the Order. The urgency is essential in order to give both certainty to the market on the regulatory framework and certainty for the proposed Lloyds/HBOS merger.

3. Matters of Special Interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 Section 23 of the Act provides that a "relevant merger situation" arises for the purposes of the Act where two or more enterprises cease to be distinct and where either the UK annual turnover of the enterprise being acquired is in excess of £70 million or the combined enterprises would, as a result of the merger, have a market share for the supply of particular goods or services that is in excess of 25% of the UK market or of the market in a substantial part of the UK.

4.2 Under Section 42 of the Act, the Secretary of State may intervene in a relevant merger where he believes that a public interest consideration specified in Section 58 of the Act is or may be relevant to a consideration of the merger. Where such an intervention is made, the Office of Fair Trading (or in the case of a media merger, Ofcom) must provide a report to the Secretary of State, within such time as he may specify, in accordance with Section 44 of the Act. The Secretary of State must then take decisions in accordance with Section 45 of the Act on whether to refer the case to the Competition Commission or to clear the merger.

4.3 Where the Secretary of State intervenes on the basis of a new public interest consideration he believes should be specified in Section 58 of the Act but which has not yet been finalised, he is required to take the necessary action to finalise the proposed new public interest consideration as soon as practicable.
4.4 Section 58(3) of the Act provides that the Secretary of State may add new public interest considerations by Order. Section 124(7) provides that the Order is to be made and then laid before Parliament where it needs to be approved, by resolution of each House, within 28 days.

4.5 The new public interest consideration does not apply to concentrations with a European dimension and therefore the ECMR does not apply. The new consideration will be available for use only in respect of relevant UK merger situations that fall within the jurisdiction of the UK competition authorities, as is the case with the proposed Lloyds TSB/HBOS merger.

5 Extent

5.1 This instrument applies to all of the United Kingdom.

6 European Convention on Human Rights

6.1 I am satisfied that this Order is compatible the European Convention on Human Rights.

7 Policy Background

7.1 Advice from the Tripartite authorities (HM Treasury, Bank of England, Financial Services Authority) stressed the importance of significant weight being given to financial stability issues alongside competition questions in the assessment of the proposed merger between Lloyds TSB and HBOS. The Secretary of State also considers that the proposed merger may raise public interest considerations of the highest order on grounds that maintaining financial stability within the UK should be a public interest consideration. The Order will enable the Secretary of State to consider public interest issues alongside competition issues in making his final decisions on this proposed merger.

7.2 As provided for in the Act, the Secretary of State has already issued an intervention notice on the basis of the new public interest consideration in anticipation of making the necessary order and finalising the new consideration. This 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.

7.3 The Enterprise Act 2002 provides for the regulatory consideration of all mergers and acquisitions by the competition authorities on the basis of a merger's effects on competition in the relevant market. The Act also provides that the Secretary of State may intervene in any merger he considers raises concerns relevant to a public interest consideration that has been specified in the Act or that he believes should be so specified. Presently, there are two public interest considerations specified in the Enterprise Act – national security and plurality, quality and standards in the media. This order will introduce a third consideration of maintaining the stability of the UK financial system. Since the coming into force of the Enterprise Act 2002, the power to intervene in mergers on public interest grounds has been used seven times: five times on national security grounds in respect of mergers in the defence sector, once on media plurality grounds and now once on the basis of this new consideration.

7.4 The financial services sector is vital to the rest of the economy. It matches the resources of savers to the needs of borrowers; provides firms and individuals with the
means to make and receive payments; and provides channels for the distribution and
diversification of risk. Financial instability in the financial services sector can disrupt
these functions and have a damaging effect on the wider economy. In particular, the
failure of a bank, building society or other deposit-taking firm would leave customers
— individuals or businesses — unable to access savings, to raise finance or to meet
obligations. A single bank failure has the potential to spread to other parts of the
financial system through consequent effects on consumer confidence, through the
inter-bank lending market, or through other channels. This, in turn, can have knock-
on negative effects for the wider economy. For these reasons, the failure of a bank
can involve greater and more widespread costs to the economy than that of a similar
size business in a different sector. Creating this new public interest consideration will
enable the interest of maintaining the stability of the UK financial system to be taken
into account when considering and taking decisions about relevant UK merger
situations.

8. Impact Assessment

8.1 An Impact Assessment has been prepared for this Order and is attached to this
Explanatory Memorandum.

9. Contact

9.1 Paul Bannister at the Department for Business Enterprise and Regulatory
Reform, telephone 0207 215 5009 or e mail paul.bannister@berr.gsi.gov.uk can
answer any queries regarding this instrument.
What is the problem under consideration? Why is government intervention necessary?

In the light of extraordinary stress in the worldwide financial markets and specifically, in the case of the proposed Lloyds TSB Group merger with HBOS plc and the systemic importance of HBOS to the UK banking system, the Secretary of State considered that there is a need to act quickly as there is a serious threat to the stability of the UK financial system.

Financial instability has a damaging effect on the wider economy. The failure of a bank can involve greater and more widespread costs to the economy than that of a non-financial firm of a similar size, as it has the potential to spread to other parts of the financial system through the effect on consumer confidence (contagion), through the inter-bank lending market, or through other channels. This, in turn, can exert a negative externality on the wider economy.

Having received advice from the Tripartite Authorities (HM Treasury, Bank of England and the Financial Services Authority), the Secretary of State believes mergers in the banking sector are capable of giving rise to concerns relevant to the financial stability of the UK.

Advice from the Tripartite Authorities also stressed the importance that significant weight should be given to the financial stability issues alongside competition questions in the assessment of the proposed Lloyds TSB Group merger with HBOS plc. There was also a need to give clarity to the market on the regulatory framework and some certainty for the proposed merger.

The Chancellor, the FSA and the 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. It would not have been possible for that deal to be completed without the Government issuing an intervention notice and so it was important that this action was taken immediately.

What are the policy objectives and the intended effects?

The Financial Services sector and the banking sector in particular, are vital to the rest of the economy. It matches the resources of savers to the needs of borrowers, provides firms and individuals with the means to make and receive payments, and provides channels for the distribution and diversification of risk. Financial instability in the financial services sector can disrupt these functions and have a damaging effect on the wider economy. In particular, the failure of a bank, building society or other deposit-taking firm would leave individuals and businesses unable to access savings, raise finance or meet day to day financial obligations.

Creating this new public interest consideration will enable the interest of maintaining the stability of the UK financial system to be taken into account when considering and taking decisions about relevant UK merger situations. This should alleviate the potential consequences of increased financial instability set out above.

What policy options have been considered? Please justify any preferred option.

The following options have been considered:

- Do nothing
- A private-sector merger, achieved through an Order under the Enterprise Act identifying 'stability of the UK financial system' as an additional public interest consideration
When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The power to intervene in mergers on the basis of a public interest consideration specified under Section 58 of the Enterprise Act 2002 will be available unless and until the consideration concerned is removed from the statute.

Ministerial Sign-off For final proposal/implementation Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: ____________________________ Date: ____________________________
### ANNUAL COSTS

| Description and scale of key monetised costs by 'main affected groups' |
| Taking no action is likely to have significant impact on shareholders and some depositors of financial institutions that may fall as a result of increased financial stability. Parties in the wider economy may be affected via the transmission of these risks through the financial system and beyond. |

<table>
<thead>
<tr>
<th>One-off (Transition) Yrs</th>
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<td>N/A</td>
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**Average Annual Cost (excluding one-off)**

| N/A |

**Total Cost (PV)**

**Other key non-monetised costs by 'main affected groups'**

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### ANNUAL BENEFITS

**Description and scale of key monetised benefits by 'main affected groups'**

There are likely to be negligible benefits to a situation in which no action is taken, as this could lead to increased instability of the UK financial system.

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<th>One-off Yrs</th>
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<td>N/A</td>
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</table>

**Average Annual Benefit (excluding one-off)**

| N/A |

**Total Benefit (PV)**

**Other key non-monetised benefits by 'main affected groups'**

---

**Key Assumptions/Sensitivities/Risks**

---

### Price Base

**Year 07/08**

**Time Period**

**Years 0**

---

**What is the geographic coverage of the policy/option?**

United Kingdom

**On what date will the policy be implemented?**

October 2008

**Which organisation(s) will enforce the policy?**

BERR

**What is the total annual cost of enforcement for these organisations?**

Negligible

**Does enforcement comply with Hampton principles?**

Unclear

**Will implementation go beyond minimum EU requirements?**

No

**What is the value of the proposed offsetting measure per year?**

£ 0

**What is the value of changes in greenhouse gas emissions?**

£ None

**Will the proposal have a significant impact on competition?**

Yes

**Annual cost (£-£) per organisation (excluding one-off)**

<table>
<thead>
<tr>
<th>Amount (Baseline)</th>
<th>£ 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ 0</td>
<td></td>
</tr>
</tbody>
</table>

**Are any of these organisations exempt?**

N/A N/A N/A N/A N/A

---

**Impact on Admin Burdens Baseline (2005 Prices)**

**Increase £ N/A**

**Decrease £ N/A**

**Net £ N/A**

---

**Key:**

Annual costs and benefits: Constant (£) ££ ££ ££ ££
## ANNUAL COSTS

| Description and scale of key monetised costs by ‘main affected groups’ |
|---|---|
| One-off (Transition) Yrs | The measure has no general impact on costs to business. Introducing the possibility of making such interventions and making decisions on the basis of the new public interest consideration is a factor that business will need to take into account when contemplating a merger. |
| Average Annual Cost (excluding one-off) | |
| Total Cost (PV) | |
| Other key non-monetised costs by ‘main affected groups’ |

## ANNUAL BENEFITS

| Description and scale of key monetised benefits by ‘main affected groups’ |
|---|---|
| One-off Yrs | The benefits of increased financial stability of the UK through having the power to intervene in mergers on the basis of a public interest consideration. At the present time it is not possible to provide an assessment of the precise economic benefits that may arise from making such an intervention. |
| Average Annual Benefit (excluding one-off) | |
| Total Benefit (PV) | |
| Other key non-monetised benefits by ‘main affected groups’ |

### Key Assumptions/Sensitivities/Risks

Specifying this new public interest consideration will enable public interest interventions to be made so that the effects of mergers on the financial stability of the UK can be taken into account in taking merger decisions. Whether or not it is appropriate to use the power in respect of a particular merger will depend on the circumstances of the case.

### Price Base

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>07/08</td>
<td>Years 0</td>
<td>October 2008</td>
</tr>
</tbody>
</table>

### What is the geographic coverage of the policy/option?

<table>
<thead>
<tr>
<th>United Kingdom</th>
</tr>
</thead>
</table>

### On what date will the policy be implemented?

| October 2008 |

### Which organisation(s) will enforce the policy?

| BERR |

### What is the total annual cost of enforcement for these organisations?

| [? ] |

### Does enforcement comply with Hampton principles?

| No |

### Will implementation go beyond minimum EU requirements?

| No |

### What is the value of the proposed offsetting measure per year?

| | | |

### What is the value of changes in greenhouse gas emissions?

| | | |

### Will the proposal have a significant impact on competition?

| Yes |

### Annual cost (£-£) per organisation (excluding one-off)

| N/A | N/A | N/A | N/A |

### Are any of these organisations exempt?

| N/A |

### Impact on Admin Burdens Baseline (2005 Prices)

| Increase | £ N/A | Decrease | £ N/A | Net | £ N/A |

### Key:

- Increase
- Decrease
- Net
IMPACT ASSESSMENT
The Enterprise Act 2002 (Specification of Additional Public Interest Consideration) Order 2008

INTRODUCTION

The financial services sector makes a vital contribution to the rest of the economy by: matching the resources of savers to the needs of borrowers; providing firms and individuals with the means to make and receive payments; and providing channels for the distribution and diversification of risk. The contribution of financial service has increased from 6.2 per cent of UK GDP in 1997 to 9.4 per cent in 2006.

The financial stability of UK economy is therefore clearly a matter of public interest. Further, private sector mergers, especially between financial institutions, can be an important tool for maintaining that stability. It is therefore important that any benefits of a merger to the financial ability of the UK are considered alongside the effects of that merger on competition. Adding “the stability of the UK financial sector” to the list of public interest considerations will allow both factors to be considered in cases where I issue an intervention notice.

This Impact Assessment is structured as follows:

- Section 1 - background and rationale for government action.
- Section 2 - brief review of the cost and benefits analysis
- Section 3 - Specific Impact Tests with special attention paid to the impact on Competition and Small Firms.
- Section 4 - assessment of the affected groups and sectors.
- Section 5 - Summary and Recommendation.

Background and Rationale for new public interest consideration

In light of the current extraordinary stress in the global financial markets there has been a marked increase in the risk of bank defaults which in turn threaten the stability of the UK financial services sector. Should stability of the UK financial services sector be undermined the effects are likely to be long lasting.

The financial services sector is vital to the rest of the economy. It matches the resources of savers to the needs of borrowers; provides firms and individuals with the means to make and receive payments; and provides channels for the distribution and diversification of risk. Financial instability in the financial services sector can disrupt these functions and have a damaging effect on the wider economy. In particular, the failure of a bank, building society or other deposit-taking firm would leave customers – individuals or businesses – unable to access savings, to raise finance or to meet obligations. A single bank failure has the potential to spread to other parts of the financial system through consequent effects on consumer confidence, through the inter-bank lending market, or through other channels. This, in turn, can have knock-on negative effects for the wider economy.
For these reasons, the failure of a bank can involve greater and more widespread costs to the economy than that of a similar size business in a different sector. 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.

Creating this new public interest consideration will enable the interest of maintaining the stability of the UK financial system to be taken into account when considering and taking decisions about relevant UK merger situations.

CONSULTATION

Within Government

In laying this order, BERR has received representations from HM Treasury, which itself received advice from the Financial Services Authority and the Bank of England.

