Strategic Review of Retail Banking Business Models – Annexes to the Final Report

January 2022

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Annex 1
UK Retail Banking business models profitability

Key messages

All banks have come under pressure from the low interest rate environment, increased competition, changing consumer expectations and regulatory costs arising due to Covid, and most have experienced lower returns over the last three years (2018-2020) than the preceding period (2015-2017).

Big 4 banks continued to achieve higher returns on capital than other cohorts of banks, but the gap has narrowed. Big 4 banks face expectations and associated costs to provide support particularly to consumers in vulnerable circumstances, such as through access to cash and basic bank accounts, while some smaller challengers do not. However, the Big 4 continue to benefit from advantages compared to other archetypes:

- low retail and wholesale funding costs
- economies of scale and scope
- favourable regulatory capital requirements

Many smaller banks and building societies have struggled to compete head-to-head with larger firms as competition has intensified in the mortgage market. Some have exited altogether; others have moved into more esoteric areas of the market in a search for better yields.

Scale challengers have played an important part in driving competition in the mortgage market. These firms are better able to compete with the Big 4 due to their large, stable and low cost funding bases. However, this has come at a price: their returns have been driven down significantly.

Specialist lenders do not compete head-to-head with larger banks, restricting themselves to niche lending segments requiring specialist underwriting expertise. These small-scale lenders have been able to maintain relatively high returns although these have also reduced over time as other lenders have encroached on some of their specialist areas.

Introduction

1. The process of competitive rivalry should over time narrow the gap between prices and costs, as firms seek to win customers through offering better value. Therefore, examining the direction in which prices and costs are moving can help us to understand the degree of competitive rivalry in a market. One way of getting some insight into this question is to look at firm profitability, considering the revenues that firms make and the costs they incur in generating these revenues, and whether the gap between these two, the margins, have moved over time and why. We can use this information to calculate firms' overall returns on equity, i.e. the capital held in their business. In this chapter we've used this type of insight to build up a picture of the state of competition, including the impact of environmental drivers such as the Covid-19 pandemic, low interest rates and regulation.

2. In addition, forming an understanding of which business models are more profitable than others, and why, can help us to understand the level of competitive pressure that they exert and may be expected to exert in the future. A situation in which new entrants systematically struggle to establish a profitable and sustainable business model might indicate the presence of barriers to expansion and could be a sign of some feature of the market that is preventing competition from developing. The ability of competing firms to expand and grow to become effective challengers is an important question for us.

3. In this section we examine trends in net interest margins and returns, and how they differ between business models. We consider the factors which drive these margins and returns, including funding composition and costs, lending yields, transaction fee income, operating costs, and capital.

4. We start by describing the various business models operating in the market, distinguishing between Personal Current Account (PCA) operators and non-PCA operators.

5. We then analyse trends in, and drivers of, net interest margin, followed by costs, and then capital. Decomposing returns in this way enables us to explain the drivers of trends in return on assets and return on equity, and how these differ between business models.

Overview of retail banking business models

6. In this review, we have focussed on deposit-taking institutions, including banks and building societies. Non-deposit takers such as E-money institutions (EMIs) and non-bank lenders are subject to different requirements, so are not the focus of this study but are referred to where relevant.[1]

7. We distinguish two types of deposit takers: those that offer PCA banking, and those that do not. This choice turns out to have a fundamental impact on the business model.

1 See BoE (2019) How Banks are Authorised in the UK for further information on deposit-taking and other permissions

PCA operators

8. PCA operators offer PCAs and often a wide range of additional products for consumers, including savings accounts, lending products such as mortgages, credit cards and personal loans, often serving both individual customers and Small to Medium Enterprises (SMEs). Many of these firms are long established and have a network of high-street branches. For the purpose of examining trends in the market, we have grouped PCA operators into four types, according to factors such as size and nature of operations: the Big 4, Scale challengers, Mid-tier banks and Digital banks.

9. The Big 4 banks are Lloyds Banking Group, Barclays, HSBC and Natwest and are long established with around 65% of all PCAs in 2020 by account numbers. These large banks offer a wide range of products for consumers, both individual customers and SMEs. Traditionally, Mortgages have comprised the highest proportion of the Big 4's lending. The Big 4 have a strong High Street presence, with extensive branch networks allowing their customers to purchase and manage their banking in-person. Branches provide an important source of access to cash for consumers, coverage of which is monitored by the FCA. As of 2020, the Big 4 had approximately 6.2 branches per 100,000 PCA customers[2]. In recent years, the Big 4 have improved their digital banking services, giving customers the option to visit them in branch or manage their banking completely remotely.

10. "Scale challengers" include banks and building societies which have a sizable personal current account business, including Santander, Nationwide, Virgin Money, and TSB, collectively operating around 25% of all PCAs as of 2020. Two of these firms, Santander and Nationwide, have their origins as traditional building societies. Santander purchased the building society Abbey National plc in November 2004 creating Santander UK. Both have built up their personal current account business over many years since liberalisation[3]. TSB was divested from LBG as a condition of the state-aid package provided to LBG in the wake of the Global Financial Crisis (GFC), with a view to it growing its PCA market share[4]. Virgin Money was a relatively small new entrant PCA provider until it merged with long-established Clydesdale Bank in 2019. Scale challengers have a significant branch network across the UK, however in comparison to the Big 4, they had more branches available per 100,000 PCA customers, at approximately 7.4 in 2020.[5]

11. "Mid-tier banks" are smaller in size again and include Co-op, Metro, Tesco and Sainsbury's. They collectively operated around 4% of UK current accounts in 2020[6]. These banks vary widely in character: Co-op is a long-established bank with an ethical brand; Metro launched in 2010 seeking to offer a branch-based service; and Tesco Bank launched its PCA in 2014 aiming to provide banking services to customers of the supermarket chain by the same name. Mid-tier banks vary in the size of their branch networks, although on the whole they are much smaller than those of the Big 4 or Scale challengers. Their number of branches per 100,000 customers is approximately 5.5, which is mostly driven by Metro Bank.

2 As per the data received from firms for the Strategic Review. We have calculated branches per 100,000 PCA customers as number of branches reported divided by number of PCA accounts over 100,000.

3 The Building Societies Act, 1986 paved the way for Building Societies to diversify into personal current accounts and other forms of lending other than mortgage lending, and to demutualise subject to member agreement.

4 See CMA: TSB Case study

5 As per the data received from firms for the Strategic Review. We have calculated branches per 100,000 PCA customers as number of branches reported divided by number of PCA accounts over 100,000.

6 As per the data received for the Strategic Review. We note that Sainsbury's and Tesco no longer operate current accounts as of the date of this report.

12. "Digital banks" include Starling and Monzo. These banks are recent entrants, having been authorised in 2016 and 2017 respectively, and offer personal current accounts. They operate without a branch network and focus on providing services through smartphone apps. The number of PCAs operated by these banks has increased rapidly over recent years. These two banks now operate around 8% of all UK current accounts. We do not cover Digital banks in this annex. Please refer to Annex 2 for the analysis performed on these banks.

Non-PCA operators

13. Non-PCA operators operate simpler business models with a more limited product offering, focussing on offering savings accounts of various types and using these deposits to fund lending activities. We group these firms into two categories as follows:

14. "Specialist lenders" include banks such as Shawbrook, Aldermore, Close Brothers, and Oaknorth. They aim to serve consumers who are not typically well served by traditional banks, such as those with more complex or specialist lending needs, and have a high proportion of buy-to-let (BTL) mortgages and lending to SMEs. These firms mostly acquire customers through broker networks and have limited branch networks. Brokers therefore play an important part in customer acquisition and retention. Often, brokers manage the customer relationship entirely, with the lender having limited communication with the customer. For this reason it is important for lenders to maintain a wide and stable broker network to facilitate customer relationships.

15. "Building societies" focus for the most part on mortgage lending, predominantly to individuals, and are funded through personal savings, both instant access and fixed term. Building societies rarely offer current account products due to the lack of scale economies to absorb the infrastructure-related costs required to develop and maintain this type of product, including costs linked to conduct requirements such as checks and controls. As mutuals, Building Societies aim to reward their members (savers) with interest on savings balances, and do not have shareholders.

16. The data on which this report is based covers the majority of UK deposit taking institutions and we would not expect any omissions to have a material impact on our conclusions. We cover the largest 12 deposit takers plus a sample of smaller banks and building societies as outlined above. We do not cover banks domiciled overseas but operating branches in the UK. Furthermore, we have not included certain types of non-banks, for example e-money institutions like Tide or Revolut.

Net interest margins fell across all retail banking business models between 2015 and 2020

17. A key source of earnings for banks is net interest income (NII). Banks earn most of their NII by charging higher interest rates on loans than they pay for funding. They also earn fees and charges on lending products and on current accounts. Net interest margin (NIM) is a useful, but incomplete, measure of profitability. Importantly, it is stated before any costs, including costs associated with risk and operations, and capital.

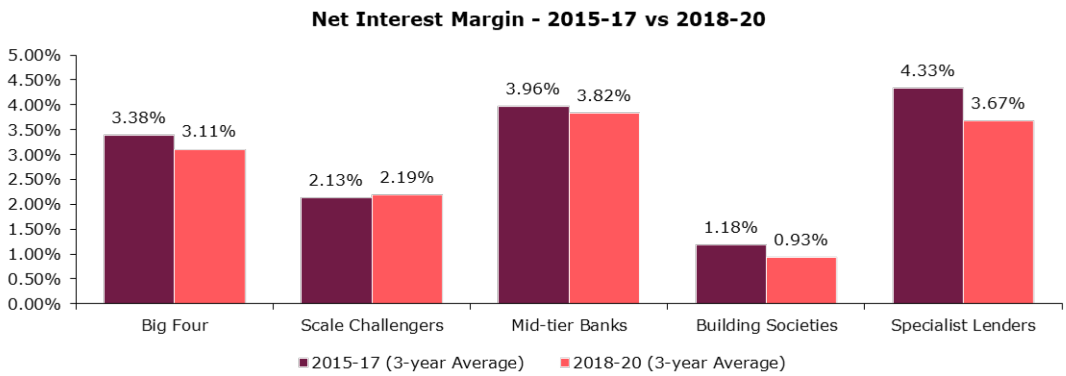
18. Banks tend to define NIM as net interest income divided by interest-earning lending assets.

19. However, we include non-interest income (i.e. fee income) on lending products within our definition of NIM in order to view the overall profitability of lending assets. Therefore, we define NIM as follows, where all-in lending yield is (interest + fees on lending)/lending assets:

$$\text{Equation x: Net interest margin} = \text{all-in lending yield} + \frac{\text{non-lending fee income}}{\text{lending assets}} - \frac{\text{funding costs}}{\text{lending assets}}$$

20. Figure 1.1 shows 3-year average NIMs across two periods, 2015-17 and 2018-20. The figure below illustrates that NIM has fallen for most business models between 2015 and 2020, with the exception of scale challengers. Big 4 and Specialist lenders experienced the largest drops in NIM of 28 and 66 basis points respectively.

Figure 1.1



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders

21. In the analysis that follows, we look at the factors that have contributed to the changes in NIM and differences between cohorts.

We explain:

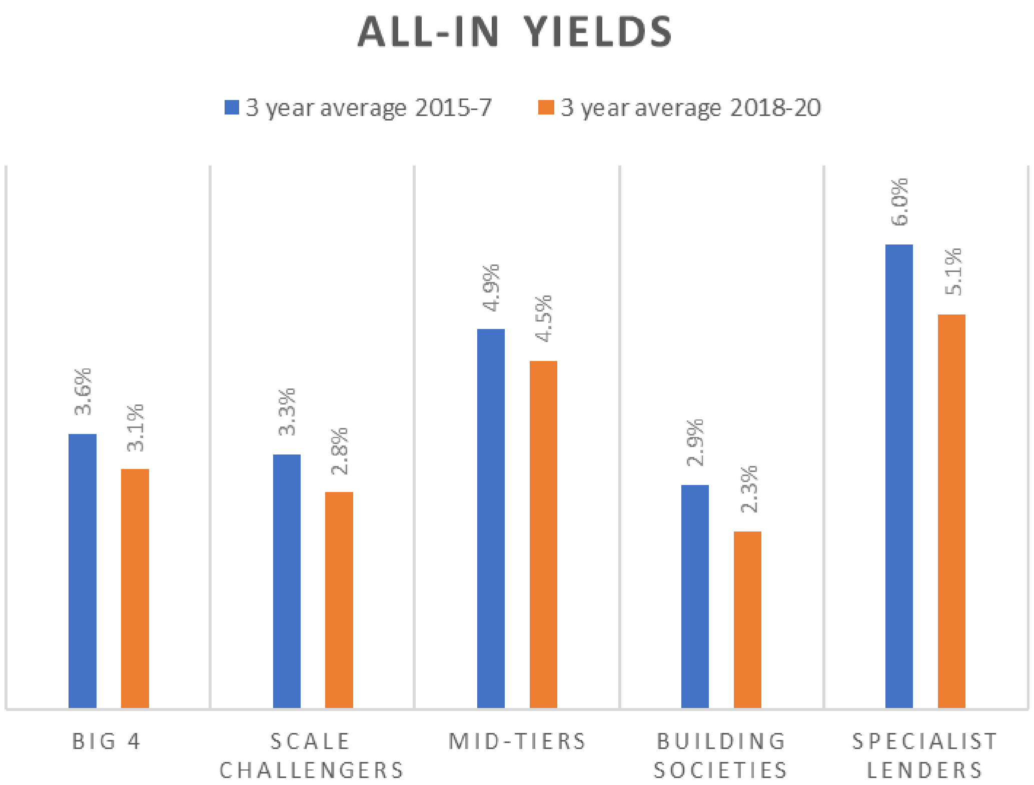
a. why mid-tier banks and specialist lenders earn higher average NIM than Big 4, scale challengers and building societies, by advancing more unsecured lending and higher risk secured lending. Annex 3 explains the changes in risk profiles of challengers in Mortgages.
b. how lending composition contributes to differing yield levels between cohorts.
c. how the Big 4 and scale challengers achieve low funding costs by paying lower rates on retail deposits, including PCA and BCA balances and savings balances
d. how funding costs have declined and have partially offset the impact of declining yields
e. how fee income deriving from transactional banking has fallen across the different business models, including as a result of Covid-19.

Lending yields are higher for firms that take on higher risk

Lending yields have declined across most cohorts

22. Figure 1.2 shows that over time, lending yields have declined for most cohorts, as rates have fallen on both mortgages and consumer credit. Reasons for this include increased price competition and, for firms offering overdrafts, a combination of the Overdraft remedy we introduced in 2020 which caused a significant decline in unarranged overdraft yields and the temporary interventions we made during the pandemic. We expect that once our temporary interventions on overdrafts ended, yields on arranged overdrafts increased to pre-pandemic levels. Annexes 3 and 4 go into more detail on mortgages and consumer credit yields respectively.

Figure 1.2[7]



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders

23. In order to explain the differences between cohorts and the reason for changes over time, we have analysed loan book composition and considered whether differences between cohorts are due to the competitive environment or other factors.

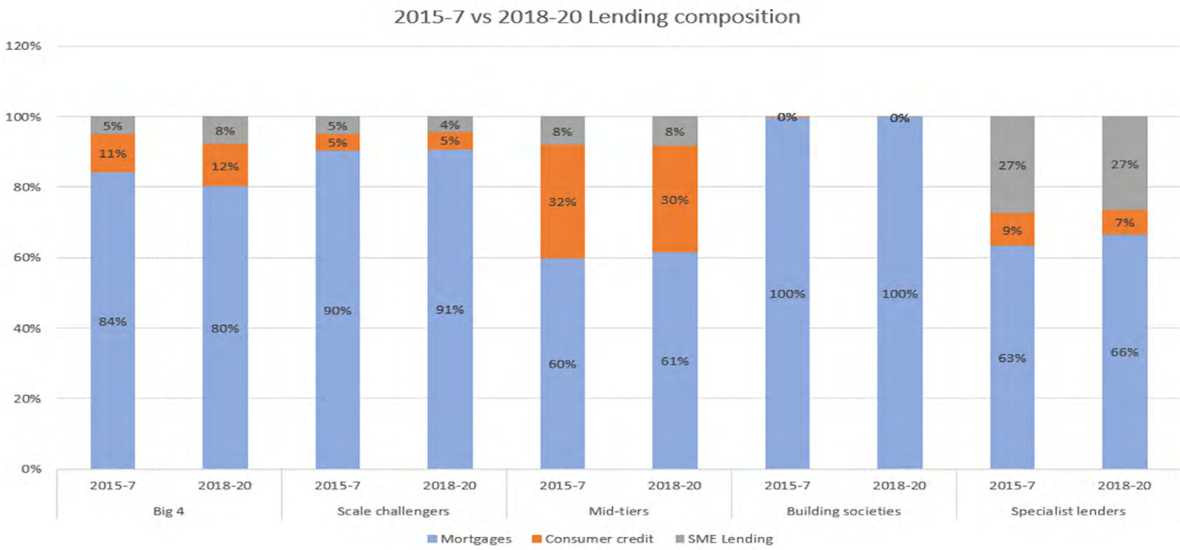
Firms with larger proportions of mortgage lending tend to earn lower yields

24. Yield levels are driven by many factors such as target margins and sales costs. Yields are needed to offset costs to the business, like loan losses, and factors that reduce overall return on equity, such as minimum capital requirements.

