

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.

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## **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.