Wider Consultation


OPTIONS REVIEW (Including Benefits and Costs)

The actual economic benefits and costs of this additional power to intervene in mergers will depend upon the specific impact on the particular circumstances of those cases in respect of which the power is used. However, the analysis below outlines the potential costs and benefits in broad terms.

Option 1 - Do nothing

Benefits

There are no tangible benefits to not implementing the public interest order.

Costs

There would be no way for the Secretary of State for BERR to intervene in a merger to ensure that financial stability implications were considered alongside competition issues. A merger can make a significant contribution to ensuring the financial stability of the UK economy. In the case of such a merger, if competition issues were considered in isolation and this delayed or prevented the merger this would damage the stability of the financial services sector which is worth 9.4% of the UK economy (2006). In particular, if the absence of the merger caused the failure of the bank this would prevent individuals and businesses from accessing savings, raising finance or meeting obligations. The resultant effect on consumer confidence and the inter-bank lending market, particularly during current financial conditions, would mean that in some cases such a failure would have significant effect on the rest of the financial sector. Either there would be significant economic costs as a result, or the Government would be required to intervene. The latter could involve a need for taxpayer funding.

Option 2 – implement additional public interest consideration, as proposed

Benefits

This option allows the Secretary of State to consider the implications of a proposed merger for both competition and financial stability, in those cases where he or she chooses to intervene. This will ensure that the overall public interest is served in the consideration of that merger. In cases where a merger is considered essential for maintaining financial stability and where this
outweighs any competition concerns, the benefits could include: preventing the failure of a financial institution, protecting depositors and maintaining market confidence (particularly important during the current market stresses). Further, if a private sector solution could not be found and a financial institution was at risk it may be necessary for the Government to intervene in a way which incurs taxpayer expense.

**Costs**

There are no direct economic costs of implementing a public interest order and the measure has no general impact on costs to business.

The Secretary of State may, as a result of this power, allow a merger to proceed which would have been prevented purely on competition grounds or prevent a merger which would have been allowed purely on competition grounds. However, he will only do so when it serves the overall public interest.

**SPECIFIC IMPACT TESTS**

**Competition Assessment**

According to the OFT's guidelines "Completing competition assessments in impact assessments", the purpose of conducting an impact assessment from a competition law viewpoint is to consider whether the proposed regulation prevents, restricts or distorts competition (OFT876, page 7). Whilst adopting a power to intervene in mergers on the basis of their impact on the public interest as it relates to the financial stability of the UK does not necessarily directly prevent, restrict or distort competition, exercising the power under that order could potentially have an impact on competition in financial services in some cases. However, this power does provide for non-competition impacts to be taken into account when taking decisions about certain mergers, such that competition is no longer the only relevant consideration.

**Small Firms Impact Tests**

Smaller firms – who by definition have smaller capital bases – are disproportionately vulnerable to adverse changes in the availability of liquidity in the marketplace. The protection that this new consideration would offer to small firms against systemic instability adds to the protection that the competition regime would otherwise provide.

**AFFECTED SECTORS AND GROUPS**

The consideration could apply to any merger. It is our expectation that this would primarily apply to the financial services sector, however – including banks, building societies and mutuals, and other financial service providers – where the performance and viability of firms in the sector has a direct impact on financial stability more widely.

**SUMMARY AND RECOMMENDATION**

The addition of a new public interest consideration of financial stability to the existing considerations under the Enterprise Act 2002 allows the SoS to act to protect the UK economy from the damaging effects of financial instability.

For an intervention to be undertaken in the public interest, the SoS would have to be convinced that the benefits of acting in the public interest outweighed the opposing case for allowing the competition regime to run its course, based on assessments from the Office for Fair Trading, the Financial Services Authority and the Bank of England. The Government remains committed to supporting competition as a fundamental characteristic of dynamic, solvent financial markets.
By taking this step Government is moving to ensure that conditions in these markets are sufficiently stable to enable these forces to operate.
Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

<table>
<thead>
<tr>
<th>Type of testing undertaken</th>
<th>Results in Evidence Base?</th>
<th>Results annexed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competition Assessment</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Small Firms Impact Test</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Legal Aid</td>
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<tr>
<td>Human Rights</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Rural Proofing</td>
<td>No</td>
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</tr>
</tbody>
</table>
No Annexes are attached to this Impact Assessment
The Creation of a new Public Interest Consideration on Stability of the UK Financial System

Background

The Enterprise Act 2002 ("the Act") provides for the regulatory investigation of mergers largely on the basis of their effect on competition in markets. The provisions for investigation apply to mergers that breach certain thresholds relating to the annual UK turnover of the enterprise being acquired, or the combined market share of a market or markets covered as a result of the merger.

The responsibility for the investigation of mergers falls to the Office of Fair Trading, and the Competition Commission where a merger is referred, the UK's independent competition authorities. Mergers are investigated on the basis of whether they will lead to a substantial lessening of competition which generally provides the most effective method for promoting competition in markets, promoting efficiency and innovation, whilst also protecting the needs of consumers.

The Act also, however, provides limited powers for the Business and Enterprise Secretary of State to intervene in mergers in order to protect legitimate public interest considerations. Section 58 of the Act specifies the public interest considerations that the Secretary of State may intervene in - currently national security and plurality of media ownership - and also allows him to add new considerations when the need arises. Any new consideration can be added by Order through an affirmative resolution procedure which must be passed through both Houses of Parliament.

Process

On the 17 September 2008, Lloyds TSB Group plc announced that it proposed to merge with the HBOS plc. On the 18 September 2008 the Business and Enterprise Secretary of State issued an Intervention Notice to the Office of Fair Trading under Section 42 of the Enterprise Act and announced that he would lay an Order in Parliament when it reconvened from its summer recess to seek a new public interest consideration to be specified under Section 58 of the Act.

The Order was laid on 7 October, and if Parliament passes it the Order will, for example, give the Secretary of State the power to consider the public interest issues of the "stability of the UK financial system" alongside the competition issues in making his final decision on the proposed merger between Lloyds TSB Group plc and HBOS plc. The new public interest consideration will apply to those UK mergers which do not fall to be regulated under the European Merger regulation (ECMR 139/2004).

As a result of the intervention notice issued on 18 September 2008, the Office of Fair Trading will provide a report to the Secretary of State on the effect of the proposed merger on competition in the market, and on the public interest
consideration on stability of the UK financial system, by 24 October 2008. Based on these reports, and any other submissions or representations that are made to him, the Secretary of State will take the final decisions on the proposed Lloyds/HBOS merger, provided the Order is passed by Parliament.

Reasons for the intervention and for making an order to specify a new public interest consideration

In deciding to make the order to specify the "stability of the UK financial System" as a new public interest consideration, the Secretary of State has had regard to the fact that the Financial Services sector and the banking sector in particular, are vital to the rest of the economy. They match the resources of savers to the needs of borrowers, provide firms and individuals with the means to make and receive payments, and provide channels for the distribution and diversification of risk. Financial instability in the financial services sector can disrupt these functions and have a damaging effect on the wider economy.

The failure of a bank, building society or other deposit-taking firm would leave individuals and businesses unable to access savings, raise finance or meet day to day financial obligations. A single bank failure has the potential to spread to other parts of the financial system through its effect on consumer confidence, the inter-bank lending market and through other channels. The failure of a single bank can involve greater and more widespread costs to the economy than that of a similar sized business in a different sector.

In the light of extraordinary stress in the worldwide financial markets at the time of the proposed Lloyds/HBOS merger, and the systemic importance of HBOS plc to the UK banking system, the Secretary of State considered that there was a need to act quickly and intervene in the proposed merger given the serious threat to the stability of the UK financial system. This enables stability of the UK financial system to be taken into account, along with competition effects, in regulatory decisions relating to the merger.

In making his decision to intervene and to specify the new public interest consideration the Secretary of State took advice from the Tripartite Authorities - HM Treasury, Bank of England and the Financial Services Authority - who stressed the importance that significant weight should be given to the financial stability issues alongside competition questions in the assessment of the proposed Lloyds/HBOS merger. The Secretary of State was also mindful of the need to give clarity to the market on the regulatory framework, and some certainty for the proposed merger.

7 October 2008
Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008

1.29 pm

The Secretary of State for Business, Enterprise and Regulatory Reform (Lord Mandelson) rose to move, That the order laid before the House on 7 October be approved (SI 2008/2645).

The noble Lord said: My Lords, it is a great honour to speak for the first time in this House. I want to begin by thanking your Lordships for the wonderfully warm welcome I have received from all sides of the House over the past few days and also from the staff who work here and add so much to the character of the House. It means a lot to me; it is nice to be back.

Being greeted by such a succession of noble Lords these past few days—many old friends and former colleagues—has been like replaying the last 30-odd years of my life, starting in the Wilson years and moving through the eras of Callaghan, Foot, Kinnock, Smith and then Blair. I know that a lot of people think of me as being quintessentially new Labour—indeed, who could doubt that?—but my roots go deeper. One of the privileges of being a Member of your Lordships' House is the richness of the political experience drawn from past decades that I have benefited from over the years, and which is available to our debates today.

Of course, my greatest wish is that my parents were alive today. My gregarious father loved mixing with politicians. When I was a boy, he was not above driving his car into the precincts of Parliament, although not a Member, relying on a cheery wave and a copy of Hansard left casually on the back shelf of his car to reassure the policeman on the gate—in those days it was a single policeman on the gate. My mother had more mixed feelings about politicians. The daughter of one, and then the mother of another, she had no appetite for more.

The House is very different from the one my that my grandfather attended. Its breadth is wider. It is more representative. It is also a House that takes its scrutiny role very seriously, as I know from my European experience. There is not only a breadth but a depth in this House—something that might be more generally acknowledged.

More than 50 years ago, my grandfather, making his maiden speech in this House, spoke of the Marshall plan and its importance in rebuilding the shattered economies of the allied countries of Europe after the Second World War. Now, as then, the world must come together to secure the future of its financial systems and the international architecture supporting them, at a time of deep uncertainty and turbulence in global markets.

A strong, stable banking system is essential to support and protect the investments, savings and loans that help us grow our economy and succeed as individuals. Further to the recent measures announced by the Prime
Minister and Chancellor to put the British banking system on a sounder, more secure long-term footing, private sector mergers can play an important role in helping a financial institution in difficulty.

It is critical that in cases where a proposed merger could bolster financial stability in the UK’s economy, the overall public interest is served by a proper consideration of the need for stability, alongside the implications for competition.

I beg to move, therefore, that your Lordships consider the Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008, Statutory Instrument No. 2645. The order was considered by the Lords Merits of Statutory Instruments Committee at its meeting on Tuesday.

Merger control in this country is regulated under the Enterprise Act and the European Community merger regulations, with the Office of Fair Trading and Competition Commission responsible for investigating UK mergers on the basis of their impact on competition in UK markets.

The Enterprise Act provides limited powers for the Secretary of State for Business, Enterprise and Regulatory Reform to intervene in mergers to protect legitimate public interests. Public interest considerations are currently defined under Section 58 of the Act as ensuring national security and plurality of media ownership. Section 58 also provides the Secretary of State with the power to specify additional considerations, when necessary, to protect the public interest.

As noble Lords will be aware, my right honourable friend John Hutton—my predecessor at the Department for Business, Enterprise and Regulatory Reform—announced on 18 September that he had issued an intervention notice in respect of the proposed Lloyds TSB group merger with HBOS plc. He also announced that he would place an order seeking the necessary power to enable him to take into account the vital public interest issues surrounding this merger.

Let me be clear. It is not that the merged bank would be sheltered, if the merger goes ahead, from competition law. Were there to be any evidence of market abuse at some future time—not that I expect any such behaviour—the normal powers will be available to the competition authorities to protect consumers.

The order specifies the maintenance of stability in the UK financial system as a public interest consideration under Section 58 of the Enterprise Act 2002—a new public interest consideration. This will enable the Secretary of State to intervene in those mergers in order to be able to make the final decisions based on the vital public interest of financial stability, alongside the competition issues.

As Secretary of State, I am unable to take decisions on this merger until parliamentary approval is received for the order. Subject to approval of the
order by your Lordships, I will ensure that I receive all available advice and views before I make any decisions. This will include advice from the Treasury, the Bank of England and the FSA, which make up the tripartite authorities. I am sure that your Lordships would agree that swift, decisive action is needed to give investors the regulatory certainty that they need and to send a clear signal to the market about the proposed merger between Lloyds TSB group and HBOS.

The order will allow us to make careful and urgent consideration of financial stability an additional part of our assessment process, and as a result, support our work to help millions of UK businesses and families get through these very difficult times. It is a critical addition to the public interest considerations specified in the Act and I commend it to your Lordships.

Moved, That the order laid before the House on 7 October be approved (SI 2008/2645).—(Lord Mandelson.)

Lord Hunt of Wirral: My Lords, on behalf of us all, I welcome the noble Lord to the House of Lords and congratulate him not only on his appointment as Secretary of State for Business, Enterprise and Regulatory Reform but on his very accomplished maiden speech.

He led us on a fascinating and absorbing journey through history. There are many lessons to be learnt from the events that he described. We also share his pride in his family’s contribution in the past. We also thank him for the way in which he praised the width and depth of the experience of this place. We all value the contribution that he is going to make, given his impressive career to date. His tributes to colleagues, in particular to the staff, will be much appreciated and are reciprocated by us all.

As I was reminded by one of my more senior colleagues, the Minister, now that he is a life Peer, can be introduced only once in the House of Lords. Under the present system, we will all work together until death do us part. He has now indeed joined the aristocracy. Revisiting my well thumbed copy of his book, The Blair Revolution, which was published in 1996, I came across his reference to Joseph Chamberlain’s biblical allusion and comment on the aristocracy:

"they toil not, neither do they spin".

Although the Minister may find it necessary to toil in his new post, I am sure that he will already have reflected deeply on the second part of that formulation, and so we look forward to hearing from him on many future occasions as we toil together in the public interest. We in this House assure colleagues in the other place that we intend to hold the noble Lord and his fellow Ministers fully to account in this place.