7 All-n yields are calculated as Interest income and fees on lending divided by lending assets.

25. We look at loan book risk as a major driver of yield. Low risk lending such as mortgages secured on residential property generates lower yields than consumer credit which is typically unsecured. SME lending tends to be a mixture of secured and unsecured, but overall is more risky than secured personal lending. However, there is still a range of risk on products within product categories. For example, mortgages with a high loan-to-value (LTV) ratio are riskier than those with a low LTV ratio.

Figure 1.3[8]



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders

26. Figure 1.3 gives a high-level view of the lending composition of each cohort, split by mortgages, consumer finance and SME lending. Building societies followed by Scale challengers hold the highest proportion of mortgages 100% and 91% respectively for the 3-year period 2018-20). Scale challengers include Nationwide and Santander, which either began as or continue to be Building societies.

27. This composition helps to explain why Building societies earn a lower yield than the Big 4 and Scale challengers, because they are almost entirely focused on mortgage lending. Refer to Annex 3 for further detail on recent dynamics in the mortgage market.

28. Mid-tier banks have a lower proportion of mortgages 61% than the other cohorts. This reflects their relatively greater focus on consumer credit, which in turn has generated higher yields.

29. The Big 4 and Mid-tiers have increased their proportion of SME lending between the two periods, which is attributable to the Government lending schemes introduced in 2020 to support businesses throughout the pandemic. Annex 5 sets out our detailed analysis of the SME lending market.

30. Specialist lenders have a notably different lending book to other banks and building societies and tend to take on more high-risk lending which requires more manual underwriting, such as BTL mortgages, refer to Annex 3. To compensate for this risk and the cost of manual underwriting, they charge higher prices. This is consistent with the higher yields that they earn on their lending books.

8 There was a change in SME Lending data requested for the years 2019-2021, compared with the data used in the 2018 Final Report. Therefore, we have made an assumption about the total level of SME lending in 2019-20 to ensure consistency across the years.

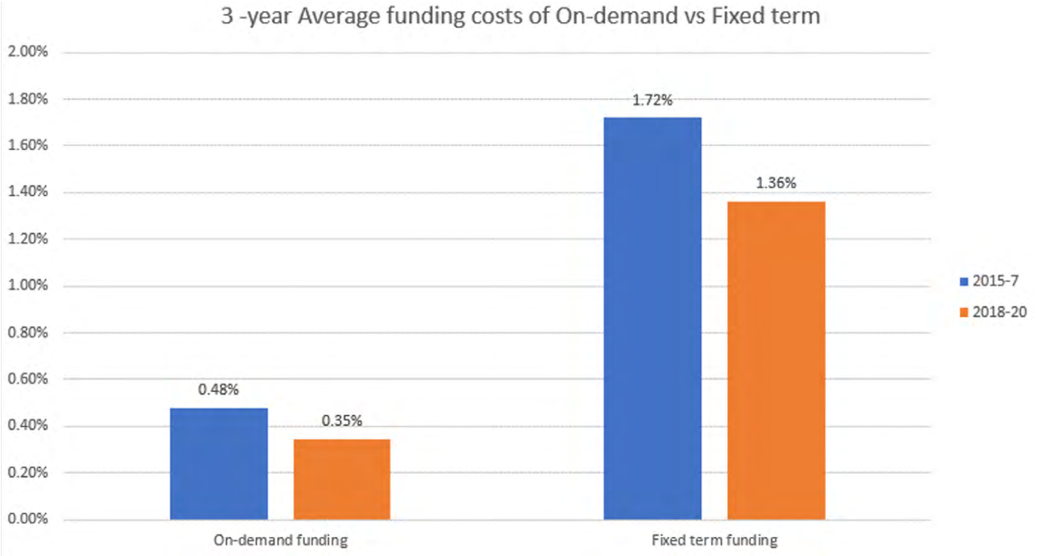
PCA providers have a lower cost of retail funding than non-PCA providers. Large banks have the lowest retail funding costs

31. Banks provide current and savings accounts where customers can place deposits, which banks use in turn to fund their lending activities. They can also access wholesale funding sources from the financial markets. Each type of funding incurs a different cost for the banks dependent on several factors, such as the Bank of England base rate, the interest rate being offered to consumers or in the case of wholesale funding, their credit rating.

32. In order to make positive returns on lending, banks consider the relative costs of funding in comparison with their lending yields, the lending risks, and factor these into their pricing. In this section we discuss how funding compositions and the base rate impact firms' overall funding costs.

33. On-demand deposits (i.e. PCAs and instant access savings) continue to be a relatively cheap and stable source of funding. Figure 1.5 shows the disparity in funding costs between on-demand vs fixed term funding, with fixed term funding being much more costly for banks. However, we can also see that fixed term funding fell in the 3-year period 2018-20 by a greater amount than on-demand deposits, indicating lower rates are being paid to customers.

Figure 1.5

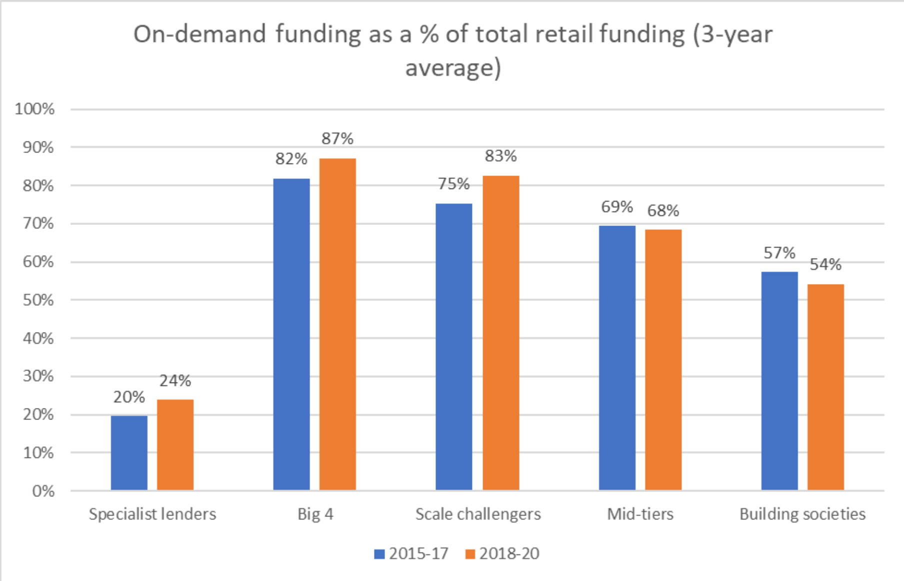


Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders. Funding costs in this analysis have been calculated as gross interest paid out divided by deposit balances for on-demand funding (PCAs and Instant access savings) and fixed term savings respectively.

34. The Big 4 have achieved a funding advantage through their high proportion of on-demand funding, and customer inertia in switching has contributed to this funding advantage being maintained throughout the years. This is covered in further detail in Annex 2.

35. Over time, banks have relied more on this cheap on-demand funding compared to fixed term funding (i.e. fixed term savings). Figure 1.6 shows the percentage of on-demand funding as a percentage of total retail funding for each cohort, and how it has changed over time. Specialist lenders, Big 4 and Scale challengers have clearly increased the proportion of on-demand funding. Specialist lenders and Building societies have the lowest proportions of on-demand funding, indicating their funding base contains more fixed-term funding.

Figure 1.6

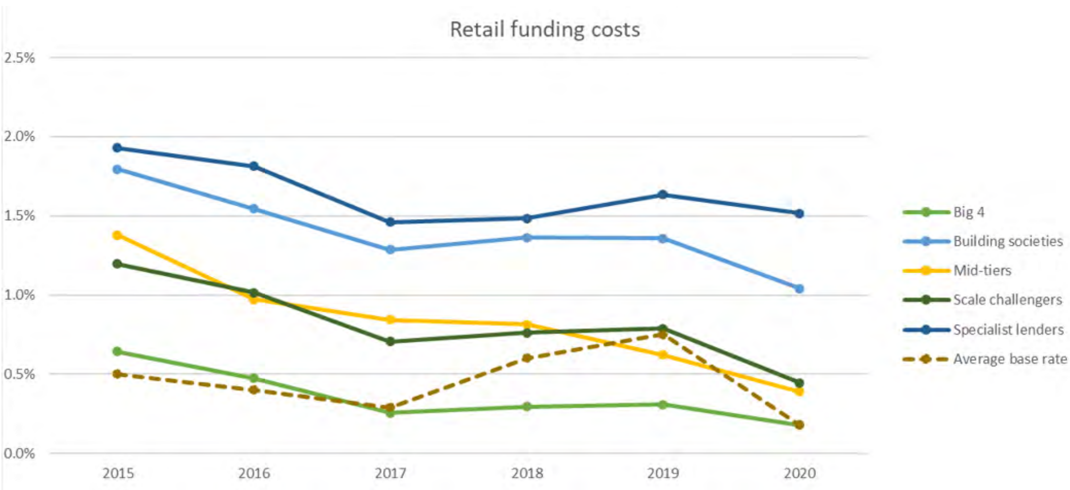


Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders. This has been calculated as the total of PCA and Instant access savings balances divided by total retail deposit balances

36. Higher proportions of fixed-term funding have led to Specialist lenders and Building societies having the highest overall retail funding costs. However, these firms have passed on base rate reductions to their savings customers, with Building societies in particular experiencing a steep decline in funding costs in 2020.

37. Figure 1.4 displays the total retail funding cost by cohort over time alongside changes in the Bank of England base rate. Firms' funding costs have tended to move in line with base rates over the last few years, as banks have reduced the interest paid out to consumers on their deposits. These changes are not solely driven by changes in the base rate alone, they also depend on the term of the savings product and competitive conditions.

Figure 1.4[9]



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders. Funding costs in this analysis have been calculated as gross interest paid out divided by deposit balances.

9 We have calculated an average Bank of England base rate for each year based on the number of months spent at a particular rate.

38. Specialist lenders and building societies have significantly higher funding costs than other cohorts. This reflects the fact that they don't operate current accounts, which means they must attract funding by offering savings accounts. This tends to be more costly than current account funding, although they don't incur the costs of the infrastructure associated with operating current accounts.

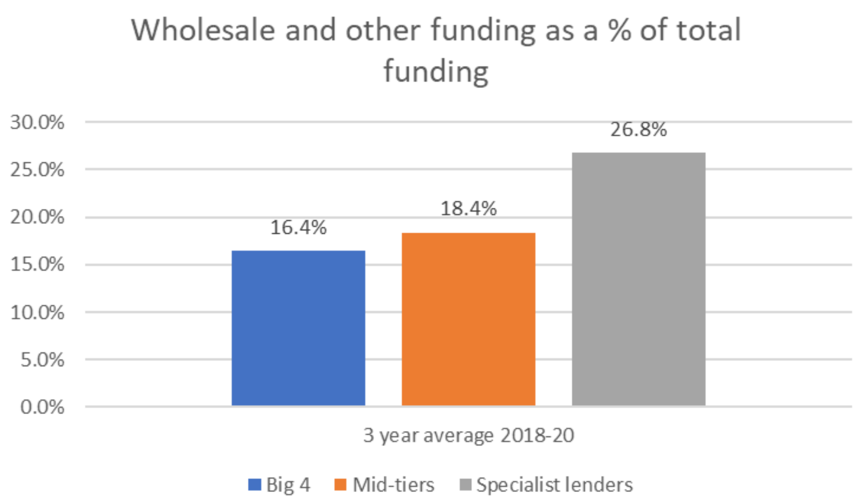
39. Amongst the PCA providers, Scale challengers and Mid-tiers have higher costs of retail funding compared to the Big 4 because they compete for customers by offering higher interest rates. For example, Santander 123 accounts offered a 1.5% rate on savings in 2019 which reduced in 2020. Their higher cost of funds could therefore be attributed to competing with the Big 4 to attract and retain current account customers.

Large PCA providers have less wholesale funding as a proportion of overall funding than other firms

40. Most banks use wholesale funding as an additional component of their overall funding mix. Wholesale funding includes short-term interbank borrowing (repos); capital market debt issuance (bonds etc); and funding from the central bank (eg under schemes such as FLS, or TFSME).

41. Our analysis indicates that for the Big 4 around 16.4% of funding came from wholesale and other sources in the 3 year period to 2020, with the remaining portion generated by customer deposits and equity. Smaller banks and Specialist lenders are more reliant on wholesale funding than major banks, with around 18.4% and 26.8% of funding from wholesale sources respectively.

Figure 1.7



Source – Annual reports available from firm websites, sample includes 4 Big 4 banks, 4 mid-tier banks, 4 specialist lenders

42. Since the GFC, there has been a trend to reduce reliance on wholesale funding. The Bank of England presented evidence of this in an article published in March 2019.[10]

10 Has the link between wholesale bank funding costs and lending rates changed?, Bank of England, March 2019

43. The cost of wholesale funding tends to be higher than Retail funding, despite the low interest rate environment in 2020. Taking the 3-year average return on 1-year corporate bonds on the S&P UK Investment Grade Corporate Bond Index as a proxy, wholesale funding costs for large banks were likely to average around 3.7%. We expect wholesale funding costs to be higher for Mid-tiers and Specialist lenders, as they have lower credit ratings than incumbents. This in turn would increase their funding costs.

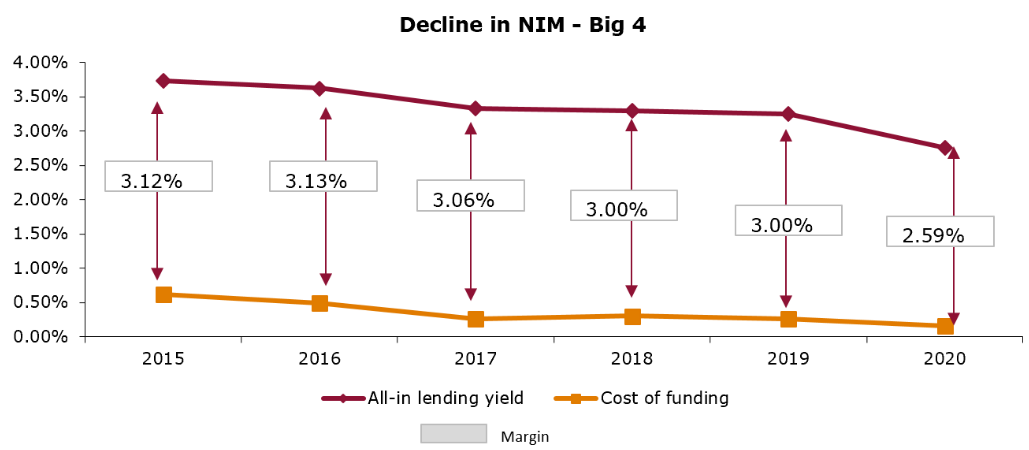
Lending yields have fallen by more than funding costs, contributing to NIM compression

44. In the sections above, we highlighted how changes in interest rates and in funding composition have driven lower funding costs across all business models. In addition, we highlighted that lending yields have also been on a downwards path as a result of competition in prices and other factors such as our overdraft rules.

45. If yields and funding costs across the whole business move together and to the same degree, the spread between yields and funding costs would stay constant over time and NIM would be unaffected. However, we find that all business models experienced a decline in NIM across 2015-2020 because funding costs did not decline as much as lending yields. We find that this margin compression was most pronounced for Big 4 banks.

46. Figure 1.8 illustrates the trend in all-in lending yield and cost of funding for Big 4, demonstrating NIM compression caused by funding costs falling by less than all-in lending yield. NIM declined by 53 basis points (17%) from 3.12% in 2015 to 2.59% in 2020. Much of this was driven by the fall in NIM between 2019 and 2020. Of the 53 basis point fall over the period, 41 basis points occurred between 2019 and 2020.

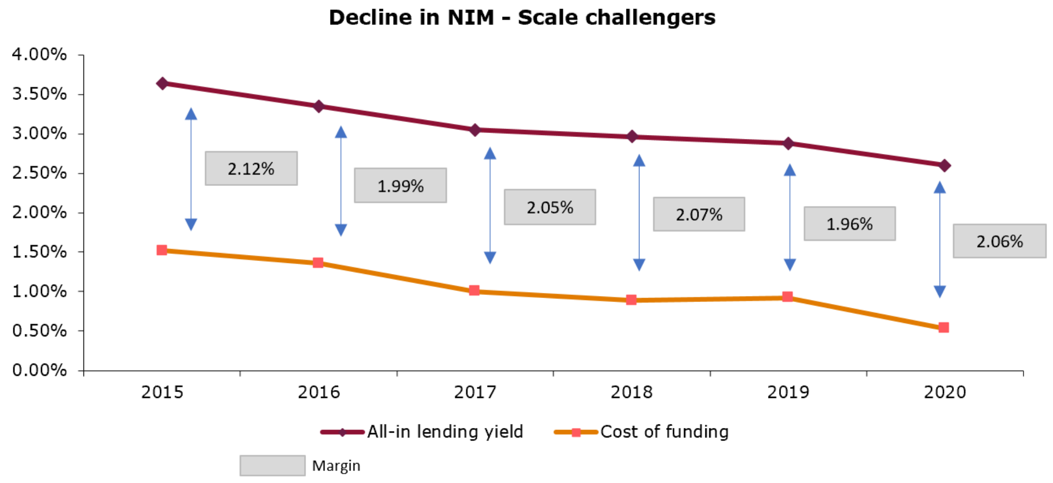
Figure 1.8



Source – FCA analysis, sample includes 4 Big 4 banks. Calculation based on weighted average.

47. Scale challenger NIM declined by 6 basis points (3%) between 2015 and 2020, from 2.12% to 2.06%, again due to funding costs declining at a lesser rate than all-in lending yield. Margins did not decline by as much for the scale challengers that had more flexibility to alter the interest rates they offer to their customers and were able to do so without high levels of customer attrition.

Figure 1.9



Source – FCA analysis, sample includes 4 scale challenger firms. Calculation based on weighted average

Non-lending transactional fee income on PCAs and BCAs has remained stable

48. PCA providers earn non-lending fee income from payment fees and other charges related to PCAs and BCAs. This includes revenue from interchange on debit card transactions, fees and commissions from foreign exchange and insurance, and monthly account fees net of cashback and other negative revenue items.

49. Total transactional fee income on PCAs and BCAs fell very slightly (by 2 bps) between 2015-2017 and 2018-2020 when viewed as a percentage of lending assets. Our analysis suggests that fees and charges remained relatively stable on a per-account basis. See Annex 2 on PCAs and Annex 5 BCAs.

Underlying return on capital has fallen but remains highest for Big 4 and specialist lenders

50. In this section we discuss the additional analysis required to understand bank profitability in terms of underlying return on assets and equity. Our analysis focuses on pre-tax return to assess the relative performance of firms' retail banking business model. Profit after tax was considered as part of our work but measures both firms' operational performance and their management of tax liabilities, and so was not used in the main line of our analysis.

51. To assess business model profitability we focus on the performance of a firm's retail banking activities, i.e. the performance of a firm's retail banking division or entity within the wider ring-fenced group (if applicable). As in previous studies of this nature, we have excluded the impacts of business lines in wind-down, exceptional items such as regulatory fines and revenue from sales of assets. As such, our assessment of underlying profits may not always accord with the distributions that are available to shareholders.

52. In the previous section, we discussed the costs banks incur in generating net interest margin, including loan losses and operating costs, and the impact of these costs on net returns. As in previous studies, we look at net returns as a percentage of lending assets as this is an effective way to compare the results of banks of different sizes.

53. In this section we introduce equity capital and its relationship with risk weighted assets. We use the metric 'risk weighted asset density', or RWAs as a percentage of lending assets, because again this provides an effective way to compare banks of different sizes. By measuring the amount of equity banks hold against RWAs and combining this with the results of our net return analysis, we are then able to look at underlying pre-tax return on equity.

54. This analysis illustrates the trends in underlying profitability of retail banking business models between 2015 and 2019 and extends the analysis to look at the impact of the pandemic on returns in 2020 as well as the impact of competition dynamics.

Big 4 banks achieve higher returns on assets than most other banks

55. Between 2018-2020, Big 4 banks, on average, had higher returns on retail lending assets than scale challengers and mid-tier banks.

56. The table below shows 3-year average return on lending assets for different retail banking business models. Big 4 return on assets was 0.9% during this period, compared to 0.5% and 0.1% for scale challengers and mid-tier banks, respectively. This is a function of their ability to generate relatively high lending yields, whilst keeping loan loss ratios and costs low, in combination with their low cost of funds.

57. Specialist lenders have a different lending mix to other business models and earn a relatively high return on assets at 1.4% despite having higher funding and operating costs in comparison to most other business models. This is due to the higher prices they charge on their lending products as explained earlier.

58. We explore loan loss ratios and costs in further detail below.

Return on Lending Assets 3 year average (2018-20)

	Big 4	Scale Challengers	Mid-tier Banks	Building Societies	Specialist Lenders
Lending yield	3.1%	2.9%	4.5%	2.3%	5.1%
Cost of funds	-0.2%	-0.8%	-1.1%	-1.3%	-1.4%
Non-lending fee income	0.2%	0.1%	0.4%	0.0%	0.0%
Net interest margin	3.1%	2.2%	3.8%	0.9%	3.7%
Loan loss ratio	-0.4%	-0.2%	-0.6%	0.0%	-0.5%
Costs	-1.6%	-1.3%	-3.5%	-0.6%	-1.8%
Other income / expenditure	-0.2%	-0.2%	0.4%	0.1%	0.1%
Return on lending assets	0.9%	0.5%	0.1%	0.4%	1.4%

Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders. Figures in the table may not sum to the return on lending assets due to rounding.

Notes: Underlying pre-tax return includes: wholesale funding costs; net interest arising from structural hedging arrangements and intra-group transfer pricing; negative income. Excludes: income and costs relating to non-core and winddown activities; exceptional costs and benefits such as fines and redress; fair value adjustments.

All-in lending yield includes fees associated with lending.

Cost of funds is calculated as gross interest paid out a % of lending assets, rather than a % of funding balances.

Additional fee income includes fees from transactional banking, FX, and insurance as well as negative revenue.

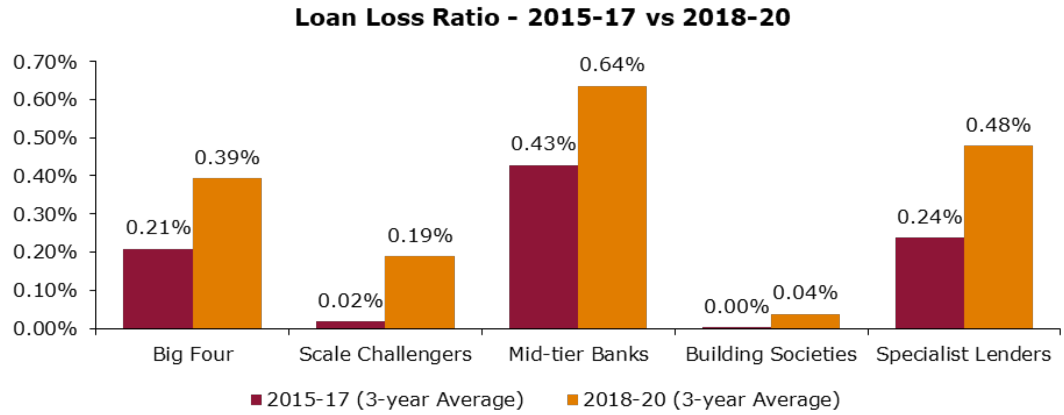
Loan-loss ratio is calculated as in-year impairment provisions / average lending assets

59. As demonstrated in the table above, another key factor for mid-tier banks' higher average NIM is non-lending fee income. Mid-tier banks earned higher fee income, as a percentage of lending assets, at 0.4% compared to other business models. In comparison, the Big 4 and scale challengers earned significantly less at 0.2% and 0.1% respectively. Mid-tier banks derived substantial revenue from interchange fees and commission earned from the distribution of insurance products.

Loan loss ratio has increased significantly between 2015 and 2020 across all business models

60. Between 2015 and 2020, the loan loss ratio (calculated as in-year impairment provisions / average lending assets) increased for all business models. Big 4 banks, Mid-tiers and Specialist lenders recorded the highest increase at 18, 21 and 24 basis points respectively. Increases in the loan loss ratio are driven by two factors – introduction of IFRS 9 and the Covid-19 pandemic. In 2018, the International Accounting Standards Board (IASB) brought into effect International Financial Reporting Standard 9 – Financial Instruments (IFRS 9), which introduced an "expected credit loss" (ECL) framework for the recognition of impairment. Due to the introduction of IFRS 9, firms increased impairment provisions to meet requirements under the standard. The Covid-19 pandemic further increased provisions across all business models. These were partially reversed in 2021 due to an improved macroeconomic outlook.

Figure 1.10



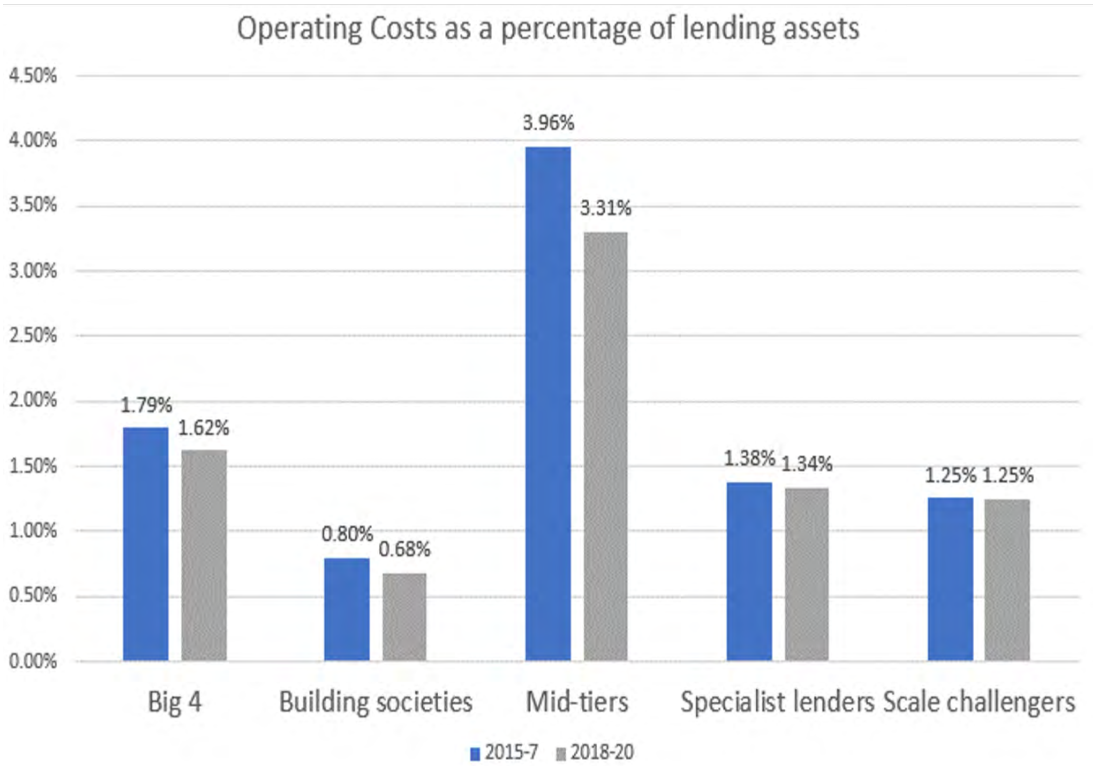
Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders.
Loan-loss ratio is calculated as in-year impairment provisions / average lending assets

61. Loan book composition has also played a role in loan loss provisions. Business models with higher levels of unsecured consumer credit (Big 4, Mid-tier banks and Specialist lenders) on average saw a greater increase in loan loss provisions than those which are primarily made up of mortgages (Building societies and Scale challengers).

Banks are cutting costs in the face of increased margin pressure

62. Banks have been making efforts to reduce operating costs to generate better returns on their assets. Figure 1.11 has been calculated using total operating costs as a percentage of retail lending assets.

Figure 1.11



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders

63. This figure suggests that the largest banks' funding cost advantage on its PCA and other retail funding business is not outweighed by higher operating costs when compared with Mid-tiers. Branch closures and investment into more advanced and automated IT systems have contributed to more efficient operating models, while large banks' large customer base grants them economies of scale.

64. Scale challengers have achieved a lower cost asset ratio than the Big 4, primarily due to lower customer service costs and regulatory costs. However, Scale challengers have higher IT costs, demonstrating the Big 4's efficiencies gained through automation and digitisation.

65. Mid-tier banks have the highest cost-asset ratios of all cohorts, which is driven by the large branch network of some, without the economies of scale achieved by the Big 4.

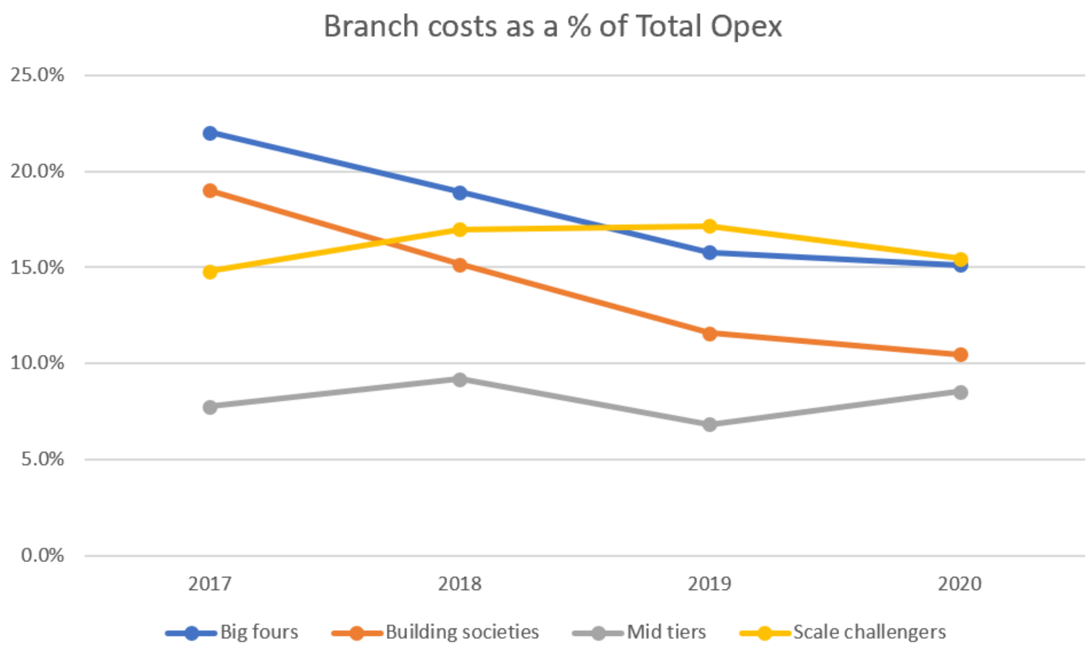
66. The Office for National Statistics reported that number of bank and building society branches in the UK reduced from 13,345 in 2012 to 8,805 in 2021. This reflects their focus on improving their digital offering and providing branch services to those most in need. This helps to explain why cost asset ratios have fallen for the Big 4 and Mid-tiers.

67. The introduction of lockdowns throughout 2020 and into 2021 paused banks' plans to close down large portions of their branch networks. This was in response to the FCA's guidance FG20/3[11], which was put in place partly to protect customers' ability to access cash and banking services, but also based on their commitments to minimise job losses during the initial stages of the pandemic. The Treasury Committee[12] published correspondence from high street banks in August 2021, which demonstrated that consumers were choosing to use online and mobile banking more often since the start of the pandemic, and that further closures have been announced for 2021.

68. Branch closures have played a significant role in the strategic direction of many banks to reduce operating costs to improve profit margins. Figure 1.12 displays the proportion of total costs relating to branches over time.

11 FG20/3: Branch and ATM closures or conversions, FCA September 2020
12 High street banks respond to Treasury Committee on branch closures, Treasury Committee August 2021

Figure 1.12



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies

Big 4 banks have achieved higher underlying returns on equity, but these have fallen over time

69. We now consider the profitability of different retail banking business models by examining return on equity capital. Due to the Bank of England's requirement for a certain level of equity to be held as a % of risk-weighted assets (RWAs), we calculated equity capital based on banks' RWAs. We have assumed a ratio of equity to risk-weighted-assets (RWAs) of 15% based on a simplified average for the industry between 2015 and 2020.[13] This is a simplification because in practice CET1 ratios vary across firms and business models, for example due to differences in capital requirements, access to capital markets, management buffers, and growth strategies. Where our assumption caused a firm to fall below the minimum leverage threshold, we have adjusted their equity to meet the leverage threshold.

70. Though we have examined financial performance using a range of different measures and ratios, our analysis primarily focuses on pre-tax underlying returns on equity. This is because, as explained in paragraph 1.53, our focus is on the returns generated by the businesses' primary operating activities. Our aim is to make fair comparisons between cohorts and analyse changes over time consistently, rather than looking at final return on equity figures. As such, the amounts presented will not agree to firms' public returns on equity. Should tax have been taken into account, overall returns on equity would be lower than we have calculated below.

13 Banking Sector Regulatory Capital, 2015-2020, Bank of England.

Return on Equity Table 3 year average (2018-20)

	Big 4	Scale Challengers	Mid-tier Banks	Building Societies	Specialist Lenders
Estimated total RWA density	34.2%	28.2%	59.9%	21.7%	64.6%
Underlying pre-tax return on risk-weighted assets (RoRWA)	2.7%	1.8%	0.1%	1.7%	2.2%
Underlying pre-tax return on equity (ROE) assuming equity is a minimum of 15% of RWAs and each firm meets minimum leverage requirements	18.0%	12.1%	1.0%	11.5%	14.8%

Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challengers, 4 mid-tier banks, 2 building societies, 5 specialist lenders.
Estimated total RWA density is calculated as total RWAs/total lending assets
Where required, alternative CET1 ratios were used to calculate underlying pre-tax return on equity (ROE), ensuring firms meet minimum leverage requirements.

71. We find that on this basis, on average over the 3 year period between 2018-2020, the Big 4 banks made a higher underlying return on equity than other types of firms in our sample. As can be seen from the table below, Big 4 banks' underlying 3-year average ROE was 19.2%. This is a function of their relatively high return on assets combined with relatively low RWAs, when expressed as a percentage of assets this equates to RWA density.

72. Specialist lenders have higher return on assets but lower average ROE than Big 4, at 14.8%, reflecting high RWA density and increased risk of the business model.

73. Scale challengers' ROE averaged14.0% over the period, as a function of their lower NIM and return on assets combined with relatively low RWA density, indicative of their increased focus on mortgage lending as opposed to higher risk consumer credit.

74. Mid-tier banks ROE was lower than that of scale challengers, at 1.0% over the period. This reflects relatively high RWA density and increased risk of their business models as discussed above.