This is not the first experience that the noble Lord and I have of working together. I have many memories of our partnership 30 years ago when together we ran the British Youth Council. Here I declare my interests as set
out in the Register of Members' Interests. In the spirit of transparency, perhaps I should also declare a generous gift that he gave to me when I completed my term as president of the council. He arranged for me to receive a Toby jug, and I admire him for his forethought. This object now beams at me from my mantelpiece with the well known face of Neville Chamberlain. I do not think that I have ever thanked him enough. Although I greatly appreciated that gesture three decades ago, with all its nuances and subtexts, I assure him that, although we on this Front Bench will approach each issue on its merits and will not oppose for the sake of opposing, we shall not adopt a policy of appeasement.

There has been broad cross-party consensus, both here and in another place, on the Government's response to the banking crisis. Although we on these Benches have repeatedly made it clear that we will not stand in the way of the Government's efforts to deal with the crisis—this also applies to the order—a number of points and questions need to be raised. Although no one seriously queries the need for significant intervention in the banking sector at this juncture, we should pause for a moment before making our next foray into this minefield of moral hazard.

The Bank of England is the long-established lender of last resort and the provider of liquidity of last resort. By establishing Her Majesty's Government as the owner of last resort, we have entered almost entirely uncharted waters. Implicit in everything that we are discussing today is a recognition that the levers that we had in place before this crisis have proved to be inadequate. This is probably the most fundamental point of all. The biggest and most pressing question today, therefore, is what convincing assurances, if any, the Government can give for the future. How can we now feel confident that the merged superbank that we are helping to create today will not abuse its dominant position in the market? It is implicit in the order that competition issues are being raised. What do we need to do in addition to what we are doing today? What will the management of this new entity be required to do to allay the legitimate concerns of Which? and a number of other bodies about market power?

In the Northern Rock case, we on these Benches, strongly supported by the Liberal Democrats, said that the Government should lay annually before Parliament a report on the impact on the competitiveness of the market in the UK of any merger that might proceed by virtue of that emergency legislation. We said further that it should report to Parliament as soon as it identified a significant adverse effect on the competitiveness of the market in the UK as a result of that merger. Our concerns are, if anything, greater in this case. The Minister referred to those concerns in his opening speech, but we need more detail.

1.45 pm

The Explanatory Memorandum makes it clear that the order is intended specifically to address the HBOS/Lloyds-TSB case. However, the investments announced this week in several of our biggest banking names serve only to
underline our wider concerns. It would be helpful if the Minister explained how the Government have addressed competition issues across the board. The Explanatory Memorandum further indicates that the new public interest consideration will not be available in the case of a merger or a takeover with a European Union dimension. Is it correct to assume that the specific ground on which the HBOS/Lloyds-TSB merger avoids breaching the regulation is the two-thirds rule? If so, will the Minister confirm for the record under which threshold the Alliance and Leicester/Santander transaction avoids such a breach?

The Government claim to have adopted the five principles of good regulation set out by the Better Regulation Task Force. I remind your Lordships that these are proportionality, accountability, consistency, transparency and targeting. Will the Minister describe the procedure that he has been through to ensure that the order complies with these principles? I emphasise accountability in particular. Accountability does not imply a one-off debate here or in another place; it must be ongoing. The departmental impact assessment of the order fails to provide concrete figures for one-off or annual costs either to UK plc or the public purse. We appreciate that time is of the essence, and I fully understand that the order has necessarily been drafted with considerable urgency, but will the Minister confirm that such costs are genuinely anticipated to be zero over the medium to long term, or at least negligible? It is by no means a negligible action to amend an Act of Parliament as the order does.

We all hope that this period of crisis management is coming to an end and the Government can establish themselves as the master of events, not the victim. Only then will we start to see confidence return to the market. If the most violent part of this economic squall is indeed over, we must turn our attention to the well-being of the real economy, for which we hold the Government responsible. Against that background, the Minister now holds probably just about the most important departmental brief in government. The resilience of every firm in this country will be sorely tested in the months, and possibly years, ahead. In business, as in life, survival is all. A healthy banking sector is an essential foundation stone for our economy, but it is not the be-all and end-all. By buttressing the banks, we make it possible for British firms of every shape and size to survive now and flourish later, but we cannot make that inevitable. Most of the real hard work remains to be done, and our thoughts are with every individual and business, particularly our small businesses, at the present time.

As we seek to get the economy back on its feet, the order is not the end. To paraphrase a wise old statesman in another place, it is not even the beginning of the end, although it is perhaps the end of the beginning.

**Lord Razzall:** My Lords, like the noble Lord, Lord Hunt of Wirral, I congratulate the new Minister on his appointment and on his elegant and eloquent maiden speech. I am sure that the Minister appreciates that he cannot avoid his reputation, which precedes him here. Indeed, such was his reputation when I made my maiden speech 11 years ago— at a time when it
was rumoured that he had instructed every Labour Member of Parliament to wear a pager on which to receive his instructions—that I was considerably embarrassed when my pager went off in the middle of my speech. I was even more embarrassed when someone from the far reaches of the Cross Benches loudly shouted: “Oh my God, he’s got Peter Mandelson on the phone!”

No one has commented on the welcome that the Minister received from the civil servants in the department upon his return after 10 years. It is very much an indication of the respect in which they held him at the time and which they obviously continue to hold. He has to be congratulated on that as well.

I agree with almost everything that the noble Lord, Lord Hunt of Wirral, said. There is a concern that the world has moved on, in terms of HBOS/Lloyds, since the order was first mooted. Had the order been brought in immediately after the announcement of the HBOS/Lloyds merger, the concerns now being expressed in this House and elsewhere would not have arisen. With the share-price variations of the two companies, we do not know whether the merger will take place. Assuming that it does, it will be in circumstances in which the Government will have taken a significant stake in both banks. That poses a problem for the Government, but it also gives them leverage to deal with a number of the competition and consumer issues causing concern.

It is not as if the banking industry has been noted for its non-competitive business practices. As the consumer organisations have drawn to everyone’s attention, over the years the banks have been in serious difficulties over practices such as ATM charging; the mechanics of the clearing system, whereby no one quite knows what happens to their money after it leaves one bank account and before it appears in another; and unfair overdraft charging, on which the banks have often been criticised. The merger is not taking place in what is, prima facie, a competitive environment. Two major high street banks—which on some reports will have 30 to 40 per cent of UK current account business—are being put together in a way which would never have been allowed were it not for the current circumstances of the economy.

The noble Lord, Lord Hunt of Wirral, raised a number of the concerns that consumers, consumers’ organisations and noble Lords will inevitably have. Due to their increased power with the banks, the Government have the opportunity to insist on rigorous conditions. For example, will they attempt to impose on the merged bank a similar restriction on the proportion of retail deposits that it can have? It is understood that such a requirement was imposed on Northern Rock, so that it could not have more than 1.5 per cent of the aggregate retail deposits in the UK. As a result, the week before last Northern Rock had to close many accounts because of a danger of breaching the 1.5 per cent threshold. Will the Government impose a similar requirement on this bank?

What will the Government do where there is a branch of Lloyds and of HBOS in the same street or the same town? Will closures be required? Will there be a restriction on the number of closures? Theoretically, these banks are
competing with each other. What will be the Government's position on closures?

Which? is concerned that the two banks will be allowed to maintain separate banking licences, thereby triggering separate calculations for purposes of deposit protection. If someone has £50,000 deposited with Lloyds and £50,000 with HBOS, will they have £50,000 protection for each deposit following the merger, or will they lose the protection in one of the banks?

This is an important moment for the Government and for regulation of the banking sector. This order will go through—only a lunatic would attempt to vote against it at this sensitive time—but the Government should at least look very hard at what undertakings they can extract in the HBOS/Lloyds merger in order to provide proper protection for the consumer.

Baroness Kingsmill: My Lords, I offer my noble friend my heartfelt welcome to this House. Perhaps I may also say how pleased I am that we will have the benefit of his skills and talents in charge of this very important ministry, which will add to the tremendous skills already being displayed by the Prime Minister and the Chancellor of the Exchequer in tackling the banking crisis that we are facing.

I commend the order in the sense that I welcome the extension to this sector of the powers under the Enterprise Act to intervene in circumstances where the public interest is at stake. Financial stability is the paramount public interest issue. However, I am concerned about the Lloyds-TSB/HBOS merger. I should draw to the attention of the House an interest: I advise another banking group. However, I feel able to speak on this matter because, a little while ago, when I was deputy chairman of the Competition Commission, I had the privilege of chairing the inquiry into the proposed Lloyds-TSB/Abbey National merger, which was a much smaller merger. I commend to your Lordships the report into that merger. It gives a good insight into exactly what Lloyds-TSB might do as a merged entity.

Other noble Lords have already referred to the merged entity's large market share of current accounts and mortgages. In the business model of our high street banks, the current account is the entry product, if you like, because the business model is based on the need to cross-sell. Others have referred to some of the difficulties which the banks have gotten into by being forced to cross-sell, perhaps often inappropriately, because they make no money at all from current accounts. I ask the Minister to take careful note of the risks to consumers of this very large merged entity. At the moment, the cards are all in the air in the banking market. We may have part-nationalised banks, and we will have a very large merged entity. The competitive landscape in banking is uncertain. Given that, will the Minister take careful account of the risks to the consumer?

There should be more than simply a reliance on the existing powers of the OFT to intervene. For all its merits and strengths, that body moves rather slowly in this area. We need to be certain that this matter will be subject to
careful scrutiny. Does the Minister propose to look at the situation after two years to ensure that there has been no market abuse? Can he explore the possibility of securing pre-merger undertakings from Lloyds-TSB/HBOS?

2 pm

Lord Billimoria: My Lords, I congratulate the noble Lord on his appointment and on a super maiden speech. Having accompanied him in his previous role on visits to India, I look forward in my role as the chair of the UK India Business Council to working closely with him in the future.

The order before us concerns the global financial crisis, which we all noticed rapidly unfolding during the summer Recess. I could not help but think that to the world at large, we in Parliament may have appeared to look like Nero fiddling while Rome burned. I felt very frustrated and helpless. We have now been back for almost two weeks. Earlier this week the noble Lord, Lord Peston, asked why we have not had a major debate lasting a whole day on the global financial crisis. The noble Lord, Lord Davies, said that we have had three Statements and that Questions had been tabled. Yesterday, at the weekly meeting of the Independent Cross-Bench Peers, this issue was brought up again. There was a unanimous request not just for one major debate lasting a day but for a series of regular debates. I ask the noble Lord to institute such debates.

One of the greatest strengths of this House is that we have experts in every field. What more could we ask for when considering global business? We have some of the world's most famous economists, academics, captains of industry, entrepreneurs and chairs of banks, former Chancellors, Chief Secretaries to the Treasury and a former Secretary of State for business. We are not tapping into all the expertise of this House enough. During a debate on just one of the Statements made last week, the issue of using preference shares to support the banks was raised. Three noble Lords instinctively, on the spot and without preparation, said that the Government might have to consider convertible preference shares and that they might have to consider equity. That sort of instant expertise is available in this House, so why do the Government not use it more?

The Government are to be congratulated on offering £500 billion-worth of support; indeed, the whole world is congratulating our Government and looking to them, which is fantastic. But I ask the Minister to use this House. Today in Switzerland, that bastion of financial stability, we heard that two of the most famous banks in the world require support. A debate that I tabled on the reform of global institutions has been waiting in the pipeline for months, while just this week the Prime Minister said that we need a new Bretton Woods. That suggestion should be debated right now. With unemployment rising and the possibility of a long and deep recession, what could be more important to this House than business? We have other matters to discuss, but this is the priority now, otherwise we in Parliament could be accused of being
ostriches with our heads in the sand or of living in an ivory tower and wearing tinted glasses, and thus not looking out at the real world. At long last we have a Secretary of State for business who is a Member of this House. I urge the noble Lord as Secretary of State and all noble Lords to make the most of it and to put business at the top of the agenda.

Lord Borrie: My Lords, in making his speech a short while ago my noble friend indicated that it was on 18 September that his predecessor issued an intervention notice stating that a public interest consideration might arise in the case of Lloyds-TSB/HBOS. That was nearly a month ago, and I thought I would start by making the point that during the past three or four weeks, we have seen a tremendous general intervention by the Government through the Treasury in the banking system. I am thinking particularly of the United Kingdom, but we know that similar events have taken place in many other countries as well. We know also that two of the banks to have received financial assistance are Lloyds-TSB and HBOS. Given that, how urgent is this public-interest-consideration intervention into Lloyds-TSB/HBOS now, in order to favour the merger, when it is already going to receive benefits under the so-called bail-out package that has been agreed? Has the level of urgency changed?

I want to ask my noble friend a basic question. Do the Government accept that a major takeover involving two of the five largest retail banks in the UK may well create substantial competition problems and consequent consumer disadvantage, as well as disadvantage to small and medium-sized enterprises? Under the present procedure set out in this order—assuming that it goes through, as I am sure it will—the Office of Fair Trading has to report to the Secretary of State that, subject to and absent the public interest consideration about the stability of the financial system, the takeover ought to be referred to the Competition Commission. If the Office of Fair Trading says that, absent the public interest consideration, the normal competition concerns should prevail, will the Secretary of State retain an open mind on whether he should rule that that public interest consideration should trump the competition concerns that may be identified by the Office of Fair Trading?

I also want to ask my noble friend whether, if he is minded in due course to allow this takeover to go ahead, which is the point of the order before us, he feels able to impose any conditions on the lines suggested by my noble friend Lady Kingsmill to ensure that the new enlarged bank does not abuse its market position? Bearing in mind my noble friend's recent transition from Brussels to London, I hope he will recall the statement made last week by the relevant EU Commissioner, his former colleague Mrs Neelie Kroes, that, "competition policy has a constructive part to play in this crisis".

I hope that he agrees with it.

Finally, does my noble friend agree that it might be a good idea to state that he would welcome an investigation by the Office of Fair Trading in either two years' time, as my noble friend Lady Kingsmill suggested, or, as I would
suggest, in 12 months, to see whether the abuses that can arise from the new dominant bank among other banks in this country are sufficiently serious to disadvantage the consumer?