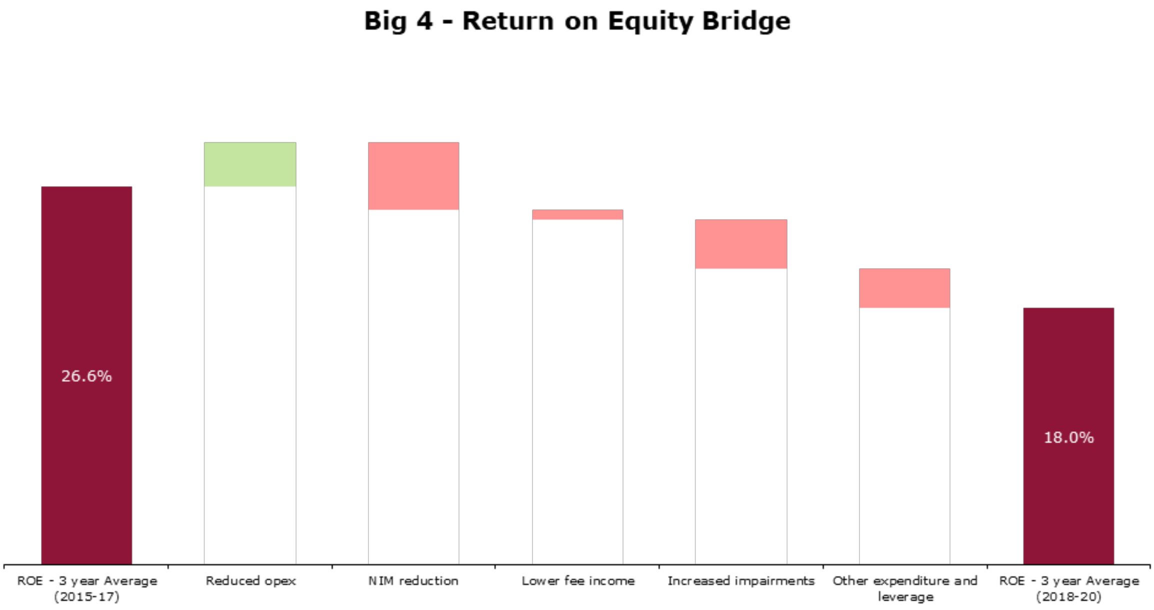
75. Building societies have relatively low returns, reflecting their focus on mortgages. However, they do not need to reward shareholders in the same way many other banks do, because of their mutual business model.

76. We discuss RWA density, RoRWA and ROE in further detail below.

ROE has fallen over time for Big 4 banks

77. The chart below explores the movements in ROE for the Big 4 between 2015-2020. The Big 4 achieved an average ROE of 26.6% between 2015-2017. Between 2018-2020, the Big 4's average ROE dropped to 18.0%. Declining yields contributed significantly to the decreased ROE for the Big 4. Between 2015 and 2019, the Big 4 experienced a gradual decline in lending yields. As explained above, this could be explained through increased competition in pricing as well as other factors influencing yields. Over this time period, the impact of declining yields was partially offset through lower cost of funding and lower operating costs. In 2020, lending yields declined further as well as an increase in impairments due to the COVID-19 pandemic. These factors had a significant impact on ROE for the Big 4.

Figure 1.13



Source – FCA analysis, sample includes 4 Big 4 banks. ROE includes: wholesale funding costs; net interest arising from structural hedging arrangements and intra-group transfer pricing; negative income. Excludes: income and costs relating to non-core and winddown activities; exceptional costs and benefits such as fines and redress; fair value adjustments. The elements of the bridge such as reduced opex and NIM reduction are factored in in the order of the chart reading left to right. Note that the opening figure for ROE does not agree to our Final Report of the Strategic Review of Retail Banking published in 2018. This is due to the change in banks included within the "Big 6" cohort used previously. We now present ROE for the Big 4 as explained earlier in the chapter.

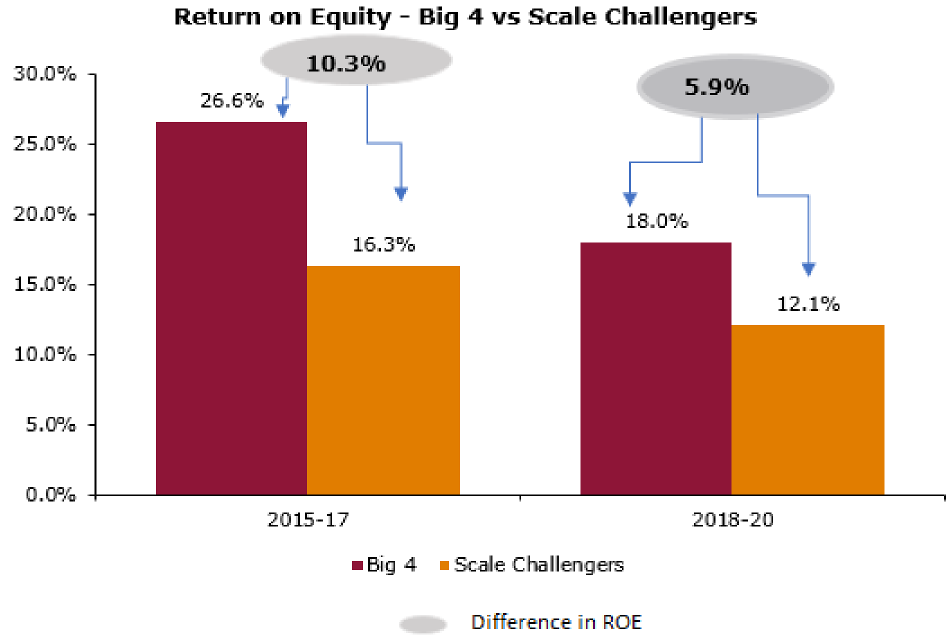
78. Scale challengers and mid-tiers also experienced a decline in ROE between 2015-2020, due to falling lending yields. However, the decline was less pronounced for scale challengers, which during this period reduced funding costs significantly, offsetting the declining yields. This is covered in more detail in the following section.

Big 4 ROE has fallen by more than that of scale challengers

79. In this section we consider the reasons for the difference in return on equity between the Big 4 and scale challengers. The difference in ROE between the Big 4 and scale challengers is perhaps of most interest since these business models are more closely comparable in terms of size and scale.

80. In Figure 1.14, we highlight that return on equity has declined for both Big 4 and scale challengers, and the gap in returns between Big 4 and scale challengers has reduced. Between 2015-17, the gap in return on equity between the Big 4 and scale challengers was 10.3 percentage points, narrowing to 5.9 percentage points between 2018-20. The key factor contributing to this narrowing of the gap is that funding costs for scale challengers have come down by more than for Big 4 banks. Starting out with significantly higher funding costs, they have had more flexibility to alter the interest rates they offer to their customers on PCA and savings accounts.

Figure 1.14



Source – FCA analysis, sample includes 4 Big 4 banks and 4 scale challengers.

81. Although there has been a reduction in the profitability gap between the Big 4 and Scale challengers, a relatively large gap still remains. This is due to Big 4 still earning better yields due to their higher proportion of unsecured consumer credit lending. Annex 4 on consumer credit analyses this further. In addition, the Big 4 have managed to reduce their operating costs through digitalisation and branch closures, whereas operating costs for scale challengers have declined but at a lower rate.

82. Leverage is also an important consideration when considering why the Big 4 have maintained higher returns on equity in comparison to Scale challengers. Typically, higher yields are associated with higher risk lending, and therefore higher capital requirements and lower leverage. However, the Big 4 maintain high leverage due to their diversified lending book. In contrast, despite having a lower risk loan book, scale challengers do not receive capital benefits to the same extent as the Big 4.

83. Although numerous factors have impacted profitability of banking business models in recent years, we can see through our analysis that competition has played a positive role in narrowing the profitability gap between the Big 4 and their competitors.

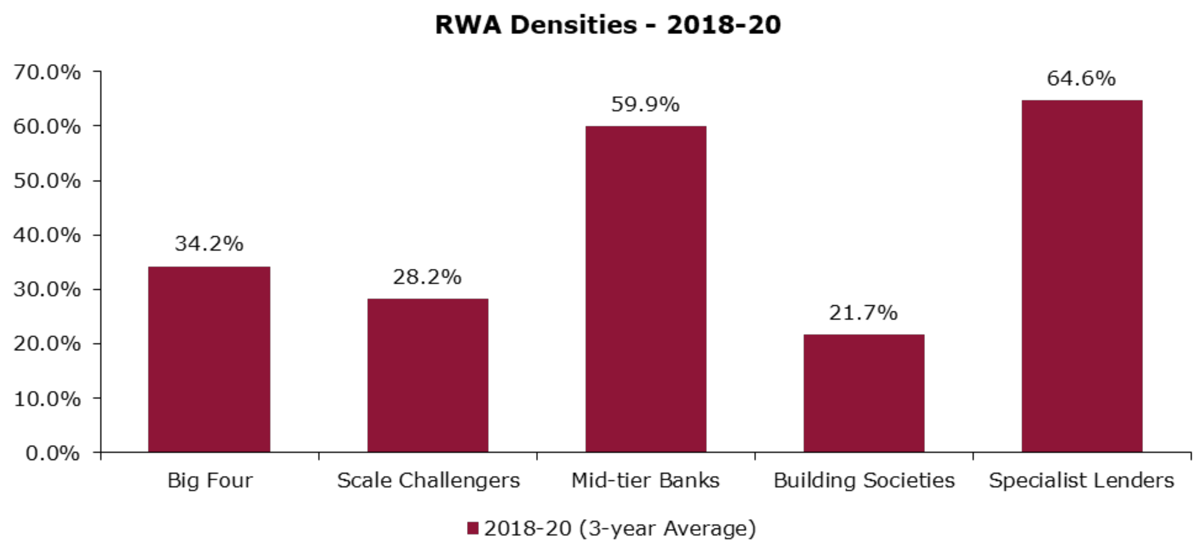
RWA density is higher for mid-tiers and specialist lenders

84. Banks have to ensure that they meet minimum capital requirements as set out in legislation. These minimum capital requirements are a function of the riskiness of the lending portfolio. This in turn is measured by applying a 'risk-weighting' to different components of the lending book. Banks take different approaches to this risk-weighting. Larger banks can use their own internal models under the 'internal ratings based' (IRB) approach, smaller banks use pre-defined risk-weightings as specified by the rules under the 'standardised approach' (SA).

85. The standardised approach is less risk-sensitive than the IRB approach, as it specifies a single RWA % for a given asset category. On low risk lending the SA % is generally higher than that under IRB. For example, on residential mortgage lending, a bank using the standardized approach would need to apply a risk weighting of 35%, whereas the average mortgage risk weight of an IRB bank is 13%[14]. But the converse may be true for higher risk lending, and an IRB bank might model a higher risk weighting than would need to be applied by a SA bank. As noted by the BoE, this can have the effect of encouraging non-IRB banks to focus on riskier lending.[15] This is consistent with the picture below, in which we observe smaller banks and specialist lenders having materially higher RWA densities and focusing on higher risk lending as discussed above.

86. Figure 1.15 shows the 3-year average RWA densities across different retail banking business models between 2018 and 2020. RWA densities are the highest for mid-tier banks and specialist lenders between 2018 and 2020, due to their greater holding of unsecured lending and use of the standardised approach for calculating RWAs. We note, in particular, that RWA density increased for mid-tier banks between 2018 and 2020 as certain firms within this categorisation reduced their mortgage holding. This is explored further in Mortgages Annex 3. The building societies in our sample have the lowest RWA density because they predominately operate in the mortgage market which is less risky than the unsecured lending market, and due to the fact that they use IRB approach for calculating RWAs for their mortgage lending assets.

Figure 1.15



Source – FCA analysis, sample includes 4 Big 4 banks, 4 scale challenger, 4 mid-tier banks, 2 building societies, 5 specialist lenders.
Estimated total RWA density is calculated as total RWAs/total lending assets

14 CP14/20 Internal ratings based UK mortgage risk weights: Managing deficiencies in model risk capture, Bank of England, September 2020

15 RESPONSE TO THE EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE POSSIBLE IMPACT OF THE CRR AND CRD IV ON BANK FINANCING OF THE ECONOMY. ANNEX 2: The case for a more proportionate regulatory regime

87. Under leverage ratio requirements, retail banks, with deposits in excess of £50bn, are required to hold a minimum level of Tier 1 capital against their assets, regardless of the individual risk weightings applied to their lending assets. If banks only held low risk lending assets such as low LTV mortgages, the leverage ratio would require them to hold more capital than suggested by their risk weight models. To avoid having to hold more capital than is necessary against low-risk lending, the Big 4 have diversified to include lending with higher risk weights (including consumer credit and SME lending) in their lending portfolios. As such, the Big 4 are able to benefit from the very low risk weightings of low LTV mortgages as a result of their diversified business model in a way that mono-line mortgage lenders cannot, even if they have IRB permissions. Their greater share of higher risk, unsecured lending also provides them with higher yields and net interest margins. Smaller banks using IRB may be able to replicate this advantage through diversification.

88. As such, IRB banks achieve capital advantages by combining a diverse and relatively high yielding loan book with low credit risk weights for mortgages. This is an important driver of the higher return on equity that they achieve relative to mid-tier firms and building societies. It is worth noting that Specialist Lenders still derive high returns on equity while using the standardised approach due to their diversified lending book which focuses on unsecured lending as well as high risk, more niche mortgage lending.

89. However, steps are being taken to change the current IRB approach. The Policy Statement PS16/21 published by the Bank of England in July 2021 proposes to reduce the disparity between the Standardised and IRB approaches to RWAs by considering the calibration of parameter floors for mortgage exposures, and an exposure-weighted average risk weight of at least 10% for UK residential mortgage exposures (excluding those classified as in default) of IRB firms.

90. As part of the finalised Basel III post-crisis reforms, which will be consulted on in 2022, more risk-sensitive approaches to risk weights have been developed for firms on the standardised method, with risk weights based on the LTV of the mortgage. This allows for a lower minimum risk weight of 20% on low LTV mortgages.

91. As a result of these measures, firms under the Standardised approach may be able to utilise a greater proportion of their capital. The difference in return on equity between IRB and Standardized approach firms may therefore reduce in the future.

Smaller banking institutions may face pressures caused by MREL

92. The minimum requirement for own funds and eligible liabilities (MREL) is a minimum requirement for firms to maintain equity and eligible debt so that they can be 'bailed in' or otherwise support a resolution should a firm fail. The purpose of MREL is to help ensure that, when firms fail, the resolution authority (the Bank of England in the UK) can use these financial resources to absorb losses and recapitalise the continuing business and support its restructuring.[16]

16 The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)

93. As mentioned in the letter to the Rt. Hon Mel Stride MP, firms affected argue that the current level of the total asset threshold is too low, causing a competitive disadvantage for smaller firms.[17] They believe that the current MREL threshold discourages growth, with smaller institutions being restricted to remain below a certain size to avoid the requirement posed by the regime.[18] Moreover, smaller banking institutions have relied more on retained earnings to meet their MREL to meet their MREL requirements. In comparison to the larger banks and building societies, smaller banking institutions are at a disadvantage due to the increased cost of debt in capital markets. We note that the PRA's decision in CP14/21 to extend the leverage ratio to non-systemic firms is an expectation rather than a requirement.

94. The Bank of England have launched a series of consultations to review their approach to the MREL framework. In the consultation, the Bank have suggested that a glidepath increase in MREL requirements could be introduced over a more extended period of time. This aims to address potential competition imbalances created by regime.

17 See Correspondence between Representatives of Mid-tier and Specialist Banking Sector and Specialist and the Rt. Hon Mel Stride MP, 20 April 2021

18 See Correspondence between Representatives of Mid-tier and Specialist Banking Sector and Specialist and the Rt. Hon Mel Stride MP, 20 April 2021

Annex 2
Personal Current Account (PCA) and Savings Market

Personal Current Accounts (PCAs) are a fundamental part of the business model for most banks. They provide large volumes of low cost and stable funding that banks lend out to consumers and businesses in the form of mortgages, loans, credit cards and overdrafts. In addition, many customers also take out savings accounts, credit cards, and other products with their PCA provider.

Competition has historically been weak in the PCA market. Many banks have sought to expand their PCA businesses in the past but have struggled to do so.

Technological and regulatory changes have contributed to the rise of digital only banks, which have rapidly grown market share over the last 5 years.

Some consumers have benefited from increased competition, as larger banks have adopted the innovations introduced by digital challengers.

Introduction

1. The PCA and Savings market plays an essential role in the lives of millions of consumers in the UK. As of 2020, there were c.97m personal current accounts, c.102m instant savings accounts, and over 7m fixed term deposit accounts. Overall, total retail deposits amounted to above £1.5 trillion.

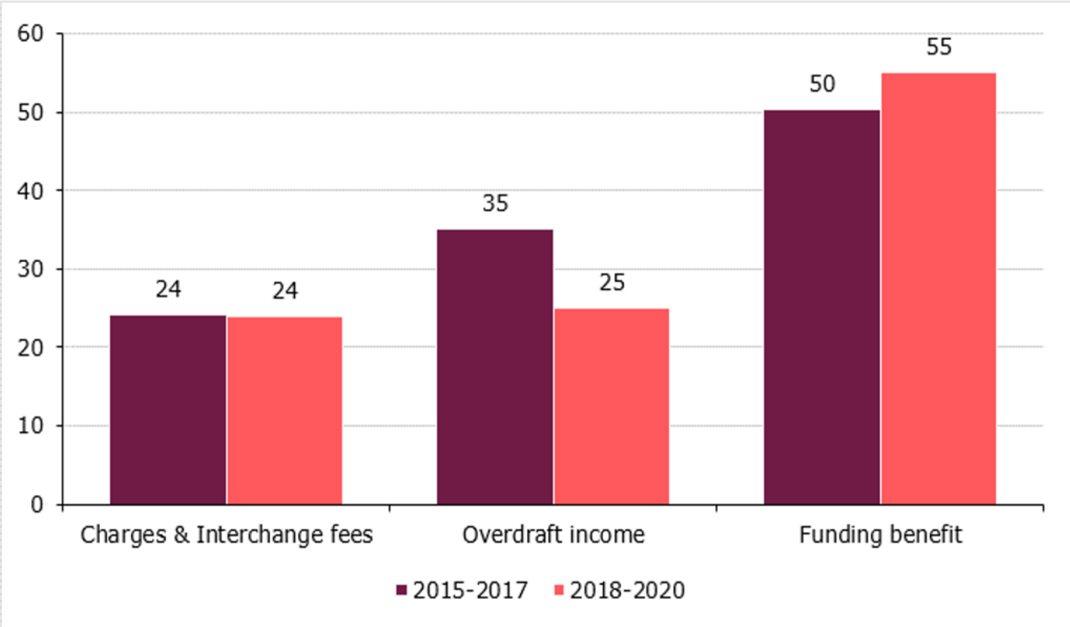
2. Current accounts are the foundation of large-scale retail banking business models. PCA providers can access cheap and stable funding, derive revenue from fees and charges levied on PCAs, and cross-sell different products.

3. Over the past few years, the increased pace of digitalisation, the low-interest rate environment and the ongoing pandemic have all altered the way that the market functions. This section provides an overview of these changes and how they have impacted competition in the market.

PCAs are a fundamental part of the business model for most banks and make a positive contribution to profits

4. Figure 2.1 below illustrates the three key sources of value that Big 4 PCA providers obtain from a typical current account: charges and interchange fees, overdraft income, and funding benefit. As seen from the chart, funding benefits make the largest contribution, and increased between 2015-17 and 2018-20. This has largely been driven by increased deposits during the pandemic. However, during the same time-frame, overdraft contributions fell, primarily due to our interventions in the high-cost credit market to protect consumers in vulnerable circumstances. Overall, total contribution per account fell slightly from £99 to £94, after accounting for overdraft impairments and any interest paid for PCAs.

Figure 2.1 – PCA Contribution Breakdown



Source: FCA analysis, the sample is big 4 banks. This is the weighted average of contributions between two periods, calculated by total value divided by number of accounts.

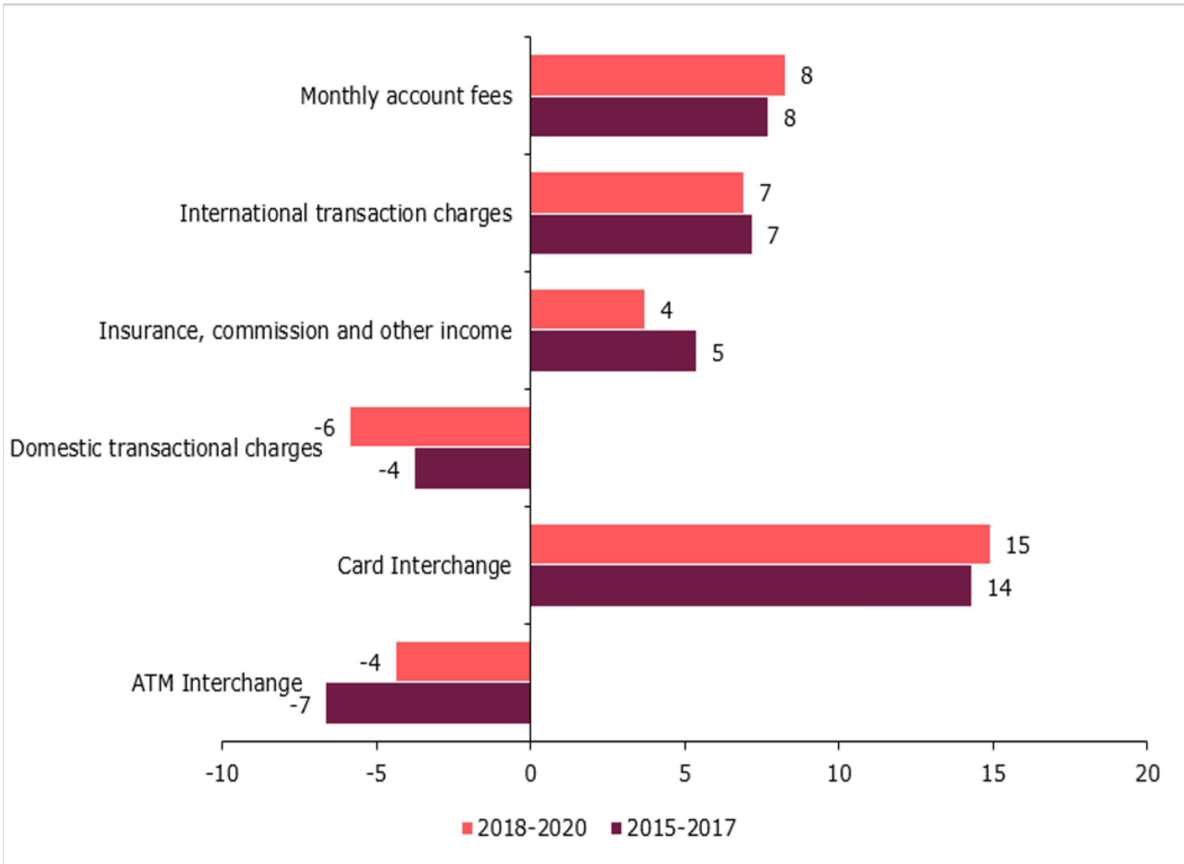
5. Funding benefits represent the value of the deposits to the bank and depend on factors such as how much interest the bank pays depositors, how long the depositors are likely to keep their money at the bank, and the margin the bank can earn from lending the deposits out. In the above calculation, we used the average PCA funding benefit provided to us by Big 4 banks, expressed as a percentage of the average balance. This was 1.8% in 2015-2017 and 1.6% in 2018-2020. Whilst funding benefit fell in percentage terms, average balances rose between 2015-2017 and 2018-2020 resulting in an increase in the absolute value.

6. Interchange and fees comprise two distinct sources of revenue for PCA providers:

- Fees are received from customers and include monthly charges on packaged and reward accounts, fees for foreign currency transactions, CHAPS and international transfers, refused payment charges, and fees for replacement cards and statements. We have taken the total of all the fee revenue earned on PCAs and divided it by the number of accounts to give an average fee revenue per account. However, PCA customers experience a wide range of fees around this average: customers with packaged accounts can pay considerably more than customers with 'free-if-in-credit' (FIIC) accounts.
- Interchange revenues are received from merchants or their agents when customers use debit cards to make purchases. The fees are paid to the card-issuing bank to cover the costs of processing the payment and the risk of fraud and bad debt. ATM interchange charges are included within this category. They can be a net benefit or a net cost to a bank depending on the extent to which its customers use its own ATM estate or that of other banks.

7. Total fees and interchange on a per account basis have remained relatively stable over time. However, constituent components of fees and charges, as shown in Figure 2.2 below, have moved in different directions across the years. For example, card interchange fees grew from £14 per account in 2015-2017 to £15 per account in 2018-2020 due to an increase in card transactions. Conversely, banks incurred increased domestic transactional charges, mainly driven by increased cashback rewards paid to customers as incentives.

Figure 2.2 – PCA Transactional Income Breakdown



Source: FCA analysis of big 4 banks. This is the weighted average of transactional income per account between two periods, calculated by transactional income of that period divided by number of accounts.

8. Overdraft revenues per account fell from an average of £35 in 2015-2017 to £25 in 2018-2020. There are two separate drivers for this. Firstly, the practice of higher charges on unarranged overdrafts was banned by our overdraft rules which came into effect in April 2020. These were a package of remedies designed to make overdrafts simpler, fairer, and easier to manage. Secondly, arranged overdraft revenues were also affected by the temporary support measures we put place in April 2020 which allowed customers affected by Covid-19 to request for an arranged interest-free overdraft of up to £500 for three months on their main PCA.

9. PCA customers often take out other products with the bank. According to the Financial Lives Survey (FLS), 79% of consumers hold savings accounts with their main current account provider. This is consistent with our Cash savings market study report in 2015, which indicated that over 75% of sales of instant savings accounts, containing an average of £5,168 per PCA account in 2018-2020, were coming from existing PCA account holders. These accounts often pay quite low rates of interest and convey significant additional funding benefits to the bank. We estimate the additional funding benefit from cross-held instant access savings accounts was on average £75 per account in 2018-2020. This value has risen over time as the value of funds in instant access savings has increased.

10. PCA providers are also able to cross-sell other products to their customers, creating further advantages. For example, Ipsos MORI data shows that c.33% of main PCA customers hold credit cards with their PCA provider, c.7% hold a mortgage and c.4% hold a loan product. Furthermore, Ipsos MORI research suggests that cross-selling not only provides financial value for PCA providers but might also lead to non-tangible benefits such as increased brand loyalty and higher satisfaction amongst consumers.[19]

11. Mid-tier banks and scale challengers have only slightly lower PCA contribution per account than Big 4 banks. On the other hand, Digital banks have a significantly lower level of contribution per PCA compared to Big 4 banks, due to a large number of secondary banking relationships. As such, their average balance per PCA account is significantly lower than that of more established banks, and their accounts generate lower transaction revenues and overdraft income. Secondary banking relationships are also associated with lower rates of cross-held products such as savings and credit cards.

12. Contribution, as measured above, does not take into account the costs of running PCAs. These costs are difficult to assess and compare between providers due to different approaches to reporting and allocating costs between different parts of the bank. We asked the Big 4 banks to estimate how much of their total operating costs could be attributed to PCAs: the average was 35%. On this basis, we estimate that the approximate cost per PCA has slightly declined from £88 in 2015-2017 to £81 in 2018-2020.

13. Taking into account all of the above, we illustrate the net value per Big 4 PCA account as follows:

Illustrative net value per PCA

	2015 - 2017	2018 - 2020
Fees & Charges	24	24
Overdrafts income	35	25
Overdrafts impairments	-6	-7
Funding benefits	50	55
Interest paid	-4	-3
Direct PCA contribution	**99**	**94**
Additional funding benefits through crossholding instant savings	78	75
Instant savings interest paid	-17	-14
Contribution including instant access savings	**160**	**155**
Operating expense assigned to PCA	-88	-81
Net PCA Value	**72**	**74**

Sources: FCA analysis, big 4 banks

14. The decreasing operational expenditure largely nets off with reduced overdraft income in 2018-2020, leading to a slightly higher PCA value.

19 Source: Ipsos MORI FRS. Data shown is for the twelve months ended 31st July 2021, based on 50,231 interviews (All main current accounts - holding level). Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

15. This calculation includes the funding benefits from instant savings accounts but excludes any value from cross-held credit cards, loans, mortgages, or other products. The calculation also excludes the cost of capital, for example in relation to overdrafts and operational risk capital. Notwithstanding these exclusions, we consider that this demonstrates that PCAs are a driver of value for banks.

16. The role of the PCA as a fundamental driver of the full-service retail banking business model helps to explain why many banks, and some building societies, have sought to grow PCA market share and others have sought to enter the market.

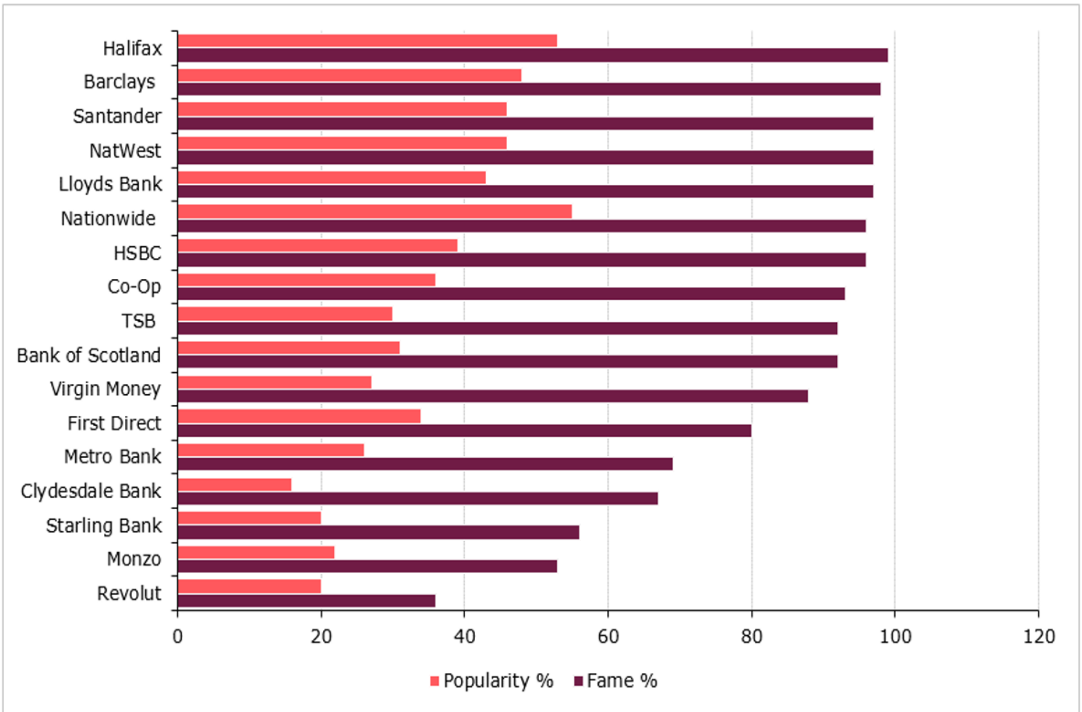
Competition in the PCA market has historically been weak and challengers have struggled to grow market share

17. In its 2016 Market Investigation, the CMA found that consumer engagement in the PCA market was low, making it difficult for new entrants and other challengers to attract new customers. The CMA also noted that incumbents derive competitive advantage from their extensive branch networks and high-street presence. It found that overall market shares had been broadly stable since 2005. In our last Strategic Review of Retail Banking in 2018 we found that incumbents continued to enjoy a "high and stable" share of the PCA market.

18. Consumer engagement remains low when measured by switching and has not improved since the CMA's last review. According to the Financial Lives Survey (FLS), around two-thirds of consumers have not switched their current account for more than 10 years and just over half of consumers shop around before choosing their provider. This is the lowest rate of switching amongst all retail products covered in the FLS. Of the people who have never switched, most indicate that they are happy with their existing provider (60%), that they have never considered switching (26%), or that they consider it to be too much of a hassle (24%).

19. According to the FLS, reputation, trust and brand recognition are some of the most important factors for consumers when choosing a current account provider. Given the extensive history and high-street presence of incumbents, we believe that this has acted as a barrier to expansion for challengers. Our meetings with firms indicated that certain cohorts of consumers who have banked with the same firm for many decades were extremely loyal to their bank. Figure 2.3 below highlights that while most incumbents have almost 100% brand recognition, most of the challengers don't garner the same level of brand awareness in the market.

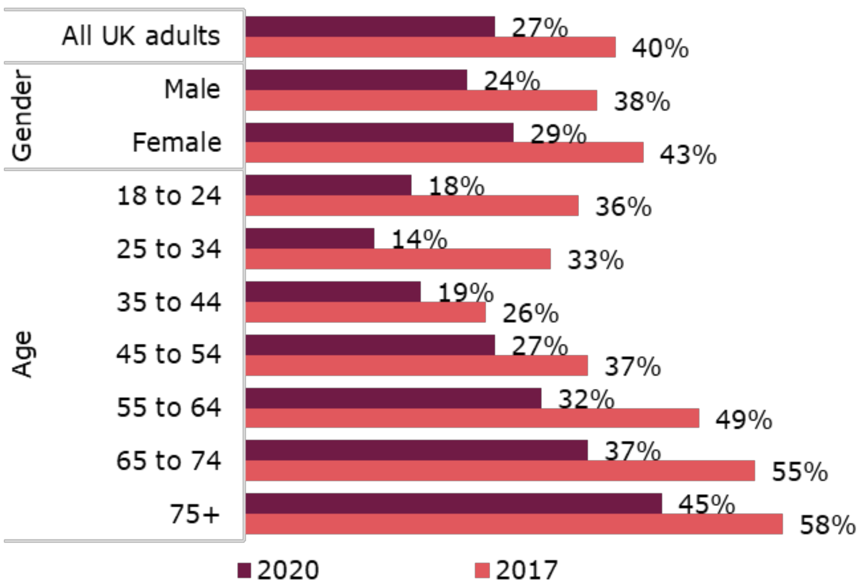
Figure 2.3 – YouGov Brand Recognition Data (Q3 2021)



Sources: YouGov Data

20. Branches have historically been an important consideration for many consumers but have fallen in importance in recent years. Figure 2.4 from the FLS shows that the percentage of consumers regularly using a branch has fallen by 13 percentage points between 2017 and February 2020. We believe that this trend may have been further accelerated due to Covid-19 and the increased digitisation of services. For example, evidence from Mintel in 2021 indicates that 64% consumers plan on doing more online banking services in the future, primarily due to behavioural changes caused because of the pandemic.

Figure 2.4 – Percent of Consumers Regularly Using a Branch



Source: Financial Lives Survey 2020

21. Traditional challengers have, in general, not found it easy to build up PCA market share organically. They have either gained market share through mergers and acquisitions, or by offering monetary incentives (such as sign-on bonuses or high interest rates). This latter strategy can result in higher funding costs, and customers who are more price sensitive and likely to switch in the future. As seen in Figure 2.5 below, scale challengers have found it difficult to build market share over the past few years.