Lord Whitty: My Lords, I join in the congratulations being offered to my noble friend the Secretary of State and give him a warm welcome to this House—long overdue, in my opinion. In his long history, there was a point when my noble friend worked for me. It was a somewhat notional arrangement, as I recall, but nevertheless we were all deeply impressed by his talent, and his career since then has borne that out.

As others have said, my noble friend has made an elegant speech. It is of course the tradition of this House that we make non-controversial maiden speeches. Not long ago, a speech which effectively promoted the amalgamation of two giant banks accompanied by a substantial degree of partial nationalisation would have been regarded as a touch on the controversial side, but it seems to have met with general consensus around the House and in another place.

I also welcome my noble friend's reappointment as Secretary of State in the current department. I do so because he is not only the Secretary of State for business but also the Secretary of State for consumers. I declare an interest which I have not declared in its present form in this House as yet because my new organisation, Consumer Focus, was formed by the merger of the National Consumer Council, energywatch and Postwatch only a fortnight ago. We are now the major nationally-backed consumer organisation in the country.

In that context, I echo some of the concerns about the banking merger. Given the turmoil in the financial markets and the international situation about which we are all deeply concerned, it is inevitable that we should go down this road. However, once things have settled down, longer term issues in relation to individual consumers and, in particular, small businesses will arise. As the noble Lord, Lord Razzall, said, there are many flaws in the retail banking system and the banking system as a whole, but the combination of some degree of intervention by regulators, the Government's commendable activity on financial inclusion and competition within the banking sector has extended banking and credit facilities to a swathe of the population and vastly increased their quality of life as a result.

The fact that we are now merging, with government funding support, into an organisation which will control about 30 per cent of the retail banking system and about 30 per cent of mortgages must give us cause for some degree of concern. I have written to my noble friend on this issue and suggested that, from a consumer point of view, a number of concerns need to be addressed. I echo the words of my noble friends Lord Borrie and Lady Kingsmill that when things have settled down the OFT needs to have a longer-term look at the operation of competition within the banking sector. Within the mortgage sector, particularly given the equivalent turmoil in the housing sector, it is important that the OFT is specifically committed to looking at the mortgage
sector in its next annual plan and at how it extends mortgages to both individual consumers and small businesses.

Also in this context is a hotchpotch of different regulatory activities for what most people regard as normal banking. If you go for a loan, it is one sector; if you go for a mortgage, it is another; and if you go simply for the normal retail banking functions with a current account or a deposit account, it is a third set of regulations—the OFT, the independent banking code and the FSA. Consumer interests and consumer understanding of the situation are not necessarily best served by this confusion. Given the change in the structure and the Government's involvement in the banking sector, this is an opportune point at which to look again at the whole structure.

The noble Lord, Lord Razzall, also referred to the local situation. Clearly consumers, by and large, both business and individual, operate in their locality. If there is a restriction of competition as a result of this merger in certain localities, particularly in the more remote localities, that will be an issue which the Government and the competition authorities will have to address. I hope the OFT will also at some point, whatever the timescale, look at that dimension as well.

Finally, and somewhat cheekily, I suggest that consumer institutions ought to be represented in the newly-merged bank. It would behove the management of the new bank to establish internally a proper and authoritative consumer panel representing both individual and business interests. That would give a lot of reassurance to consumers and to all parts of this House.

**Lord Cotter:** My Lords, I welcome the Secretary of State to his new role and thank him for his excellent speech. I shall be brief—I wish to raise only one issue—but I hope I will not put my foot in it as I characteristically do sometimes. As the Secretary of State may recollect, shortly after his departure from his second role in government he entered a lift in which I was going upwards, as it were. I said to him, "Are you going up?" He said, "I wish I was", and his characteristic humour came through. I thought that was very good and I shall try not to put my foot in it again.

The Secretary of State knows of my long-term interest in small businesses and I am in touch with his department on a number of issues. I hope that under the present circumstances of the merger and the influence that the Government have through the banking sector we will see small businesses being treated fairly and helpfully. The small business sector provides an awful lot of work and that is why it is extremely important. Small business could suffer and big business is suffering. I welcome the Secretary of State in his role as a champion for business—which I know he will be—and I hope he will also be the champion for small business.

On that note, I hope I will hear back from his department shortly on a number of points that I have raised.
Viscount Eccles: My Lords, in joining the welcome to the Secretary of State, I should like to go back 50 years—he went back 50 years—and describe to him my experiences in the Grand Hotel, Hartlepool, where I frequently found myself negotiating the annual wage round with the local unions. I remember that one of their strongest arguments was the need for Wellington boots for their many children.

I follow the noble Lord, Lord Borrie, in his argument. He, quite significantly, used the word "takeover", and it is important for the House to remember that there is really no such thing as a pooling of interests merger—or it is very rare. In all essentials, what we are looking at is the takeover by Lloyds-TSB of HBOS. I also remember that when I was for a time a deputy chairman of the Monopolies Commission—the predecessor body to the Competition Commission—I had to behave myself very well whenever in the presence of the noble Lord, Lord Borrie, because the OFT had a certain status in relation to the Monopolies Commission.

I declare an interest. I have been for a number of years a small shareholder in Lloyds-TSB; of course, now I am a very small shareholder in Lloyds-TSB. I am a member of the Merits Committee and it might be useful if I describe the experience of that committee in considering this order.

The order was laid on 7 October. At that time the solution to the banking crisis was being taken along institution by institution. On 8 and 13 October, we received the overall plan, which covered the eight leading banks to start with and then was to be spread to the whole sector. In the regulatory impact assessment before the Merits Committee, only two solutions were proposed. This was written on 3 October and came to us, unsigned, via the Minister, although, of course, I assume the original copy in the records will have a signature on it. It proposed two options: one was to do nothing and the other was to lift competition law restrictions. But, by the time we came to consider the order on Tuesday of this week, there was a third option—that the two banks should remain independent as they are both eligible to be recapitalised under the new scheme. Indeed, there are agreements in the Library, signed by the Treasury but not signed yet by either Lloyds-TSB or by HBOS, which provide for £6 billion of preference and open offer ordinary shares to Lloyds- TSB and about twice that to HBOS. Around £17.5 billion has been committed. But these agreements stand up independently, as they have been written; they are not dependent one upon the other. So the Statement made to this House which said that the acceptance of these agreements by the banks and the confirming of them by the Treasury was dependent on the merger has not been followed in the structure of the arrangements that have been made.

The most important point that we are asking the Secretary of State to consider is not whether we should pass this order but whether he will ever use the powers that he will be granted under it. That is the crucial question. The noble Lords, Lord Razzall and Lord Borrie, asked him to think again about whether he should exercise the powers which no doubt Parliament will grant him.
The Secretary of State said that he would take very careful note of what the Treasury, the Bank of England and the FSA had to say. I should like formally to add the OFT to that list. It is due to make a report to him at the end of next week—on 24 October, I think—and this order cannot come into effect until 24 October. I should like the noble Lord to confirm to the House that he will wait until he has studied not only the advice from the present players but the report from a new player about this proposed takeover of HBOS by Lloyds-TSB.

In the mean time, I offer a little thought. It is said by the Secretary of State's department that both banks want to continue with the talks. I would think that Lloyds-TSB is a lot keener than HBOS—certainly the reports indicate that. Did the HBOS leadership put up a white flag and just depart or was it pushed? It is not very clever for the leadership of HBOS to have departed. It is rather like the captain leaving the bridge when the boat is sinking.

The fundamental question then becomes: is it wise to continue with what is being proposed? If we take short-term considerations into account, Lloyds-TSB is among the stronger of the banks at this troubled time. It has some problems of its own. HBOS has, under the Halifax title, what I believe to be a very sound mortgage book. Under the Bank of Scotland, it has a lousy commercial loan book. I may be wrong about that or I may be right; I am going on analysts' reports. Past experience of takeovers is that the majority do not deliver what is promised at the time that they are proposed. In fact, the great majority deliver significantly less, and quite a large number are failures. In my view, Lloyds-TSB's ambition should give way to common sense. It should not risk its own position, and it is very much against the public interest that it should do so. We need it, and we do not need it to be tied up with a highly complicated task which may indeed prove to be insurmountable in the problems that it brings.

If we look at the matter in the longer term, I should like to think that the rescue plan for the banks—their recapitalisation—will work. I think we are all optimistic, and it is a good sign that out of the eight to which the proposals were first made, only three have taken up the opportunity. If this recapitalisation is a success, in the longer term I do not think that anybody would support a fully investigated takeover of HBOS by Lloyds-TSB. We should not just be focused on the short term. Let us hope that the solution to that is well in progress. We should still think about the longer term.

Lord Mandelson: My Lords, I thank the noble Viscount, Lord Eccles, for his kindly reference to the Grand Hotel in Hartlepool. He will be interested to know that it has undergone a tasteful refurbishment since he last visited, and I am sure that there will be a welcome there for him.

Let me say to the noble Lord, Lord Razzall, that I am only too well aware that my reputation precedes me. Should I ever forget it, I know that my friends in the press will be there to remind me. And to the noble Lord, Lord Hunt, I say that I am very well aware that I am here to toil, not to spin. In that context, I will take very seriously the accountability that I have to Parliament through this
House. I will extend that accountability in ways to the other place, but at this Dispatch Box, I know where my duty lies.

I commend to the noble Lord, Lord Bilimoria—the article I presciently wrote for the Guardian, before I realised that I was going to be standing at this Dispatch Box, on the need for a new Bretton Woods. I stand by every word of that article which, I am glad to say, coincides with the views of the Prime Minister.

16 Oct 2008 : Column 862

I say to my noble friend Lord Whitty that it is true that the relationship between a director of campaigns and communications and a general secretary in a fraught general election campaign can be a little fraught. The campaign to which he was referring was the famous “Red Rose” campaign of 1987, which was subsequently described by Private Eye magazine as “Labour’s brilliant election defeat”. Funnily enough, I turned up a note that my noble friend left me at the end of that campaign in which he wrote, if I recall it correctly, that, “If at times it might have appeared otherwise, I would like to place on record my appreciation of your role and contribution to the result of this election”. It could have been interpreted as a little double-edged, given that the result was a Tory majority of well over 100. I think we gained a princely 28 per cent of the poll on that occasion. But, as history records, we lived to fight again.

I thank noble Lords for their consideration of this very urgent and necessary measure and for today’s frank and useful debate. I should like to offer one wider observation arising from something that the noble Lord, Lord Hunt, said, and also offer an important caveat. The wider observation is about the general economic situation that we face. I believe very strongly that we should neither exaggerate nor downplay the wider economic consequences of what has happened internationally in the banking system. It will be a struggle for us, there is no doubt at all about that, and there are no overnight quick fixes to the challenges that we face. Equally, the UK economy has some innate strengths, many very strong companies—as I know, because in my previous job I was championing them as well as those across the European Union—and we have among those companies some excellent positions in overseas markets. I hope that no one, whatever their political affiliation, will be tempted to play politics with the banking crisis in order to make out that things are worse than they are, because that will help no one. So I welcome the noble Lord’s remarks in that context.

2.30 pm

The caveat is this: the order that we considering is brought forward to allow for the careful consideration of financial stability as part of our assessment of the proposed merger between Lloyds TSB Group and HBOS. This debate, therefore, is not about the assessment, which I have yet to undertake. I will do
so following receipt by me of the OFT’s recommendations on the competition and public interest issues which are due by 24 October. I have an open mind to both the competition and the public interest considerations.

The noble Lord, Lord Hunt, asked two specific questions. The first concerned the regulatory cost of the order. There are no direct costs on business as a result of the amendment, because it simply introduces a fresh public interest consideration. Secondly, the European Commission has approved the Santander takeover of Alliance & Leicester. That arises because two-thirds of its turnover is outside the UK and the competition issue is dealt with by the Commission, which is not the case with Lloyds/HBOS.

The failure of a bank or building society could leave individuals and businesses unable to access savings, raise finance or meet their day-to-day financial obligations.

16 Oct 2008 : Column 863

That reality places on us as a Government the real and urgent obligation to take the actions that we have. Such failure has the potential to spread to other parts of the financial system, threatening the jobs of employees and wider communities, the trust and confidence of global investors, and the future success of our country. That much is at stake, which is why we have had to take the actions, supported by all parties on both sides of this House, that we have taken.

Financial services account for all but 9.5 per cent of UK GDP, while HBOS plc alone manages around one-fifth of residential mortgages in this country, holds one-fifth of all UK current accounts and employs tens of thousands of people. In such circumstances, the Government have a responsibility to act. This Government are committed to do all they can to ensure that our banking system functions effectively for the stability of our economy and good of our society.

A dynamic economy needs open, flexible markets. This Government remain absolutely committed to ensuring a regulatory framework that promotes competition, improves productivity, drives innovation and protects the vital interests of businesses but also, I say to my noble friend Lord Whitty, of consumers as well.

It is critical now that Governments work together across the international system to assure stability and responsible risk-taking in their own economies and the global financial system as a whole. Therefore, the actions that the Government have taken and measures that we have put forward are the end of the beginning; they are not yet the beginning of the end. There is plenty more that Governments have to do, but plenty more in particular that Governments have to do together to put in place the international regulatory systems that we have learnt from this crisis are essential to be created.
In addition to the measures currently being implemented at an international and national level, the powers set out in this order will enable quick and comprehensive action to be taken in the assessment of proposed mergers that could bolster financial stability in the UK economy. The order will allow the Secretary of State for Business to base final decisions on the vital public interest of financial stability, alongside competition issues. There is no question of putting aside or disregarding competition issues. They will continue to be monitored, and any abuse carefully assessed and acted upon. I emphasise, and do so in particular to my noble friends Lady Kingsmill and Lord Borrie, that all normal powers remain available to the competition authorities to protect consumers now and in the future. I understand the concerns that have been expressed and we will be vigilant. I do not, however, want to anticipate any time limit on that vigilance. Therefore, I do not envisage a one-, a two- or a three-year review following whatever decision I take on the merger in due course. I will not be drawn on conditionality in advance of my decision, but I assure your Lordships that, should a decision be taken for the merger to go ahead, we will not relax our vigilance at any time when it comes to the proper protection of consumers. I am sure that the prospective management of this potentially merged bank will have heard the suggestion of my noble friend Lord Whitty of the creation of a consumer panel.

The powers contained in this statutory instrument will be reserved for those exceptional circumstances where vital public interest issues are at stake. Now is such a time and we must take the action that we are proposing. I commend the order.

On Question, Motion agreed to.
The United Kingdom Parliament

Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008

The Committee consisted of the following Members:

Chairman: Mr. Greg Pope
† Baron, Mr. John (Billerica) (Con)
† Burgon, Colin (Elmet) (Lab)
Burt, Lorent (Solihul) (LD)
† Craggby, Mr. David (Bolton, North-East) (Lab)
† Djanogly, Mr. Jonathan (Huntingdon) (Con)
† Dobbin, Jim (Heywood and Middleton) (Lab/Co-op)
Holloway, Mr. Adam (Gravesham) (Con)
† Meale, Mr. Alan (Mansfield) (Lab)
Miller, Andrew (Ellesmere Port and Neston) (Lab)
Penrose, John (Weston-super-Mare) (Con)
† Salter, Martin (Reading, West) (Lab)
† Smith, Mr. Andrew (Oxford, East) (Lab)
† Thomas, Mr. Gareth (Minister of State, Department for International Development)
† Thurso, John (Caithness, Sutherland and Easter Ross) (LD)
† Ward, Claire (Vice-Chamberlain of Her Majesty's Household)
Young, Sir George (North-West Hampshire) (Con)
Mick Hillyard, Committee Clerk
† attended the Committee
Column number: 3

Second Delegated Legislation Committee

Monday 20 October 2008

[Mr. Greg Pope in the Chair]

Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2008

4.30 pm
The Minister of State, Department for International Development (Mr. Gareth Thomas): I beg to move,
That the Committee has considered the Enterprise Act 2002 (Specification of Additional

As is traditional at the outset, Mr Pope, may I say that I genuinely welcome the chance to serve under your chairmanship again?

As the House knows, merger control in the UK is regulated under the Enterprise Act 2002 and the European Community merger regulation. The Office of Fair Trading and the Competition Commission are responsible for investigating UK mergers on the basis of their impact on competition in UK markets, which enables the promotion of greater competition, efficiency and innovation in markets, while helping to protect the needs of the consumer.

The 2002 Act provides limited powers for the Secretary of State to intervene in mergers to protect legitimate public interests. Public interest considerations are defined under section 58 as national security and the plurality of media ownership. Section 58 also provides the Secretary of State with the power to specify additional public interest considerations as and when necessary to protect the public interest. The order will give the Secretary of State the power to make decisions on mergers that raise issues concerning the stability of the UK financial system alongside competition questions. It will apply only to mergers in the UK. We are taking separate action to have the additional consideration recognised as a legitimate public interest consideration under EU law for all member states.

Hon. Members will be aware that the previous Secretary of State for Business, Enterprise and Regulatory Reform announced on 18 September that he had issued a merger intervention notice in respect of the proposed Lloyds TSB group merger with HBOS plc. He also announced that he would place an order seeking the necessary power to enable him to take into account the vital public interest issues that surround the merger. This order specifies the maintenance of the stability of the UK financial system as a public interest consideration under section 58 of the Enterprise Act 2002. It will allow the Secretary of State to intervene in those mergers to make the final decision based on the vital public interest of financial stability alongside competition issues.

The House will recognise that swift, decisive action is needed to give investors the regulatory certainty that they need and to send a clear signal to the market about the proposed merger of Lloyds TSB group and HBOS.

Column number: 4

The order will allow us to make careful and urgent consideration of financial stability a fundamental part of our assessment process and as a result, it will support our work to help millions of UK businesses and families get through these difficult times. I commend the order to the Committee.

4.33 pm

Mr Jonathan Djanogly (Huntingdon) (Con): Given the ongoing financial crisis and market instability that has characterised recent weeks, coupled with the threat to Britain’s largest mortgage lender, the Conservative party supports the statutory instrument. We agree with the advice of the Treasury, the Bank of England and the Financial Services Authority that at a moment like this, financial stability must take precedence when compared alongside competition issues. Under normal circumstances, we would not be inclined to support in such a wholesale fashion the Secretary of State’s proposals without a more extensive debate. However, exceptional times call for exceptional behaviour. There is a need to act quickly and decisively, and the Conservative party recognises that. The potential domino effect of the failure of a high street bank of the magnitude of HBOS in the current climate would be widespread and devastating. It would have repercussions not only in the banking and financial services sectors of the UK economy, but on the money in everyone’s pockets and the lives of every individual in the country. This is no longer a problem limited to the square mile or Canary Wharf. It is a problem experienced by every family and business across the country. Individuals, companies and institutions rely on the stability of the UK economy and its key players. The Conservative party is acutely aware of how deeply these entities are engrained in the fabric of UK life.
The consumer group, Which?, has written to me to point out that in creating a super-bank with this merger, the Government must ensure that the consumer does not lose out, as the sector is one in which it believes competitive incentives have already been weakened. Does the Minister agree with this perspective, and would he explain how the Government have reviewed the competition aspects of their proposals and tell us what plans they have for their future review?

Provision is made in the Enterprise Act 2002 for the Secretary of State to take that course of action. While the circumstances and the purpose of the proposals are unusual, their legality cannot be called into question. Concerns that would usually be raised to force the Secretary of State to clarify the need for such an order are of less immediate concern when viewed in the light of the current problems, but will the Minister explain what conditions the Government will require of these two banks? For example, will they impose restrictions on retail deposits and the closing of branches, which the Minister will appreciate will have a distinct impact on competition in the marketplace?

We appreciate that the use of the national interest provisions under the Enterprise Act, which allow the Secretary of State to intercede on behalf of mergers that may otherwise fall foul of the UK Competition Commission, is not completely unprecedented. Since the legislation came into force, the power has been used on various occasions, so the power provides the Government

Column number: 5

with an effective tool to help them deal with the immediate Lloyds-HBOS merger problem. Of course, given the respective prices of those banks and the implications of the Government’s bail-out scheme, questions could certainly be raised about the financial implications and economic viability of the merger itself, but that is not a discussion for today.

4.37 pm

John Thurso (Caithness, Sutherland and Easter Ross) (LD): It is a pleasure, Mr. Pope, to serve under your chairmanship. As the Minister said, the powers that are required by the Secretary of State stem directly from the problems in the banking sector and it is quite right that financial stability should be a matter of public interest. However, we should be in no doubt that we would not be here today were it not for the fact that a merger had been proposed between Lloyds TSB and HBOS.

First, there are legitimate concerns about whether that merger needs to go ahead in the light of the very changed circumstances, bearing in mind that it was first mooted because of the weakness of HBOS. None of us suspected that the entire banking system would need to be supported to the degree that it has been by the Government. There are also concerns about what happens if the merger goes ahead, and about the impact on both consumers and depositors. What steps have been taken thoroughly to scrutinise the proposal and ensure that the competition aspects are properly covered? From my work on the Treasury Committee, I know of the lack of competition that has been apparent in the past in banking, particularly with regard to overpriced charging, overdraft rates and various other things. HBOS was one of the leaders in driving down prices, so the merger is likely to have a negative impact on high-street banking pricing.

What measures will be taken to scrutinise this properly? Furthermore, when we come out the current times of turbulence, what will be done to ensure that there is proper and sufficient competition on the high street? Stability is of the utmost importance at this time, and it is at the top of the decision tree. If the merger is still required as a matter of financial stability, that case needs to be made. After all, a considerable amount of Government money is being put into both banks. However, according to a letter I have had from Lloyds TSB, the Government will not go ahead with funding HBOS if the merger does not go ahead. That seems to be a condition precedent that requires some explanation.

My second point concerns competition. We should not lightly set aside the plurality in our markets, so we need assurances as to how that will be dealt with in future. My third
point is about depositor protection. Some banks operate on the basis that each brand in its portfolio has a separate licence, so each individual banking brand is protected. That is not the case with all banks. This super-bank will operate some 11 different brands. Will the Government consider requiring them, as part of the funding protocol, to ensure that each of those brands has a separate licence, as the Royal Bank of Scotland does for all of its brands, so that there would be proper protection for people who would have their £50,000 protection with each brand, not simply one for the entire super-bank? Notwithstanding my very real concerns, I believe that it is important that the order should go through. I hope that the Minister will have some answers to those questions.

4.40 pm

Mr. Thomas: Let me try to deal with the questions raised by the hon. Members for Huntingdon, and for Caithness, Sutherland and Easter Ross. We are obviously grateful for the support of both hon. Gentlemen. Which? and Consumer Focus have written to the Government raising the perfectly legitimate consumer interest, and expressing concern about competition on the high street in the banking sector as a result of the merger. There are a series of powers and bodies that can investigate whether there has been an abuse of market power and whether action needs to be taken by public authorities.

The hon. Member for Caithness, Sutherland and Easter Ross referred to a number of issues that have been debated in the public domain and have been investigated by bodies such as the Office of Fair Trading. It has considerable powers available to it to investigate market abuses and to insist on action being taken to prevent that abuse being perpetuated. Similarly, there is the Competition Commission, as the hon. Gentleman will be aware. Both Which? and Consumer Focus have indicated that they will watch the merger and its impact on the high street in the coming months. Consumer Focus is particularly important, because it has the power to lodge a super-complaint if it believes there are substantial consumer concerns which can trigger an OFT investigation. Certainly, it will trigger debate and substantial questions.

As for future competition, I believe that we have the regulatory scrutiny that we require available to us. Most people will recognise that the OFT and the Competition Commission have done a good job in challenging previous practices which have been an abuse of competition and therefore unacceptable. On the specifics of the merger, scrutiny to date and the various conditions that might be added, let me clear about the process. If the House, as I hope it will, endorses this statutory instrument, we are simply granting the power to the Secretary of State to allow financial stability to be considered alongside competition questions. A decision on whether to allow the merger has not been made.

The Secretary of State has to receive a report from the OFT, which has been promised for 24 October. He will consider that report and other issues which the OFT might want to provide to him. I cannot therefore speculate about the different types of conditions that could be attached until the Secretary of State has seen the OFT report. There will clearly be opportunities for the Select Committee to scrutinise the decision that the Secretary of State takes in the usual way. I hope that both hon. Gentlemen will understand that I cannot at this stage speculate on what conditions might be made.

Question put and agreed to.

Committee rose at sixteen minutes to Five o’clock.
14 October 2008

Lord Mandelson
Secretary of State for Business, Enterprise and Regulatory Reform
1 Victoria Street
London
SW1H 0ET

Dear Peter,

Proposed merger of HBOS and Lloyds TSB— the consumer interest

We are writing to you in connection with the proposed acquisition of HBOS by Lloyds TSB as we have considerable concerns in relation to the impact of this for consumers.

We fully recognise and support your decision to consider the stability of the financial system as a public interest consideration, as set out in Section 58 of the Enterprise Act 2002. 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 you to refer the merger to the Competition Commission.

However, we have real concerns about the merger and are calling for a number of steps to be taken alongside any decision on exemption:

- To protect the rigour of the UK competition regime, we would want to see a sunset clause to an intervention in the form of a commitment to revoking the order within three months.

- We have particular concerns that the surveillance that will be needed by regulators should operate with the primary goal of avoiding harm to consumers rather than harm to competitors.

- To ensure vigilance, we are calling on the Office of Fair Trading to initiate an investigation into the mortgage market in its next Annual Plan and to consider the same for other markets affected by the merger, including for SMEs as consumers.

- We would ask for an immediate review to be launched on the regulation of retail financial services, recognising that the hotch-potch of current arrangements, including the Banking Code, the OFT and the Financial Services Authority serve neither consumers nor, in terms of better regulation, banks themselves.
- We call for more active support by the Government for interventions that can promote transparency for consumers in the financial services markets.

- We propose that you ask Lloyds TSB, reflecting taxpayer support and its potential dominance, to consider setting up a Consumer Panel for the merged bank, with access to the Board, to be a safeguard for the consumer interest.

- Because there is a risk of local markets being dominated by the new bank, in terms of branches, we are calling for Government to complete a national map of branch overlap and local competition to point to where it would make sense to see branches offered to competitors.

We attach an in-depth letter Consumer Focus has sent today to the Office of Fair Trading. We would be pleased to expand on any of these points in person, if this would help.

Yours sincerely,

[Signature]

Larry Whitty                     Ed Mayo
Chair                           Chief Executive

Cc: Gareth Thomas, Minister for Trade, Investment and Consumer Affairs
    John Fingleton and Alistair Mordaunt, Office of Fair Trading
    John Kingman, HM Treasury
    Hector Sants, Financial Services Authority
    Lord Lipsey, Financial Services Consumer Panel
    Ian Larkin and Jo Lewis, Lloyds TSB
Rt Hon the Lord Mandelson  
Secretary of State for Business,  
Enterprise and Regulatory Reform  
1 Victoria Street  
London SW1H 0ET

22 October 2008

Dear Secretary of State,

Re: Proposed Merger of Lloyds TSB and HBOS

I understand you are shortly due to undertake a decision on whether to allow the merger of Lloyds TSB and HBOS.

Which? recognises that there are exceptional circumstances which mean the merger may be necessary. However we also believe any decision on the merger must take into account the long-term impact on market structure that will result from the creation of a ‘super bank’ in a sector where competitive incentives are already weak.