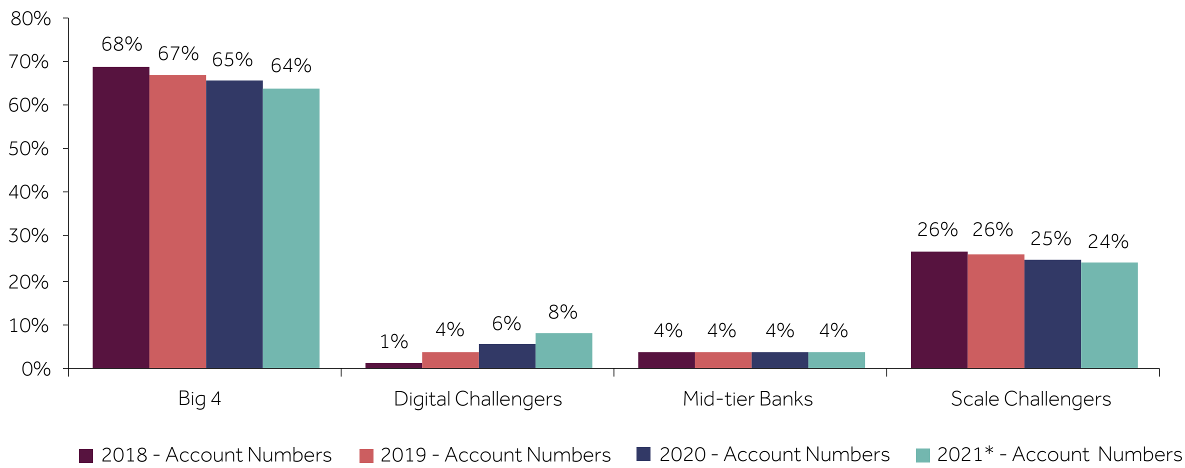
22. Banks co-branded with strong retail presence were once seen as potential competitors to incumbents, due to their large customer bases and store networks. However, in July 2021, both Tesco Bank and M&S Bank announced their intention to close their PCA businesses due to an inability to operate profitably.

23. Overall, we note that traditional challengers have historically struggled to grow significantly in the retail banking market, as evidenced by the high and stable market shares of incumbents over the past few decades. This is due to several advantages that major banks possess such as a large and loyal customer base, brand reputation built over several years, size of their branch network and other economies of scale.

Digital Challengers have rapidly grown market share

24. Even though incumbents continue to hold significant advantages in the sector, digital challengers have made rapid inroads into the PCA market. Figure 2.5 below shows that PCA market share of the Big 4 and Scale Challengers, measured in terms of numbers of accounts, declined from 94% to 90% between 2018 and 2020. During the same timeframe, digitals have increased their share from 1% to 6%, whilst mid-tier firms share remained stable at 4%. Full-year forecast account numbers for 2021 suggests that this trend will continue, with digitals taking another 2% market share from the larger firms.

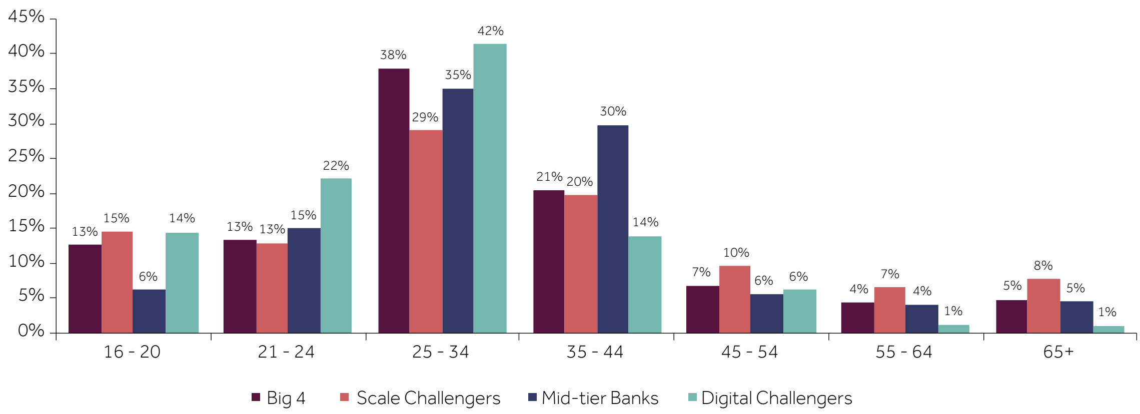
Figure 2.5 – PCA Market Share by Account Numbers



Source: FCA Analysis, sample includes big 4 banks, 3 scale challengers, 2 mid-tier banks and 2 digital challengers.
2021 figures are estimates given by firms

25. Digital challengers are attracting younger consumers than other banks. Our analysis of firms' strategy documents indicates that digital challengers are targeting relatively younger, digitally enabled consumers while incumbents target a much wider consumer base. Figure 2.6 shows that younger consumers are more likely to have switched providers and have a greater predilection towards digital challengers. This means that there might be more intense competition for younger, digitally included consumers as compared to other cohorts.

Figure 2.6 – Age profile of consumers who switched in the past 12 months



Source: Ipsos MORI FRS. Data shown is for the twelve months ended 31st July 2021 (All switching account in last 12 months; Big 4 Banking Groups (n=1,806), Mid tiers (137), Scale challengers (873), Digital banks (n=308). Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

26. Incumbents and digital challengers appear to compete based on the differing needs of customers. Evidence from Ipsos MORI suggests that the top reason for switching into a digital bank is due to their mobile banking offer (33%), because it was recommended by a family or friend (30%), or because of lower charges (15%). Conversely, the top reason for switching into a Big 4 provider is the location of their branch (34%), their branch's opening hours (23%) or cash incentives (16%).[20]

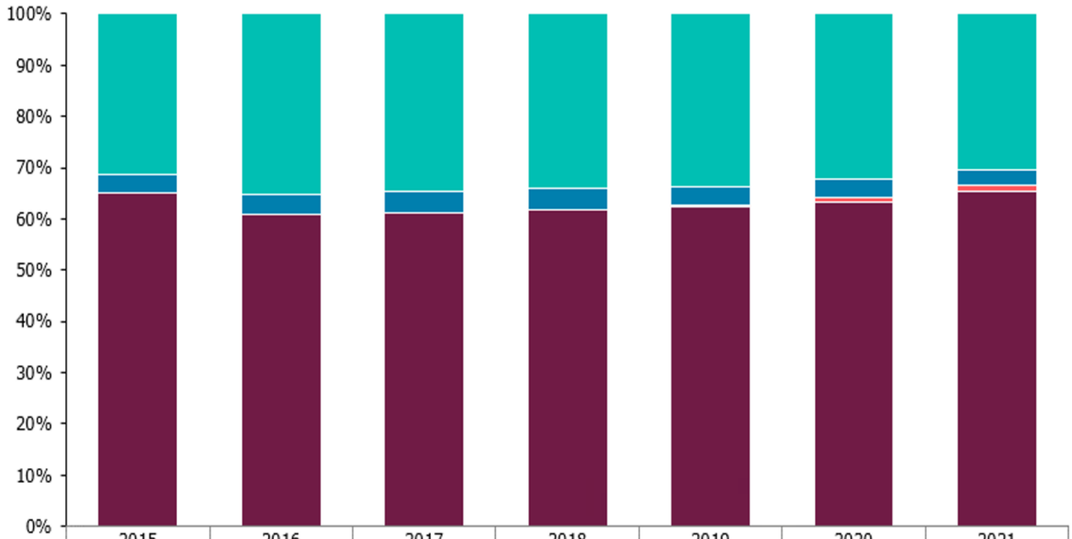
27. While digital challengers have increased their account numbers rapidly, these accounts tend to have lower balances than larger banks. Digital banks forecast operating 8% of all PCA accounts in 2021 but have only 1.2% of the total balances in the PCA market (see Figure 2.7).

28. Lower deposits at digitals can be accounted by two reasons. Firstly, many accounts at Digital challengers are 'secondary' accounts and as such, might not have income regularly paid into them. Data from Ipsos MORI[21] shows that only c.25% of Monzo and Starling customers are main current account holders, compared to the market average of c.55%. Secondly, digital banks tend to have younger customers who are, on average, less affluent than customers of other banks, and as such might have lower deposits.

20 Source: Ipsos MORI FRS. Data shown is for the twelve months ended 31st July 2021 (All switching account in last 12 months; Big 4 Banking Groups (n=1,806), Digital banks (n=308). Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

21 Source: Ipsos MORI FRS. Data shown is for the six months ended 31st July 2021, based on 48,267 interviews (All current accounts - holding level). Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

Figure 2.7 – Deposits held at banks



	2015	2016	2017	2018	2019	2020	2021
Scale Challengers	31.4%	35.1%	34.7%	34.0%	33.8%	32.1%	30.5%
Mid-tier Banks	3.6%	3.9%	4.2%	4.2%	3.6%	3.6%	2.8%
Digital Challengers	0.0%	0.0%	0.0%	0.1%	0.4%	1.0%	1.2%
Big 4	65.0%	60.9%	61.1%	61.7%	62.3%	63.3%	65.5%

Big 4 · Digital Challengers · Mid-tier Banks · Scale Challengers

Source: FCA Analysis, sample includes big 4 banks, 3 scale challengers, 2 mid-tier banks and 2 digital challengers.
2021 figures are estimates given by firms

29. There has been a strong shift towards multi-banking over the past few years. Preliminary data from 2021 indicates that there were c.100m current accounts, which is approximately 1.9 current accounts open per person. Since 2018, our estimates suggest c.13m current accounts have been added, a growth of 5% per annum. This can partly be explained by easier onboarding and fewer hurdles in opening an account, driven by digital account openings.

30. We believe that the free-if-in-credit model plays an important role in facilitating multi-banking, allowing consumers to trial products with different providers. In our meetings, firms highlighted to us that consumers now use different PCA providers to meet different needs, and that many consumers now multi-bank. This is a positive development for competition in the market, as it makes it easier for consumers to try out different providers and to access a variety of services to meet distinct needs. It may also help consumers to build trust in banks with which they are not previously familiar, thus overcoming some of the barriers mentioned above.

31. However, it is worth noting that multi-banking may incur additional costs to firms. Some banks have indicated that there may be a cost to the large number of dormant or little used accounts that do not generate much by way of revenue. Unbundling of the PCA services might also lead to lower revenue streams per account.

32. In our view digital challengers have demonstrated that it is possible, at least in theory, for new banks to build viable and sustainable business models. They have benefited from increased consumer preference towards digital channels, have a lower cost-base due to a lack of branch networks and have more modern IT infrastructures, allowing them to be agile with product-rollouts. In addition, digital banks have topped consumer satisfaction ratings, which has allowed them to win customers organically.

33. Starling has now gained sufficient scale to sustain its business and cover its ongoing operating costs: it reported in October 2020 that it had reached breakeven and expected to report a profit in 2021/22. In early 2021, it raised substantial additional funding from private investors, is considering an IPO in 2022/23, and is looking to expand its operations into Europe. It has also expanded its lending capabilities, taking advantage of the BBLS and CBILS schemes and acquiring mortgage books from specialist lenders.

34. Monzo has grown its PCA business even more rapidly than Starling but has not yet reached breakeven. The firm has yet to develop its lending business, holding more than 80% of its assets in cash and central bank deposits, and continues to rely heavily on non-interest income, comprising two-thirds of its total income in year-ending 2021. In addition, the firm reported a pre-tax loss of c.130m in 2021 and has noted material uncertainties on its ability to continue as a going concern.

35. As such, while digital challengers have made rapid in-roads in the PCA market, there are still some risks to their business model. For example, digital banks might benefit from converting their secondary relationships into main accounts, have yet to fully develop their lending business and still have some economies of scale to be realised. In addition, as digital banks increase in size, they would need to ensure that they have adequate systems and controls to continue meeting our regulatory requirements on areas such as money-laundering, financial crime, operational resilience and the fair treatment of consumers in vulnerable circumstances.

Some consumers have benefited from increased innovation and choice

36. As noted in our previous report, innovation in the retail banking sector has historically been low. This section highlights that technological innovation led by digital challengers has generated benefits for the wider market, as larger banks have followed. However, we recognise that some of these benefits might not be equally shared, especially amongst consumers with low balances, heavy branch users, charities, or businesses in higher risk industries that pose additional costs to serve.

37. In the PCA market, technological innovation has mostly taken shape in the following ways. Firstly, innovations that have enabled consumers to better manage their money; examples of this include real-time payments notifications, budgeting/visualisation tools, transactions searches and categorisation. Secondly, banks have improved their existing digital offerings via intuitive interfaces, faster onboarding, quicker app responses and better security. Finally, there has been an increase in Banking as a Service (BaaS) propositions, whereby there has been a greater consolidation and integration of other financial services within banking apps, sometimes taking advantage of open banking infrastructures.

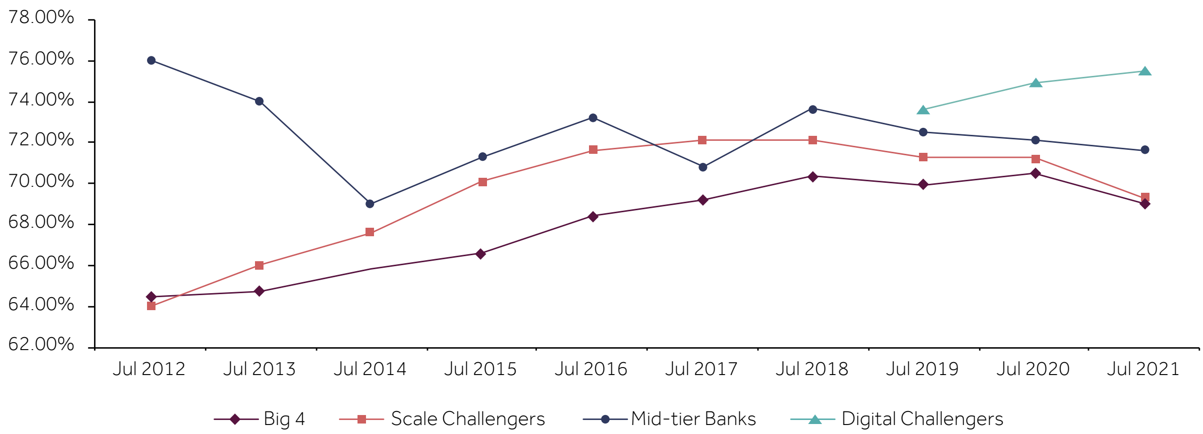
38. Data from the Open Banking Implementation Entity (OBIE) shows that while there were only 16 open banking-enabled products and services in 2018, this reached 109 by the end of 2020. Most of the growth in these services has been around improving financial decision making, expanding payment choice and better borrowing. We see this as a positive development and believe that it will improve competition and help consumers make better decisions in the future.

39. Since our last review, the majority of incumbent banks have caught up with the main innovations offered by digital challengers and are currently on a convergence path. For example, most banks now offer the ability to open accounts online/on app, create spending categories, budget expenses, or perform in-app payments. This means that a broader set of consumers may have benefited from competition without having to switch providers.

40. In our meetings with firms and analysis of strategy packs, many incumbent banks made references to the need to improve their digital services, sometimes in direct response to innovation by digital challengers. For example, NatWest introduced a digital-specific brand, Bó primarily to respond to the direct threat of the digital challengers. However, this has since closed, and NatWest, like the other large players, have focused on enhancing their digital offerings across their customer bases. Mark Bailie, Bó chief executive in 2019, said NatWest needed to respond to the fast growth of digital banks because "regardless of what people think of those business models ... customers clearly like them."

41. Figure 2.8 highlights that overall consumer satisfaction is markedly higher across digital banks when compared to other cohorts, and that overall satisfaction has increased across most major banks since 2012. However, this might mask significant differences in satisfaction across consumers, especially amongst those who use different channels for their banking.

Figure 2.8 – Consumer Satisfaction

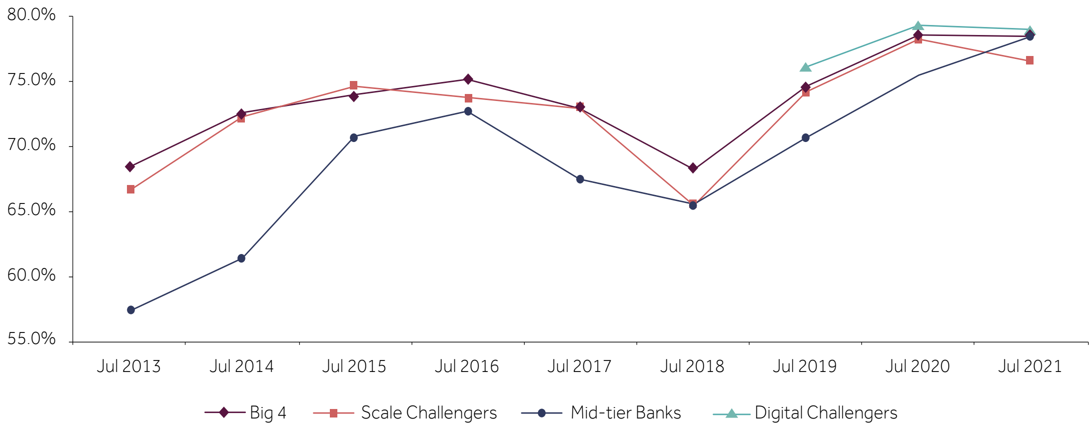


Source: Ipsos MORI FRS. Data shown is for the twelve months ended 31st July 2021, based on 24,840 interviews (All main current account holders giving a response to satisfaction) and compared against twelve months ended data for the periods as indicated. Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

42. Data from our Financial Lives Survey shows that there has been a statistically significant decline in satisfaction amongst branch users for in-branch services. While 86% were satisfied with branch-based banking in 2017, this fell to 78% in February 2020. We believe that this might have been exacerbated during the pandemic, where temporary closures and reduced opening hours lowered satisfaction with branch services. Overall, this means that a sizable minority of heavy branch users might have less choice in their banking services. We will continue to monitor firms' branch closure programs and ensure that customers are treated fairly, with a focus on those in vulnerable circumstances.