We understand that the new entity would not be shielded from existing competition law. However we do not believe the normal competition regime is sufficient to deal with the ‘super bank’ that will be created. The OFT will struggle to tackle an institution of this size that may be even less responsive to consumers and even less likely to address the many problems that have already been identified in retail banking, and are discussed below. This could result in considerable consumer detriment, particularly at a time when the competitive fringe offered by building societies and internet banks has already been severely weakened by prevailing market conditions and ongoing consolidations in the banking sector. In addition, whilst the OFT could potentially deal reactively with an abuse of market power, we strongly believe that ‘prevention is better than cure’.

On behalf of all consumers, we would urge you to ensure measures are put in place as a condition of the merger which prevent the merged parties engaging in behaviour that harms competition and consumers.

Overview of the Banking Sector

The proposed merger of Lloyds TSB and HBOS occurs in a sector where competitive incentives are already weak.

Which? has long-standing concerns about the lack of effective competition in the retail banking sector which is dominated by the ‘Big Four’ of Lloyds TSB, HSBC, Barclays and Natwest / RBS. We have embarked on a series of campaigns over the past decade to
address consumer concerns and ensure they receive a fair deal. Amongst the issues we have sought to address are excessive credit cards charges, the proliferation in charging for ATMs, unfair overdraft charges, mis-selling of Payment Protection Insurance and the slow pace of ISA transfers.

One of our key focuses has been on the personal current account market. These products are key to consumers’ banking needs and play an important role in allowing full participation in society. Furthermore, they act as ‘gateway’ products, giving banks point of sale advantage and widespread cross-selling potential. They also generate more revenue for banks (£8.3 billion) than savings and credit cards combined.

Despite our efforts and numerous reviews into the sector, the OFT recently concluded that “the market in personal current accounts is not working well for consumers”. The market study found that a combination of complexity and a lack of transparency meant that competition rarely focussed on the elements that make up the vast bulk of banks’ revenues such as unauthorised overdraft charges and forgone interest. Contrary to popular belief that Britons benefit from ‘free banking’, these costs come to £152 per active current account a year.

In addition to the hindrance on competition caused by complexity and lack of transparency, the study found that a significant proportion of consumers believe that it is complex and risky to switch accounts. This has resulted in very low switching rates, which further hinder competition in the sector:

Lloyds TSB / HBOS merger

The proposed merger of Lloyds TSB and HBOS has the potential to create a ‘super-bank’ that will dwarf its competitors.

Combined brands of Lloyds TSB and HBOS includes:

- Lloyds TSB
- Cheltenham & Gloucester
- Scottish Widows
- Intelligent Finance
- Halifax
- Bank of Scotland
- Birmingham Midshires
- The AA
- Skiagi

If the two companies retained their 2007 market shares they would stand head and shoulders above the rest of the banking sector. As outlined in Figure 1 it would control 30% of the current account, 28% of the mortgage, 25% of the savings and 24% of the personal loans markets.

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2 As 1

Page 2 of 4
Figure 1: 2007 Market Share Figures

<table>
<thead>
<tr>
<th></th>
<th>Current Account¹</th>
<th>Mortgages ¹</th>
<th>Savings¹</th>
<th>Personal Loans¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lloyds TSB</td>
<td>19%</td>
<td>8.1%</td>
<td>11.3%</td>
<td>13%</td>
</tr>
<tr>
<td>HBOS</td>
<td>11%</td>
<td>20.1%</td>
<td>13.8%</td>
<td>8%</td>
</tr>
<tr>
<td>Combined share</td>
<td>30%</td>
<td>28.2%</td>
<td>25.1%</td>
<td>21%</td>
</tr>
<tr>
<td>Nearest competitor share</td>
<td>19%</td>
<td>9.5%</td>
<td>3.5%</td>
<td>8%</td>
</tr>
<tr>
<td>(NatWest/ RBS)</td>
<td>(Abbey)</td>
<td>(Nationwide)</td>
<td>(HSBC)</td>
<td></td>
</tr>
</tbody>
</table>

Which is deeply concerned that a "super bank" of the size of Lloyds/HBOS will be less responsive to addressing the historic competition problems already identified.

HBOS has been a strong driver of price competition, raising awareness amongst consumers of the poor levels of interest generally offered by high-street banks. It is therefore particularly damaging to competition that the market leader in personal current accounts should be absorbing this key rival. Meanwhile, although current competitive conditions in the mortgage market are far from "normal", the prospect of creating a single lender with nearly 30 per cent of the overall market means that it is unlikely to feel sufficient pressure to offer competitive deals.

The proposed merger also comes at a time when the competitive fringe offered by building societies, and to a lesser extent Internet based banks, has already been severely weakened by prevailing market conditions and ongoing consolidations in the banking sector. Alongside this, weakened confidence will further undermine the ability of consumers to drive competition.

In the normal course of events Which? would ask that this proposed merger would be referred to the Competition Commission for further investigation. We recognise that there are exceptional circumstances which mean the merger may be necessary to protect the interest of consumers now from the risk of instability in the banking system. However we believe there is a strong risk that the merger will have a detrimental effect on competition. As a result measures must be taken to ensure that consumers are not adversely affected.

³ Estimated volume market share 2007. Source: GfK NOP/Mintel, October 2006
⁴ Personal loan market share by company, August 2007. Source: GfK NOP/Mintel
Potential Remedies

During this time of financial upheaval it must not be forgotten that any concentration of market share created now will have a long-term impact upon market structure and conditions of entry.

Consumers already suffer from the lack of competitive forces in the retail banking sector. Which? seeks specific assurances that special measures will be taken by the Secretary of State to prevent the merged parties engaging in behaviour that further harms competition and consumers. These measures could 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 undermined.

Without knowing the terms of the deal of the companies' business models, Which? cannot make specific suggestions. However, we would ask you to consider:

- Future divestments: There is considerable overlap between the locations of Lloyds TSB and UBS branches. Will the merged company be required to divest existing branches?
- Special supervisory powers: Will the new institution seek to abuse its market position, for example by seeking to raise fees or charge for ATMs?
- Market caps: Will you ask the new institution to cap its market share, in a similar fashion to the “competitive framework” adopted by Northern Rock?

In addition to these measures, Which? would strongly urge you to ensure that the merged companies retain their separate banking licences. Under the current system, any compensation from the Financial Services Compensation Scheme is paid on a per-institution rather than a per brand basis. As a result, if a consumer had £35,000 invested in a fixed-term bond with Lloyds TSB and a further £35,000 invested in a fixed rate ISA with Birmingham Midshires £70,000 of their money will not be protected following the merger. However, they would be unable to move the funds without incurring a penalty. Given the current low levels of confidence in the banking system, consumers will find this unacceptable.

If you decide to approve the merger we would urge you to address our concerns and ensure measures are in place to ensure consumer protection.

Yours sincerely

[Signature]

Peter Vicary-Smith
Chief Executive
29 October 2008

Dear Lord Mandelson,

I am aware that you will consider the potential merger between Lloyds TSB and HBOS under the UK merger regime established by the Enterprise Act 2002 and that the Office of Fair Trading reported to you on 24 October on this issue. I understand 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.

The international financial landscape – and indeed the picture in Scotland and the UK – has changed dramatically since the initial merger announcement on 18 September.

As I have stated repeatedly, I respect Lloyds TSB as a company and believe they have been representing their shareholder interests as they are certainly entitled to do. I have met with Lloyds management and will continue to engage with them to ensure that I am upholding my responsibilities to advocate for Scottish jobs and the maintenance of decision-making headquarters.

With that in mind, it is also my obligation to pursue the best result for Scotland in terms of maintaining a competitive banking sector and in ensuring that Scotland’s financial sector remains strong. The impact of the proposed merger on both fronts is of major concern across Scotland, as you are no doubt aware.

Should a merger proceed, 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. The concentration of market power in the hands of one or two banks must raise serious concerns of the future operation on the market in Scotland and 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 any new merged organisation. I am pleased, therefore, that the OFT has undertaken this investigation and will bring all of these issues to your attention.
I hope that the report will identify the potential market contraction in Scotland of the proposed merger, along with any proposed remedies to which you can give full consideration in advance of any decision. I must also stress the importance of not only ensuring that Scottish specific circumstances and interests are separately and distinctly considered by your in making any decision, but the issues I have outlined above are taken on board in deciding upon what constitutes the national interest.

I understand that you will be publishing OFT’s report at some stage. Given the extreme public interest in the matter, can you please undertake to publish this report as soon as possible and clarify exactly when it will be made available to the public?

Given that shareholders may be asked to make a decision on a proposed merger within the next three weeks, it is critical that the Government is making decisions with complete information and transparency.

I enclose a copy of a letter I sent to Alistair Darling today seeking further clarification around the situation with HBOS/Lloyds TSB merger. That letter poses a series of interlinked questions which cross Whitehall Departmental boundaries and I assume that Alistair will discuss the content of it with you.

I am also copying this letter to the Prime Minister, the Chancellor of the Exchequer and the Secretary of State for Scotland.

Yours sincerely,

ALEX SALMOND
29 October 2008

Dear Alistair,

I am writing with some urgency to follow up on my letter to you of 22 October, to which I have yet to receive a response, and also to seek further clarification around the situation with HBOS and the Lloyds/TSB merger.

It is my duty as First Minister to ensure that whatever the future holds for HBOS, the Scottish Government is promoting what is in the best interests of the people of Scotland. It is also my duty to ensure that all parties are treated fairly and that there is a level playing field.

In these respects I would ask that the following information is made available to the Scottish Government:

1. A copy of the OFT report on the merger of HBOS with Lloyds TSB sent to Lord Mandelson;

2. The terms of the recapitalisation of HBOS and Lloyds;

3. Whether the concessions in terms of Competition Law announced by the UK Government in September will be available to any other credible bidder;

4. Whether the recapitalisation offer to HBOS is conditional in any way to the merger going ahead and if so why; and

5. Details on the time frame for making public the information contained in the OFT Report? Can you confirm that the information will be available to HBOS and Lloyds TSB shareholders before any vote is taken on the merger terms to allow both sets of shareholders to be as fully aware of the relevant information as possible.

There is a parliamentary debate in the Scottish Parliament on Thursday, 30th October 2008 and we would welcome a timely response so that members of the Scottish Parliament can be fully informed of the situation.
I think it would also be beneficial for us to have an early meeting to discuss these issues and I will ask my office to contact yours to arrange that.

Yours sincerely,

[Signature]

ALEX SALMOND
From: Jennifer Halliday
Sent: 30 October 2008 15:14
To: david.saunders@berr.gsi.gov.uk
Cc: John Fingleton; Erik Wilson
Subject: Restricted - commercial and market sensitive

Dear David,

John Fingleton spoke with the Secretary of State this morning. In this conversation, he offered to send a little bit more detail on: OFT work of particular relevance to Scotland; [ ] which I include below.

In response to a question from the Secretary of State regarding the OFT's ability to intervene if the Secretary of State cleared the merger, John emphasised the fact that the OFT is very keen not to make any commitment now or in the near future as to specific interventions. John explained that from our experience of extensive examination of different aspects of financial services (e.g. SME banking, Personal Current Accounts Market Study) it is clear that different 'banking' markets exhibit very different issues at different times. In this regard, the OFT believes it is fundamental that we retain the flexibility we need to intervene in the right market, at the right time, in the right way, driven by promoting and protecting the best interests of consumers, businesses and the economy as a whole. It is all the more important to retain this flexibility at a time of rapid market change.

Please do not hesitate to contact me or Erik Wilson [ ] if you require anything further from us.

Please note that this e mail will also be sent to your Communications Department via ours.

Kind regards

Jennifer

The OFT appointed a Representative in Scotland (2005) and opened office in Edinburgh in February 2007.

OFT current work

[ ]
Decision by Lord Mandelson, the Secretary of State for Business, not to refer to the Competition Commission the merger between Lloyds TSB Group plc and HBOS plc under Section 45 of the Enterprise Act 2002 dated 31 October 2008.

PARTIES

1. Lloyds TSB Group plc (Lloyds TSB) 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.

2. HBOS plc (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.

3. On 18 September 2008, Lloyds TSB and HBOS announced they had reached agreement on the terms of a merger. Following further market turbulence and a significant drop in the price of HBOS shares, the terms of the merger were re-negotiated and revised terms were announced on 13 October 2008. Subject to shareholder approval, HBOS shareholders will receive 0.605 Lloyds TSB shares per HBOS share. The deal was negotiated and agreed in the context of the crisis in global financial markets in mid-September, when HBOS's position in terms of share price and funding became increasingly vulnerable.

INTERVENTION NOTICE

4. On 18 September 2008, the Secretary of State issued a notice to the Office of Fair Trading ("OFT") ("the intervention notice") pursuant to Section 42 of the Enterprise Act 2002 ("the Act") stating that he believed the stability of the UK financial system ought to be specified as a public interest consideration in Section 58 of the Act and that it may be the case that the stability of the UK financial system is relevant to a consideration of the merger situation. The intervention notice required the OFT to provide a report to the Secretary of State pursuant to Section 44 of the Act.
by 24 October 2008. The intervention notice also indicated that the Secretary of State would promptly lay before Parliament a suitable order to specify the new public interest consideration under Section 58 of the Act. The order completed Parliamentary scrutiny on 23 October 2008 and came into force on 24 October meaning the new public interest consideration is now operating. It has been added to the Act as Section 58(2D).

**JURISDICTION**

5. The Secretary of State may make a reference to the Competition Commission (CC), pursuant to the circumstances that are set out in Section 45 of the Act. This Section may be summarised as providing that, in the case of anticipated mergers, he may make such a reference if he believes it is or may be the case that: (i) arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a relevant merger situation; (ii) a public interest consideration mentioned in the intervention notice is relevant to a consideration of that relevant merger situation; and (iii) the creation of the relevant merger situation may be expected to operate against the public interest. In cases in which he 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, the Secretary of State may make a reference where he believes that it is or may be the case that the merger may be expected to operate against the public interest taking account both of the substantial lessening of competition and of the relevant public interest consideration.

6. Section 45(6) of the Act goes on to provide that:

“For the purposes of this Chapter, any anti-competitive outcome shall be treated as being adverse to the public interest unless it is justified by one or more than one public interest consideration which is relevant.”

**ADVICE FROM THE OFT AND OTHER REPRESENTATIONS**

7. The OFT has produced a report under Section 44 of the Act, dated 24 October 2008 (“the OFT Report”), advising the Secretary of State in relation to the merger. The OFT Report includes advice to the effect 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 and the creation of that merger situation may be expected to result in a substantial lessening of competition. In deciding
whether to make a reference under Section 45 of the Act, the Secretary of State is required, under Section 46(2) of the Act, to accept the decisions of the OFT included in its report on these issues.

8. In coming to his decision, the Secretary of State has taken into account the OFT Report (which is today being published by the Secretary of State and by the OFT), including the information and range of views contained in the detailed summaries of representations on the stability of the UK financial system made by the merging parties and third parties that are annexed to the OFT Report. The Secretary of State has also considered separate representations made to him in writing by Which?, Consumer Focus, the Scottish First Minister, Lloyds TSB, the Chancellor of the Exchequer and a private individual. For the most part, these reiterated points that were also made in separate submissions to the OFT.

SECRETARY OF STATE’S DECISION

9. The Secretary of State is required under the Act to accept the decision of the OFT 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.

10. The OFT has also decided that it is or may be the case that the creation of the merger situation may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom. The Secretary of State is required under the Act to accept this decision.

11. The Secretary of State has decided that the new public interest consideration now provided in Section 58(2D) of the Act, the stability of the UK financial system, is relevant to this case.

12. Taking account only of the substantial lessening of competition and the relevant public interest consideration, the Secretary of State believes that the creation of the relevant merger situation is not expected to operate against the public interest. The OFT has decided that it is or may be the case that the creation of the relevant merger situation may be expected to result in an anti-competitive outcome, in particular in view of its potential to result in a substantial lessening of competition in the market for personal current accounts, for banking services to small and medium sized enterprises (SMEs) in Scotland, and in the supply of mortgages. However, having had regard in particular to the submissions made to the OFT by the tripartite authorities (HM Treasury, the Financial Services Authority and the Bank of England), the Secretary of State considers that the merger will result in significant benefits to the public interest as it
relates to ensuring the stability of the UK financial system and that these benefits outweigh the potential for the merger to result in the anti-competitive outcomes identified by the OFT. As a result of this decision, no reference will be made to the CC.

SUMMARY OF REASONS FOR DECISION

13. The OFT Report includes the OFT’s decisions that:

(i) 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;

(ii) the creation of that merger situation may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom for goods or services, including personal current accounts, banking services to SMEs, and mortgages, such that further inquiry by the CC is warranted;

(iii) 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

(iv) it would not be appropriate to deal with the matter by way of undertakings under paragraph 3 of Schedule 7 to the Act.

14. The Secretary of State is required under the Act to accept these decisions. In deciding whether to refer the merger to the CC, he must also decide whether it is or may be the case that:

(i) the public interest consideration mentioned in the intervention notice is relevant to a consideration of the relevant merger situation; and

(ii) taking account only of the substantial lessening of competition and the relevant public interest consideration, the creation of the relevant merger situation may be expected to operate against the public interest.

15. In its report, the OFT points out that the assessment it is required to make relates to a decision on whether the merger should be referred to the CC for further investigation. The statutory threshold for making a reference
requires the OFT only to believe 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. The OFT interprets this as meaning that the test for making a reference is met if it has a reasonable belief there is a 'realistic prospect' that the merger will lessen competition substantially. This contrasts with the CC's statutory threshold for making final decisions on mergers which is based on the more determinative 'balance of probabilities' standard. Accordingly, the OFT's 'belief' regarding the prospect of a substantial lessening of competition is not formed on a balance of probabilities, but on the basis of a 'realistic prospect' under the 'may be the case' standard. Reflecting this position, the OFT makes clear that it is by no means a foregone conclusion that, following their more detailed investigation and based on the 'balance of probabilities' standard, the CC would reach the finding that the merger in fact resulted in a substantial lessening of competition.

16. The OFT Report provides a detailed assessment of the potential impact of the merger on competition in a range of markets and concludes that there are three markets in which the OFT believes there is a realistic prospect that there will be a substantial lessening of competition. These are:

- the market for personal current accounts;
- the market for banking services to SMEs in Scotland; and
- the market for mortgages.

17. In relation to personal current accounts, the OFT considered the merger will significantly increase Lloyds' share of the market and, as a consequence, its incentives to compete may be reduced. In addition, at least until recently, HBOS was a major driver of competition in this market and its removal may be expected to diminish the competitive pressure on Lloyds and on other major banks in the market. The OFT also had concerns about Lloyds' reduced incentives to compete in the market for banking services to SMEs in Scotland. In relation to mortgages, the OFT Report noted that while their concerns were less substantive, a cautious approach to a potential lessening of competition in this market was warranted in view of the importance of the mortgage business to the UK economy.

18. The OFT Report does not consider the most likely short term outcome absent the merger would be a strong, independent HBOS continuing to exist and exerting the same competitive pressure as it has done in the past. Rather, the OFT concludes the more realistic counterfactual scenario is that, absent such a commercial merger, the Government would have intervened to prevent the failure of HBOS with the most likely outcome
being that the Government would have brought HBOS into partial or full public ownership. While this may have led to the imposition of restrictions on the scope of HBOS to compete in the market (to comply with EC law on state aid), a publicly owned HBOS would continue to exert some competitive pressure in the market, though it would potentially be a significantly weaker force in comparison with conditions prior to the current financial crisis. In the medium term, once stability had returned to the markets, the Government would sell HBOS on to a new owner or owners.

19. Against this assessment of the potential impact of the merger on competition, it is necessary to consider the public interest as it relates to the stability of the UK financial system.

20. The OFT received detailed submissions on this matter from the tripartite authorities: the Bank of England, Financial Services Authority and HM Treasury. These submissions contain assessments of the importance of HBOS to UK financial stability, the circumstances leading to the crisis at HBOS, the likely impact of a failure of HBOS, alternative ways of addressing the problems at HBOS and the impact the proposed merger might have in terms of securing financial stability.

21. In its submission to the OFT, the Bank of England concludes that:

"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."

22. In its submission to the OFT, the FSA notes that:

"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."
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 2008 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.

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.

The FSA concludes that:

"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.

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.

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.”

23. In its submission, HM Treasury set out its objectives for responding to the crisis at HBOS and assessment of the options as follows:

“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.

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.

The alternatives do not meet these objectives as well.”

24. HM Treasury’s submission goes on to summarise the view of the tripartite authorities as follows:

“In the view of the Tripartite Authorities the merger remains the best option in terms of financial stability.

The Bank of England’s evidence recommends that the takeover should proceed without delay.

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.

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"

25. HM Treasury also conclude that the merger will lead to improved confidence, an improved business model for HBOS with reduced reliance on wholesale funding and less exposure to the mortgage market, a broader business base, an improved credit rating and a better quality asset base than standalone HBOS. They point out that the recapitalisation of both banks which will accompany the merger will make a significant contribution to improving the capital base of the merged entity.

26. The OFT received a number of other representations on both the competition and public interest issues raised by the merger. These are summarised and considered in the OFT Report. As noted in paragraph 8 above, the Secretary of State also received directly a small number of separate written representations which, in the main, reflected points that were also made to the OFT.

27. It is clear from the OFT Report that the proposed merger is capable of giving rise to competition concerns. However, as can be seen from the submissions made to the OFT by the tripartite authorities, the merger also provides an effective, market based means of restoring the stability of HBOS and helps to secure the stability of the UK financial system as a whole.

28. In accordance with Section 45(6) of the Act, the judgement the Secretary of State has to make is whether the anti-competitive outcome that may arise from this merger should be considered justified by the public interest as it relates to ensuring the stability of the UK financial system. On balance, he has concluded that ensuring the stability of the UK financial system justifies the anti-competitive outcome which the OFT has identified and that the public interest is best served by clearing the merger.
Friday 31 October 2008 15:48

Department for Business, Enterprise and Regulatory Reform (National)

Peter Mandelson gives regulatory clearance to Lloyds TSB merger with HBOS

Secretary of State for Business Peter Mandelson has today given regulatory clearance to the merger of Lloyds TSB and HBOS plc after concluding that the merger is in the public interest.

Lord Mandelson will not refer the proposed merger to the Competition Commission for further investigation, as the possible anti-competitive effects identified by the Office of Fair Trading (OFT) are outweighed by the public interest in preserving the stability of the UK financial system.

In making this decision, Lord Mandelson has considered the report provided by the OFT, as well as the representations on the public interest issues made by the Tripartite Authorities - the Bank of England, Financial Services Authority and HM Treasury - as well as submissions from third parties.

Lord Mandelson said:

"I am satisfied that on balance the public interest is best served by allowing this merger to proceed without a reference to the Competition Commission.

"I recognise that there are some concerns about the possible effects of the merger on competition, as set out in the OFT's report.

"I am asking the Office of Fair Trading to continue to keep the relevant markets under review in order to protect the interests of UK consumers and the British economy."

Along with his decision, Lord Mandelson is today publishing the report of the OFT, which includes submissions from the Treasury, the Bank of England and the Financial Services Authority. He has also written to the Opposition spokesmen for Business Enterprise and Regulatory Reform, and the Chairman of the Business and Enterprise Select Committee notifying them of his decision. The Secretary of State will also make a written statement to Parliament on Monday.

Notes to Editors

1. The then Secretary of State for Business, John Hutton, issued a public interest Intervention Notice in respect of this merger on 18 September 2006. Separately, an order was put before Parliament adding "the stability of the UK financial system" as a public interest ground on which public interest interventions in mergers may be made. The Enterprise Act

2. The full text of the Secretary of State's reasoned decision and a non-confidential version of the Office of Fair Trading's report on the merger, including redacted versions of the submissions from the Treasury, the Bank of England and the Financial Services Authority, can be found on the BERR website at:

3. A summary of the Office of Fair Trading's report on the merger and the report itself can also be found on the OFT website at:
http://www.ofte.gov.uk/advice_and_resources/resource_base/Mergers_home/lloydsTSB

Department for Business, Enterprise & Regulatory Reform
7th Floor, 1 Victoria Street, London SW1H 0ET

Public enquiries +44 (0)20 7215 5000
Textphone +44 (0)20 7215 8740 (for those with hearing impairment)
http://www.berr.gov.uk

Client ref 2008/253

COI ref 167030P
I am today announcing my decision on whether or not to refer to the Competition Commission the proposed merger between Lloyds TSB Group and HBOS plc.

You will recall that John Hutton intervened in this merger on public interest grounds on 18 September. Separately, "the stability of the UK financial system" has now been finalised as a new public interest ground on which public interest interventions in mergers may be made.

I received the Office of Fair Trading's (OFT) report on the competition and public interest issues raised by the merger on 24 October. This included the representations made to the OFT by the tripartite authorities (the Financial Services Authority, the Bank of England and HM Treasury), the parties to the merger and other interested third parties. I have also taken into account the small number of separate written representations made to me direct.

I have decided not to refer the proposed merger to the Competition Commission. While the OFT report does identify certain concerns about the possible effects of the merger on competition which might warrant further investigation, I believe that, on balance, the public interest is best served by allowing the merger to proceed without making such a reference.

The OFT will continue to keep the relevant markets under review in order to protect the interests of UK consumers and the British economy.

I enclose a copy of the full decision document. Copies will also be placed in the libraries of the House with the OFT's report which I am today publishing. The decision and the OFT's report will be available on the public interest mergers page of the BERR website at: http://www.berr.gov.uk/whatwedo/businesslaw/competition/mergers/public-interest/financial-stability/index.htm.
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PETER MANDELSON
The Rt Hon Lord Hunt of Wirral MBE
House of Lords
London
SW1A 0PW

81 October 2008

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1 Victoria Street, London SW1H 0ET
www.berr.gov.uk
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/sksi_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, 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

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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

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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

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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)

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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.

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.\textsuperscript{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’.\textsuperscript{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’,\textsuperscript{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

\textsuperscript{10} www.hm-treasury.gov.uk/press_100_08.htm.
\textsuperscript{11} www.hm-treasury.gov.uk/press_105_08.htm.
\textsuperscript{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.
\textsuperscript{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).

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[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). 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.

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

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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

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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 support\textsuperscript{19} 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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{19} See footnote 13.
\textsuperscript{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.
\textsuperscript{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 sequential\(^{24}\) (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


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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.
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). 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 bank 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. The average

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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. 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, 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.

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. 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.

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34 Including the Cruickshank report which found that competition was not working effectively in any of the retail banking markets it studied (including PCs) (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.
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 stating 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 HHI\(^{39}\) is 1950, which indicates that this is a highly concentrated market, with an increment of almost 500. The Guidance\(^{40}\) 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.


\(^{39}\) 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

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<th>2003</th>
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<tr>
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<td>(20-30)</td>
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<tr>
<td>Barclays</td>
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<td>(0-10)</td>
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<td>(10-10)</td>
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</table>

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

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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.
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). 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.

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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 banks 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. 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.

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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.\footnote{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.}

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.\footnote{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.}

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
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.
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

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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.\textsuperscript{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.\textsuperscript{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).\textsuperscript{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

\textsuperscript{52} SME Market Investigation Report, paragraph 1.8.

\textsuperscript{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.

\textsuperscript{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. 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). 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

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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).\textsuperscript{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]).\textsuperscript{59}

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.\textsuperscript{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:

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Market shares in SMEs (up to £15 m) in Scotland, start-up (2007)</th>
</tr>
</thead>
<tbody>
<tr>
<td>HBOS</td>
<td>[10-20]</td>
</tr>
<tr>
<td>Lloyds</td>
<td>[10-20]</td>
</tr>
<tr>
<td>Combined</td>
<td>[30-40]</td>
</tr>
<tr>
<td>Grupo Santander</td>
<td>[0-10]</td>
</tr>
<tr>
<td>RBSG</td>
<td>[30-40]</td>
</tr>
<tr>
<td>NAB Group\textsuperscript{50}</td>
<td>[0-10]</td>
</tr>
<tr>
<td>Others</td>
<td>[10-20]</td>
</tr>
</tbody>
</table>

Source: TNS, provided by Lloyds

\textsuperscript{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.