43. Figure 2.9 shows that consumer satisfaction with mobile banking is higher for digital banks than other banks, but the gap is narrowing. As incumbent banks have sought to improve the functionality of their mobile banking apps in response to competition from digitals, consumer satisfaction has increased. As such, we believe that consumers with preferences for app-based banking may have benefited over the past few years.

Figure 2.9 – Mobile Banking Satisfaction



Source: Ipsos MORI FRS. Data shown is for the twelve months ended 31st July 2021, based on 13,540 interviews (All main current account holders using mobile banking to manage account) and compared against twelve months ended data for the periods as indicated. Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

Further entry and expansion are likely to strengthen competition in the market and may improve consumer outcomes

44. Since 2010, there has been a sizable expansion in the entry of e-money firms and retail banks, which has improved competition, brought forward innovations, and increased choice for consumers. We believe that continued entry in the sector could improve outcomes and protect consumers against higher prices and low value.

45. In 2021, JP Morgan Chase launched their digital-only bank in the UK, reportedly as a testbed prior to potential further expansion into other countries. JP Morgan's strategy includes a desire to provide a competitively priced product, leverage its existing global brand and innovate using sophisticated algorithms. As such, it could compete with both incumbents and digital challengers.

46. Electronic money and payments institutions provide another avenue for firms to enter the retail banking sector, which could provide an additional layer of competition in the market. We note that some firms who started off as payments institutions have become or applied to become deposit-taking institutions.

47. However, it is worth noting that while further entry and innovation are likely to bring consumers more choice, they may also bring harm to consumers, especially those in vulnerable circumstances. For example, business models with increased exposure to riskier lending products, crypto-assets or without adequate systems and controls might heighten the risk of harm posed to consumers. We will continue to monitor whether incumbents and new entrants have sufficient consumer protection controls and whether new innovations bring forward genuine benefits for consumers.

48. The evidence in this annex highlights that entry and innovation from new players into the market has generated reaction from incumbent firms that have benefited a significant number of consumers. We believe that it is important to continue to encourage entry and innovation in the market as a primary driver of improved consumer outcomes.

The free-if-in-credit model remains highly valued by consumers

49. In our last review in 2018, we noted that free-if-in-credit (FIIC) banking may become less available if PCAs erode in value as a source of low-cost funding, or if there is an unbundling of PCA revenue streams across overdrafts, foreign exchange, or interchange services. In addition, firms may look to phase out FIIC if there is a squeeze on other sources of revenue, such as net interest income.

50. The CMA's Retail Banking Investigation in 2016 noted that there is no evidence that FIIC contributes to lower engagement or reduced switching across consumers. There is also no evidence of a cross subsidy across different types of customers. In addition, we note that FIIC might improve competition by allowing consumers to trial out different products and gain additional comfort before switching providers.

51. A move away from FIIC could have more charges placed on consumers in vulnerable circumstances, who provide less funding benefit and have fewer international transactions. In addition, making certain banking services contingent upon a flat fee could exclude some consumers with low financial resilience or capability. If moving away from FIIC, firms would have to continue to ensure that they fulfil the requirements and expectations set out in our Guidance on the fair treatment of customers in vulnerable circumstances.

52. Our analysis of firms' strategy packs indicates that while banks have put in place plans to change their pricing structure, they are aware that charging for PCAs could cause customer attrition, especially in a context of increased entry and competition in the retail banking sector. Furthermore, some banks have highlighted the broader reputational brand risk from levying compulsory charges or reducing services.

53. Evidence from Mintel[22] suggests that consumers value the FIIC pricing model, and it is the PCA style of choice for around 75% of users (including all free accounts, such as Basic Bank Accounts). 91% of consumers felt a free account option should remain available, and half said that low fees and charges were important in their choice of current account. As such, especially given the longevity of the FIIC model in the UK, consumers still strongly value the FIIC pricing structure.

54. Any move away from FIIC would have to be transparent and fair, with a particular focus on consumers in vulnerable circumstances. Firms have a responsibility to ensure that their consumers are provided with services that meet their needs, that information is provided clearly and that consumers are able to switch providers without unreasonable barriers. Our Consumer Duty sets higher expectations on the standard of care that firms provide to consumers, and any change in pricing structures would have to put a strong focus on consumer outcomes.

22 Mintel UK Current Account Report: October 2020

Annex 3
UK mortgage market

Key points:

The mortgage market has expanded over the past several years, with increased availability of funding and strong demand, underpinned by government intervention such as extension of Help-To-Buy, the reintroduction of mortgage guarantee scheme and Stamp Duty Land Tax (SDLT) temporary reduction.

Temporary support measures such as the Coronavirus Job Retention Scheme (CJRS), the FCA guidance on payment deferrals and a restriction on possessions helped to stabilise the housing market in 2020/21 and protected consumers.

Big 4 banks have grown their market share in residential mortgages in recent years, but have lost share in Buy-to-Let (BTL) mortgages.

Prices have come down as competition has meant that lenders have passed on base rate reductions and offered lower introductory rates in line with funding cost reductions.

Alongside this, yields have also fallen, as fewer consumers are on Standard Variable Rate (SVR) mortgages and more consumers engage with mortgage intermediaries.

Large banks still generate higher returns when measured against Risk Weighted Assets (RWA) as they employ the IRB method for calculating risk weights.

As competition has intensified, smaller banks and building societies have found it increasingly difficult to compete in the prime mortgage market. In response, some firms have developed niche products to meet the needs of new consumer segments or have moved into riskier mortgages e.g. higher Loan to Value (LTV) mortgages. Others have exited.

Firms are innovating to provide brokers with faster decision making ability, using open banking technology.

Introduction

1. The residential mortgage market has been growing in value since the 2007/2008 financial crisis, partly due to the increased availability of low cost funding, a return of credit risk appetite for mortgages and increasing house price inflation. More recently, the market has seen a boost from government interventions such as the temporary reduction in stamp duty land tax, extension of the help to buy scheme and reintroduction of the mortgage guarantee scheme. There has also been pent-up demand post Covid-19 lockdowns which have contributed to overall increased demand for borrowing.

2. In March 2020 we issued guidance[23] to mortgage lenders that allowed consumers affected by coronavirus to ask for a payment deferral of up to 3 months. The guidance was further updated in June 2020 and November 2020 which allowed consumers to apply for a further 3 month payment deferral by 31 March 2021, with all payment deferrals ending by 31 July 2021.

3. Complementing this we issued Tailored Support guidance for consumers whose financial situation may be affected by coronavirus after 31 March 2021. We also issued guidance on possessions where we said firms should not (absent exceptional circumstances) seek or enforce a warrant for possession before 31 April 2021.

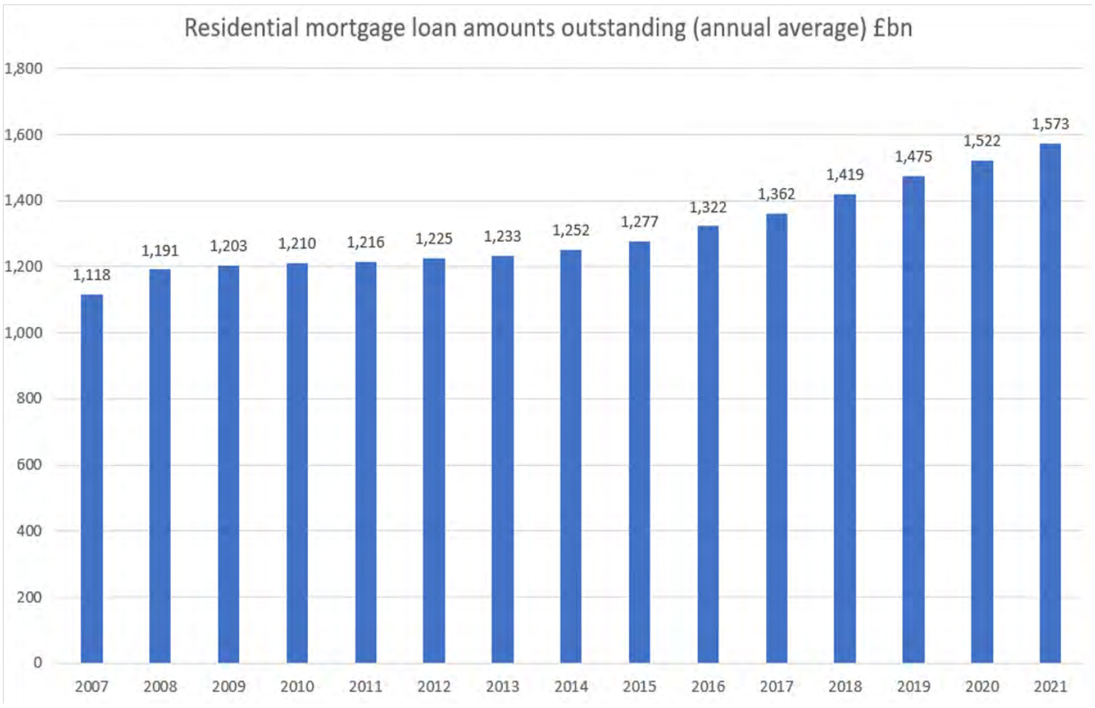
4. By January 2021[24], it was estimated that 4.5 million payment deferrals (across mortgages and consumer credit products) had been granted under our Payment Deferral Guidance (PDG).

5. According to FCA & BOE mortgage lending statistics (MLAR)[25] the proportion of total residential mortgage balances with arrears[26] decreased from 0.91% in Q1 2020 to 0.89% in Q2 2021. The combination of the Coronavirus Job Retention Scheme (CJRS), payment deferrals and the restriction on possessions helped to stabilise the housing market and protect consumers.

6. As of Q2 2021 total residential mortgage loans outstanding stood at £1,584bn[27]. See figure 3.1. The UK House Price Index[28] indicates that the price of an average house in September 2021 was £269,945, an increase of 52.7% since December 2006. However the number of property transactions completed in the UK above £40,000 hasn't reached the pre financial crisis peak in 2007 where it stood at 1.61m[29]. As of October 2021 the number of transactions stood at 1.21m. Reflecting that the increased value of mortgage debt is partly due to increased activity of remortgaging and releasing of equity by consumers.

23 See Mortgages and coronavirus: our guidance for firms
24 See January 2021 FCA Coronavirus linked forbearance: key findings
25 See Mortgage Lending Statistics on FCA website
26 Defined as the borrower failing to make contractual payments equivalent to at least 1.5% of the outstanding mortgage balance or where the property is in possession
27 See Mortgage Lending Statistics on FCA website
28 See UK House Price Index
29 See HMRC Monthly property transactions completed in the UK with value of £40,000 or above

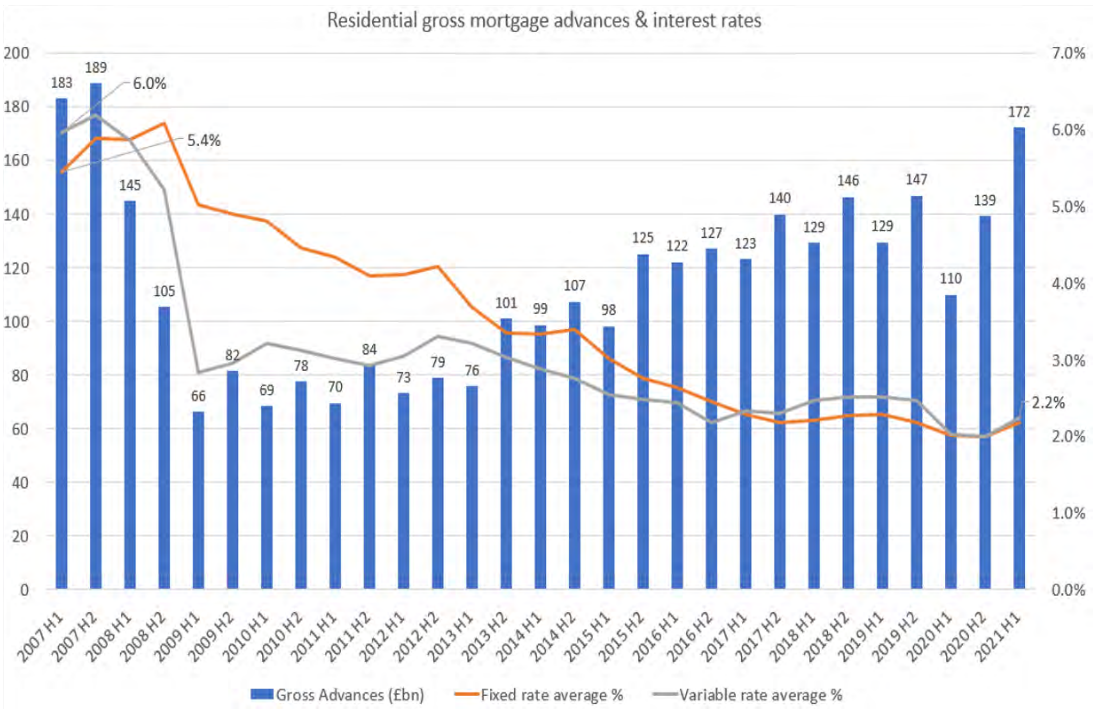
Figure 3.1 Outstanding value of residential mortgage loans (annual averages), £BN



Source – BOE & FCA MLAR (2021 is only up to Q2)

7. The value of gross mortgage advances[30] (new mortgages) in H1 2021 was £172.3 billion, the highest level since 2007 H2. See figure 3.2. This was a result of pent-up demand following the coronavirus lockdowns in 2020, changing consumer tastes and the temporary reduction in stamp duty land tax which was introduced in July 2020 and phased out by October 2021.

Figure 3.2 Residential gross mortgage advances & Interest rates



Source – BOE & FCA MLAR (2021 is only up to Q2)

30 See Mortgage Lending Statistics on FCA website

8. In Q2 2021 the share of gross mortgage advances for house purchase was 66.4% – the remainder being made up by buy-to-let (BTL) purposes, remortgages and further advances, including life-time mortgages.

9. Of the 66.4% of mortgage advances, lending to first-time buyers was 6.5pp higher in Q2 2021 than in Q2 2020, at 24.7% of gross advances.

10. The share of advances to home movers increased by 18.3pp on a year earlier, to 41.7%, illustrating how the combined drivers of increased household savings since March 2020 and increased demand for space has led to an increase in home movers.[31] [32]

11. Fixed and tracker rates have fallen as the BOE base rates remained at record lows, the most recent reduction was in March 2020 to 0.1% from 0.75% - in response to the unfolding Coronavirus pandemic.

12. Interest rates on gross advances for fixed rate mortgages fell to a record weighted average low of 1.97% in Q2 2020 while variable rate mortgages fell to a low of 1.83%. See figure 3.2 above.

13. In the November 2021 Monetary Policy Report[33] the BOE predicted that the bank rate (based on overnight index swap rates) will increase to 1% by the end of 2022. Mortgage lenders began to withdraw some of their headline rates as the number of sub-1 per cent products fell from 131 in October 2021 to 30 in November 2021[34]

14. The BOE decided to increase the bank rate at the December 2021 Monetary Policy Committee[35] meeting from 0.1% to 0.25% as 12-month CPI inflation was recorded at 5.1% in November 2021. CPI inflation is expected to fall back in the second half of 2022 as supply disruptions ease, global demand rebalances from goods to services, and energy prices stabilise.

15. According to MLAR[36], as of Q2 2021, 21.3% of outstanding mortgage balances were on variable rates which are often tracked to the BOE base rate and therefore consumers may see an increase in their monthly repayments. However 90% of new mortgages in the last four years were completed on a fixed rate and these consumers will be protected from an immediate increase in interest rates until their current term ends.