\textsuperscript{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.

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

\textsuperscript{50} 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:

<table>
<thead>
<tr>
<th></th>
<th>Market shares in SMEs (£1m to £25 m) in Scotland, stock (2006)</th>
</tr>
</thead>
<tbody>
<tr>
<td>HBOS</td>
<td>[30-40]</td>
</tr>
<tr>
<td>Lloyds</td>
<td>[0-10]</td>
</tr>
<tr>
<td>Combined</td>
<td>[40-50]</td>
</tr>
<tr>
<td>RBSG</td>
<td>[30-40]</td>
</tr>
<tr>
<td>Barclays</td>
<td>[0-10]</td>
</tr>
<tr>
<td>HSBC</td>
<td>[0-1]</td>
</tr>
<tr>
<td>NAB Group</td>
<td>[10-20]</td>
</tr>
<tr>
<td>Others</td>
<td>[0-10]</td>
</tr>
</tbody>
</table>

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.

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61 SME Market Investigation Report, paragraphs 1.3 to 1.5, and 2.235 to 2.242.
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.\(^6\)

- 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.

\(^6\) 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.\(^6\) 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.

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\(^6\) 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 Amro\textsuperscript{65}) 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/Abbey\textsuperscript{66} 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.

\textsuperscript{65} Case No COMP/M.4844 – Fortis/ABN Amro Assets.
\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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 that 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.\(^9\) 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

\(^{99}\) 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.

\(^{70}\) 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.’

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.

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.

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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". Datamonitor states that 'lenders are currently in a position where they can charge higher prices without this affecting demand'.

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.

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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.
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 purposes 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.
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. 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. 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.\textsuperscript{90} 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.

\textsuperscript{90} 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.\(^6\) 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

\(^6\) See Case No COMP/M.4284 – AXA/Winterthur, 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, 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.

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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, 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.

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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 cases 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.

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54 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,\(^5\) there are significant levels of 'multi-banking', that is, customers will have accounts, products and relationships 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.\(^6\) 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.

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\(^5\) That is, not SMEs.

\(^6\) 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. 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.

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87 Initial submission, page 50.
265. In 2005 the OFT cleared unconditionally the acquisition of HSBC’s fleet car hire business by Lex.\textsuperscript{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 is 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.\textsuperscript{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 decisions\textsuperscript{90} the market was characterised as being highly fragmented with numerous competitors. No

\textsuperscript{88} OFT Anticipated acquisition by Lex Vehicle Leasing Limited of the fleet car hire business of HSBC Bank plc November 2005.
\textsuperscript{89} See Case No COMP/M.4284 – AXA/Winterthur, paragraph 17
\textsuperscript{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." In this regard, and consistent with the accepted treatment of coordinated effects post-AirTours, 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.

- 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.
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.

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

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).

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.

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.\textsuperscript{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.\textsuperscript{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].

\textsuperscript{93} Paragraphs 4.29 to 4.35 of the Guidance.

\textsuperscript{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' 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'.

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'.

313. The type of efficiencies claimed by the parties would appear to be plausible. 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

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35 Guidance, paragraph 4.32.
36 Guidance, paragraph 4.34.
37 Guidance, paragraph 4.35.
38 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 providers. 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.

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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.\textsuperscript{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 providers.\textsuperscript{101}

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

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

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][106]) 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][104]) 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

[106] [REDACTED] is a mortgage broker, and [REDACTED] is a pensions and investment provider.
[104] [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.
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 remedi ing, 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 case 109 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.
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,\textsuperscript{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.

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

Lucilia 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. [REDEACTED]:
   • [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 form 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 minimize 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 in 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

<table>
<thead>
<tr>
<th>Market Sector</th>
<th>Market Segment - Detailed</th>
<th>Estimated market position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Financial</td>
<td>Current Accounts</td>
<td>1</td>
</tr>
<tr>
<td>Services</td>
<td>Mortgages</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Savings</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Personal Loans &amp; Cards</td>
<td>1</td>
</tr>
<tr>
<td>Insurance</td>
<td>Household Insurance</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Bancassurance</td>
<td>1</td>
</tr>
<tr>
<td>Corporate</td>
<td>Commercial Banking</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Mid-corporate Banking</td>
<td>3</td>
</tr>
</tbody>
</table>

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)

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

Source: Published accounts

Recent events and the case for action
4. On 13 October LT SB announced revised terms of its proposed merger of HBoS, reducing from 0.833 to 0.605 the number of LT SB shares to be exchanged for each HBoS share. This followed announcements by LT SB 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 gap is markedly lower than HBoS’.

### Table 3: HBoS market indicators

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

### Table 4: LT SB market indicators

<table>
<thead>
<tr>
<th>LT SB</th>
<th>02/07/07</th>
<th>09/10/08</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price</td>
<td>550.0</td>
<td>211.8</td>
<td>-338.2</td>
</tr>
<tr>
<td>Market cap (GBP millions)</td>
<td>31,473</td>
<td>12,814</td>
<td>-18,659</td>
</tr>
<tr>
<td>CDS premia</td>
<td>6.5</td>
<td>100.0</td>
<td>93.5</td>
</tr>
<tr>
<td>P/E ratio</td>
<td>9.9</td>
<td>5.1</td>
<td>-4.8</td>
</tr>
</tbody>
</table>

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 LT SB (Chart 1 and Table 5).

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

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

<table>
<thead>
<tr>
<th>LTV bucket</th>
<th>HBoS</th>
<th>LT SB</th>
<th>Merged</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;60%</td>
<td>0.38</td>
<td>0.47</td>
<td>0.42</td>
</tr>
<tr>
<td>60-70%</td>
<td>0.15</td>
<td>0.27</td>
<td>0.20</td>
</tr>
<tr>
<td>70-80%</td>
<td>0.18</td>
<td>0.15</td>
<td>0.17</td>
</tr>
<tr>
<td>80-90%</td>
<td>0.16</td>
<td>0.15</td>
<td>0.17</td>
</tr>
<tr>
<td>&gt;90%</td>
<td>0.12</td>
<td>0.08</td>
<td>0.10</td>
</tr>
<tr>
<td>Mortgages outstanding (£billions)</td>
<td>151</td>
<td>109</td>
<td>260</td>
</tr>
</tbody>
</table>

Source: Published accounts and Bank of England

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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
From: FSA
Date: 16 October 2008

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.

<table>
<thead>
<tr>
<th>Metric</th>
<th>Barclays plc</th>
<th>HBOS plc</th>
<th>HSBC Holdings plc</th>
<th>Lloyds TSB Group plc</th>
<th>RBS plc</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer loans/advances</td>
<td>£535,422m</td>
<td>£455,950m</td>
<td>$1,048,200m</td>
<td>£229,621m</td>
<td>£557,762m</td>
</tr>
<tr>
<td>Customer deposits</td>
<td>£466,176m</td>
<td>£258,130m</td>
<td>$1,161,923m</td>
<td>£178,450m</td>
<td>£432,920m</td>
</tr>
<tr>
<td>Loan:Deposit Ratio</td>
<td>115%</td>
<td>177%</td>
<td>90%</td>
<td>129%</td>
<td>129%</td>
</tr>
<tr>
<td>Funding Gap</td>
<td>£69,246m</td>
<td>£197,820m</td>
<td>N/A</td>
<td>£51,161m</td>
<td>£124,842m</td>
</tr>
</tbody>
</table>

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
4. 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 £56 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?

5. 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.

6. 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.

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![HBOS Share Price & Trading Volume (Jun - Sep 2008)](http://web.fff.com)

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

What action was taken?

7. 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 15%, reinforcing the urgency of this action.

What will be the impact on competition?

8. 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:
<table>
<thead>
<tr>
<th>Product</th>
<th>Barclays</th>
<th>HBOS</th>
<th>HSBC</th>
<th>Lloyds</th>
<th>RBS</th>
<th>Lloyds/ HBOS</th>
<th>Rest of Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Accounts</td>
<td>14%</td>
<td>13%</td>
<td>14%</td>
<td>17%</td>
<td>17%</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>Savings Accounts</td>
<td>6%</td>
<td>10%</td>
<td>6%</td>
<td>7%</td>
<td>6%</td>
<td>17%</td>
<td>65%</td>
</tr>
<tr>
<td>Residential Mortgages</td>
<td>7.1%</td>
<td>20.4%</td>
<td>4.2%</td>
<td>9.7%</td>
<td>6.8%</td>
<td>30.1%</td>
<td>51.8%</td>
</tr>
<tr>
<td>Credit Cards</td>
<td>14%</td>
<td>8%</td>
<td>10%</td>
<td>10%</td>
<td>11%</td>
<td>18%</td>
<td>47%</td>
</tr>
<tr>
<td>Unsecured Loans</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>21%</td>
<td>12%</td>
<td>29%</td>
<td>43%</td>
</tr>
<tr>
<td>Business Banking</td>
<td>20.0%</td>
<td>5.6%</td>
<td>15.5%</td>
<td>17.0%</td>
<td>33.8%</td>
<td>22.6%</td>
<td>8.1%</td>
</tr>
</tbody>
</table>

Source: FSA data, GSK FRS Consumer Survey (June 2008), Continental Research/ Market (June 2008)

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 0.89 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 £3 billion in preference shares) will be raised by HBOS and £5.5billion (£4.5billion in ordinary shares and £1 billion 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

<table>
<thead>
<tr>
<th>Lloyds TSB</th>
<th>Agency</th>
<th>Long-term</th>
<th>Short-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moody's</td>
<td>Aaa</td>
<td>P-1</td>
<td></td>
</tr>
<tr>
<td>Fitch</td>
<td>AA+</td>
<td>F1+</td>
<td></td>
</tr>
<tr>
<td>Standard &amp; Poor’s</td>
<td>AA</td>
<td>A-1+</td>
<td></td>
</tr>
<tr>
<td>DBRS</td>
<td>AA(H)</td>
<td>R-1H</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>HBOS</th>
<th>Agency</th>
<th>Long-term</th>
<th>Short-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moody's</td>
<td>Aa2</td>
<td>P-1</td>
<td></td>
</tr>
</tbody>
</table>

112 Moody’s announcement 14 October
http://www.moodys.com/moodys/cust/research/MDCdocs/14/200730000539825.asp?search=0&searchQuery=lloyds&click=1&frameOffRef=corporate

117
Fitch  
AA  
Fi+  
Standard & Poor's  
A+  
A-1  
DBRS  
AA(H)  
R-1H  

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 £8.5billion worth of ordinary shares in HBOS and £4.5billion 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 £3billion worth of preference shares in HBOS and £1billion 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, £1.7 billion of capital will be raised, of which £1.15 billion (£8.5 billion in ordinary shares and £3.3 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 1 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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Mike Smith
E-mail: lloydsstsb@finsbury.com

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 XI 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

RNS Number : 6670F
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 1 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 1 issuance based on June 2008 pro forma figures are shown below:

<table>
<thead>
<tr>
<th></th>
<th>Proforma 1.3</th>
<th>Proforma 2.3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 Capital Ratio</td>
<td>8.6%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Core Tier 1 ratio</td>
<td>6.5%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Total Capital ratio</td>
<td>12.2%</td>
<td>15.6%</td>
</tr>
<tr>
<td>Tier 1 gearing</td>
<td>24.1%</td>
<td>24.7%</td>
</tr>
</tbody>
</table>

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 (£4.3bn 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 1.

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 1

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

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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

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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

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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, [I] 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 Singleton
Chief Executive
Office of Fair Trading
Fleet Bank House
2-6 Salisbury Square
London
ECDY BUK

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 reputation of the UK’s competition regime will be jeopardised. 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 joining 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 CFT 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 £15.2 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 84,000 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 from 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 / HBCS 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 index to see a new arrangement?

- Should the Banking Code be brought under co- or direct regulators 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 size 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
Alastair Mordaunt, Office of Fair Trading
Nectar Saints, 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

THE SCOTSMAN
SCOTTISH NATIONAL NEWSPAPER

20 October 2008

John Fingleton
Chief Executive
Office of Fair Trading
Hertsmere House
2-6 Salisbury Square
LONDON
EC4Y 8JX

Dear Mr Fingleton,

The Scotsman newspaper is deeply concerned about the bad effects on competition in the Scottish banking market that will be caused by the proposed merger between Halifax Bank of Scotland (HBOS) and Lloyds TSB. We believe that such a merger would leave Scotland with the most concentrated and least competitive banking market in Britain, perhaps also in Europe.

This would result in Scottish banking customers having the least choice and probably paying the highest charges in Britain. While this would be unacceptable in itself, it would also place an unacceptable handicap on the Scottish economy, reducing Scotland’s capacity for growth and job creation.

Our purpose in writing to you is therefore to ask that the Office of Fair Trading (OFT) should make a specific study of the Scottish banking market as part of the report that you are preparing for the government on the implications of the takeover. While the government, as part of its response to the current financial crisis afflicting banks, has said it will waive the normal competition rules that would rule out an HBOS/Lloyds TSB merger, the OFT is still duty bound to report on how this move would affect competition.

The Scotsman believes that the Scottish banking market is quite different from the UK market, which is dominated by the “big four” established banks - HSBC, RBS/Natwest, Lloyds TSB, and Barclays - and within which market HBOS operates as a smaller “challenger” bank. In Scotland however, the market is dominated by HBOS and RBS, which we believe have about 70 per cent of the overall market between them. The Clydesdale Bank and Lloyds TSB

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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 2320. 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 1943 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 an unconscionably 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 Cranfield 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
TSH 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 2760, 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/HDOS 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 consumers 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

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

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Mr John Fingleton
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23 October 2006

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 RBS 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 location 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 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.

Yours sincerely,

Alex Salmond