31 See December 2021 BOE Bank Overground article How much of the recent house price growth can be explained by the 'race for space'?
32 See Mortgage Lending Statistics on FCA website
33 See November 2021 BOE Monetary Policy Report
34 See November 2021 FT article UK lenders begin to raise mortgage rates despite BoE decision
35 See December 2021 Monetary Policy Summary and minutes of the Monetary Policy Committee meeting
36 See Mortgage Lending Statistics on FCA website

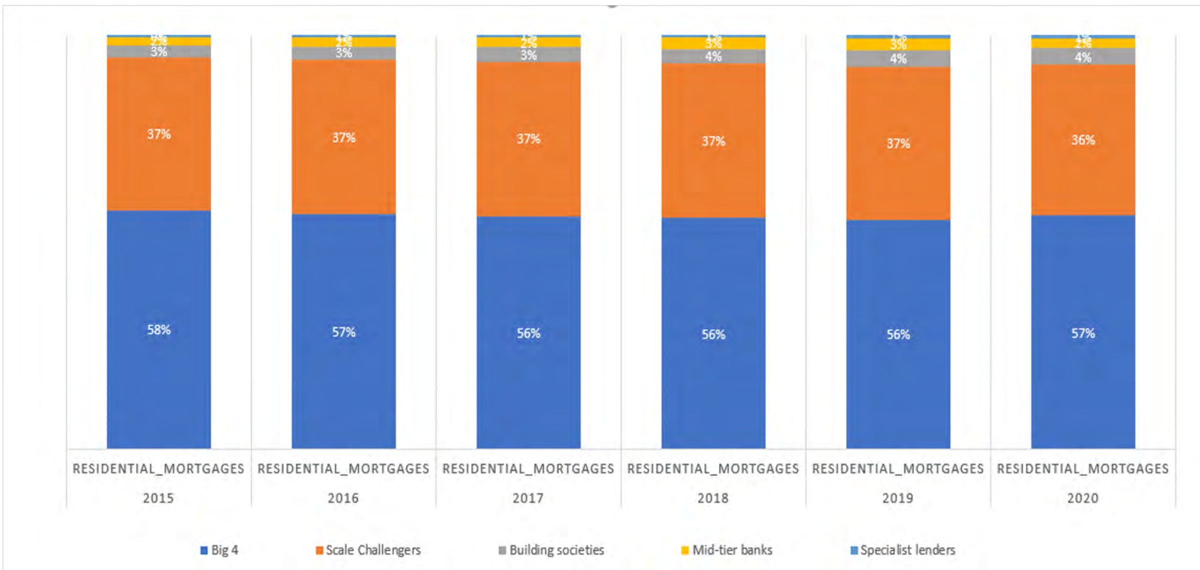
Residential mortgage market shares have been stable

16. Mortgages, both residential and BTL, typically represent the largest lending asset on a bank's balance sheet. This differs across the cohorts, with Mid-Tier banks having the lowest proportion of mortgages, representing 61% of lending balances between 2018-2020. This is in comparison with the Big 4 banks where mortgages represented 80% and Scale challengers where it represented 91% of lending assets, on average, over the same period. The building societies within our sample firms focus entirely on mortgages. Refer to figure 1.3 in Appendix 1 for more information on lending compositions.

17. The composition of mortgages also differs between cohorts in regards to the proportion of mortgage lending which is in residential mortgages and which is in BTL mortgages. Specialist Lenders tend to focus more on BTL as 81% of their mortgage portfolio was comprised of BTL mortgages between 2018-2020, the remaining being comprised of residential. The other cohorts hold a majority of residential mortgages across their mortgage portfolio, however scale challengers have been growing their market share in BTL mortgages in recent years as described in next section.

18. Our analysis indicates that the residential mortgage market share of the larger lenders, in terms of average annual lending balances, including the existing stock and flow of new mortgages, has remained relatively stable over recent years. See figure 3.3 below. Since 2015 the Big 4 banks experienced a 1 percentage point loss of market share from 58% to 57%. Scale challengers' market share also declined by 1 percentage point between 2019 and 2020. The 1 percentage point decline for Mid-Tier banks between 2019 and 2020 can be partially explained by the exit of Tesco bank from the mortgage market, as well the decision taken by Sainsburys bank to cease the origination of new mortgages. The Building societies within our firm sample have gained 1 percentage point market share since 2015.

Figure 3.3 Residential Mortgage Market Share by Annual Lending Balances

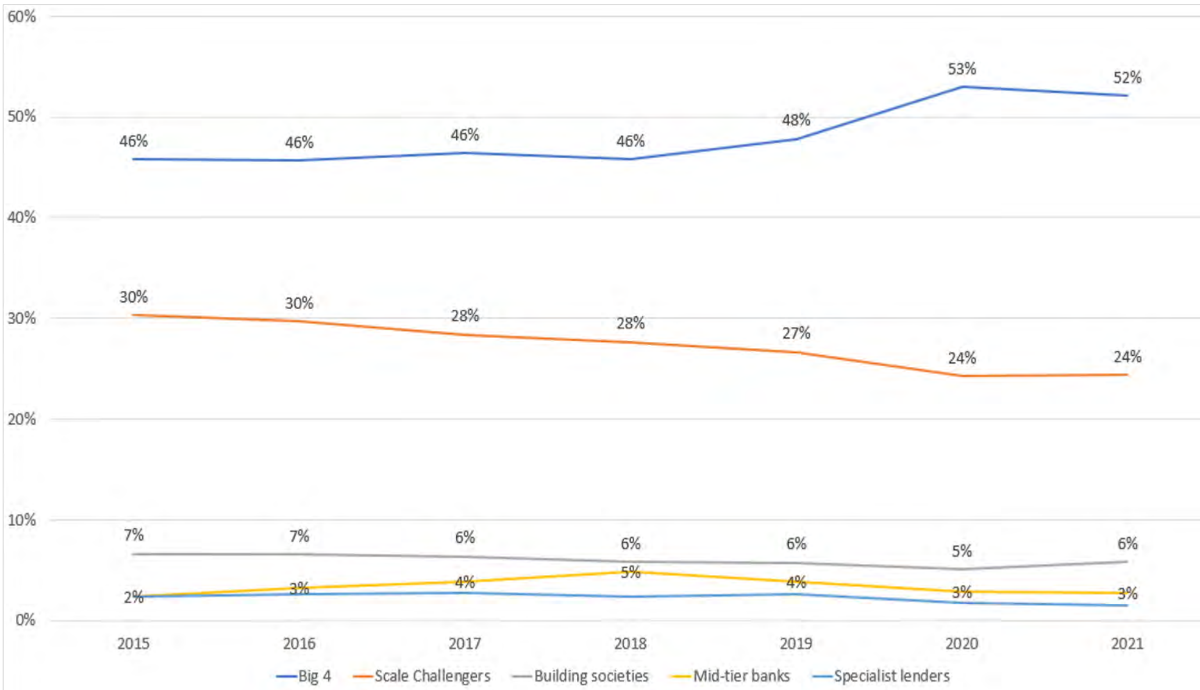


Source – FCA firm data analysis

Includes Big 4 Banks, 4 Scale Challengers & 4 Mid-Tier Banks, 2 Building Societies & 4 Specialist Lenders

19. Figure 3.4 below shows residential mortgage gross advances i.e. new mortgage loans. Big 4 banks' share of residential gross advances was stable at 46% during the four-year period between 2015-2018. It increased to 48% in 2019 and to 53% in 2020.

20. ***Figure 3.4 Residential mortgages gross advances market share***



Source – BOE & FCA MLAR (2021 is only up to Q2)
Sample includes Big 4 Banks, 4 Scale Challengers & 4 Mid-Tier Banks, 2 Building Societies & 4 Specialist Lenders
Note 2021 data is only up to August 2021

21. Some banks told us that the 2019 Ring-Fencing regulation[37] has been a contributory factor, because it resulted in additional liquidity within the retail part of the bank and that this was deployed to mortgage lending where demand was the greatest. However, this growth in market share for gross advances has not been uniform across all ring-fenced firms. Amongst the Big 4 firms, some have achieved an increase in growth through expanding their brokerage network.

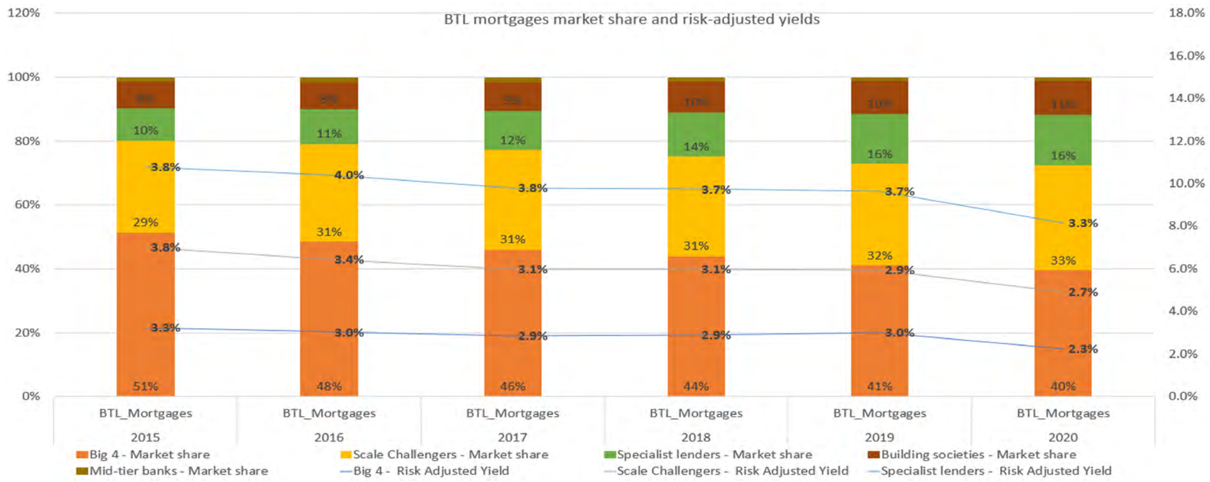
22. In 2020 funds deployed to mortgage lending increased in contrast to demand for consumer credit, which reduced significantly. (see annex 4 on consumer credit).

Big 4 banks have lost market share in BTL mortgages

23. Big 4 banks have lost market share in Buy-To-Let (BTL) mortgages, measured by average annual lending balances, reducing from 51% in 2015 to 40% in 2020. The Scale Challengers have increased market share by 4 percentage points, whilst Specialist Lenders which have seen their market share increase from 10% in 2015 to 16% in 2020. It should be noted that the BTL share of house purchases has fallen since 2016, due to various tax changes, including the introduction of an additional dwellings SDLT rate at three per cent[38].

37 See Ring-fencing initiative on PRA website
38 See UK Finance December 2019 report - The Changing Shape of the UK Mortgage Market

Figure 3.5 BTL mortgages market share and risk-adjusted yields



Source – FCA Analysis

Includes Big 4 Banks, 4 Scale Challengers & 2 Mid-Tier Banks, 2 Building Societies & 4 Specialist Lenders

Risk adjusted yields calculated as gross interest income plus non-interest income minus impairments divided by average lending balances

24. During our firm meetings, some of the scale challengers told us that they have focused more of their lending in BTL markets as yields were higher and they were more able to compete for those consumers than in prime residential mortgages segment.

25. Building Societies within our firm sample have also focused more on BTL lending as price competition has pressured margins in prime residential mortgages in recent years. They have also continued focus on their traditional strengths of regionality and lending in more niche mortgage products which require manual underwriting.

26. Specialist lenders shifted their focus to more complex BTL mortgage products which also required more manual underwriting.

27. BTL mortgages generally yield higher than residential mortgages as banks view tenants as higher risk than owner occupiers and affordability checks differ as they are reliant on rental valuations. Specialist Lenders also generate the highest risk adjusted yields on BTL mortgages, however this is also due to the overall riskier nature of lending the firms partake in. The figure above also shows yields falling for all archetypes on BTL mortgages since 2015, below we can see that yields have also fallen on residential mortgages.

Prices and yields have come down

28. As illustrated in Figure 3.2, interest rates on residential gross advances have fallen to recent lows, and as shown in the figure 3.6 below this has translated to lower risk adjusted yields for all archetypes of retail banks. Building societies had the lowest risk adjusted yield in 2020 of 2.0%, whilst Specialist lenders had the highest with 4.4%. Big 4 banks, Scale Challengers and Mid-Tiers had similar yields ranging from 2.0% to 2.1% in 2020.

Figure 3.6 Residential Mortgages Risk Adjusted Yields

Source – FCA Analysis, 2015-2020 - Risk adjusted yields for residential mortgages

Sample Includes Big 4 Banks, 4 Scale Challengers & 4 Mid-Tier Banks, 2 Building Societies & 4 Specialist Lenders

Risk adjusted yields calculated as gross interest income plus non-interest income minus impairments divided by average lending balances

29. Risk-adjusted yields fell for each class of firm almost every year since 2015. The degree of decline in 2020 was driven by the high level of provisions for impairments made at the outset of the pandemic, and some of these impairments have since been released. Falling yields are consistent with increasing price competition across a range of mortgage services.

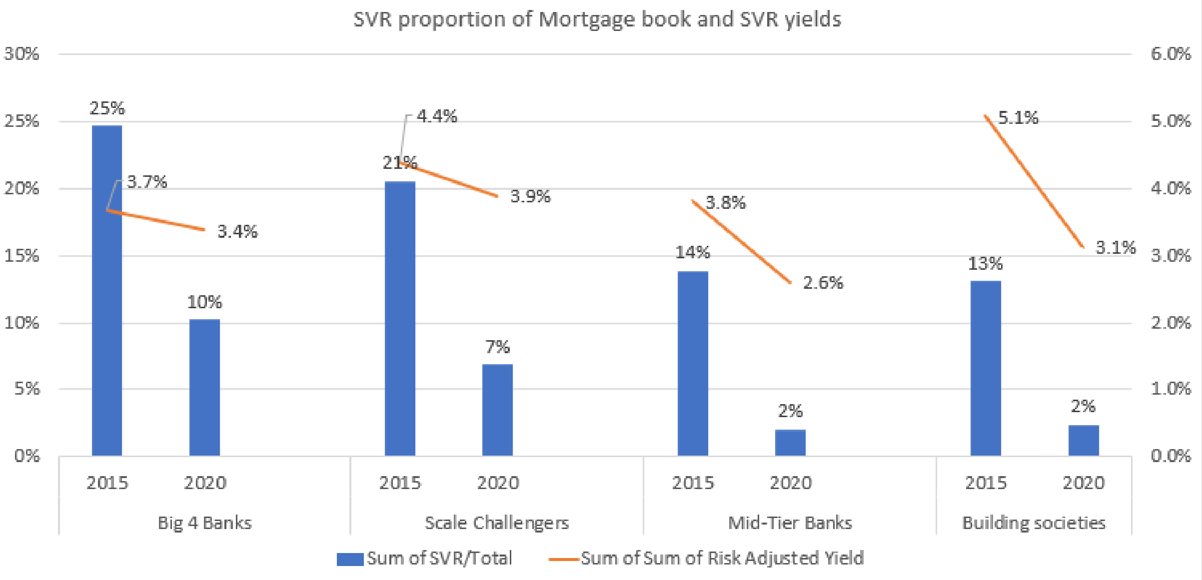
SVR balances and yields have come down

30. An additional explanation for falling yields is the lower proportion of consumers now on a standard variable rate (SVR). Consumers revert onto the SVR or a reversionary rate if they don't switch at the end of an incentivised period, and the SVR is almost always going to be higher than the incentivised rate that preceded it.

31. Figure 3.7 shows that the proportion of mortgage balances on SVR has fallen since 2015 across all cohorts.

32. Big 4 banks have the highest proportion of SVR mortgage balances in 2020 at 10%, Scale Challengers have 7% whilst Mid-Tier banks and Building Societies have only a 2% proportion of SVR mortgages.

Figure 3.7 SVR Lending balances proportion and yields



Source – FCA analysis, weighted average for 2015 & 2020

Sample includes Big 4 banks, 4 Scale Challengers, 3 small retail banks, 2 building societies.

Risk Adjusted yield calculated as the sum of gross interest income and fee income minus impairments divided by average lending balances.

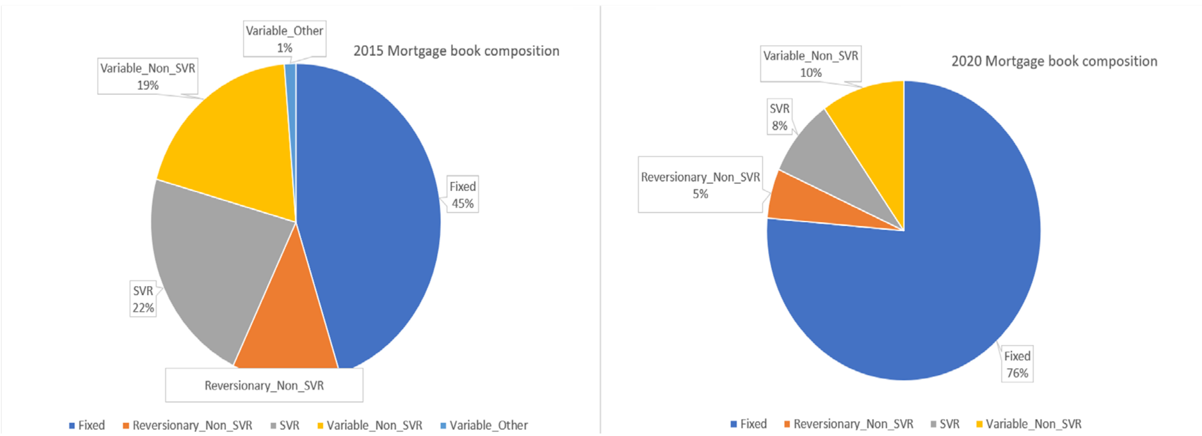
Analysis includes both BTL and Residential Mortgages.

33. The figure shows that SVR risk adjusted yields have also fallen for all archetypes since 2015. Scale challengers had the highest risk adjusted yielding SVR mortgages with a yield of 3.9%, in 2020, whilst Mid-Tier banks had the lowest SVR yields at 2.6%.

The proportion of the balances on fixed rates has increased

34. Fixed rate mortgages have grown in importance from 45% of mortgage balances in 2015 to 76% in 2020. 51% of consumers told us the reason they decided on a fixed rate mortgage is because they prefer the certainty about how much they pay each month in the 2020 FCA Financial Lives Survey[39], up 14% since 2017.

Figure 3.8 Mortgages balances composition



Source – FCA Analysis

Sample includes Big 4 banks, 4 Scale Challengers, 3 Mid-Tier Banks, 2 building societies, 4 Specialist Lenders

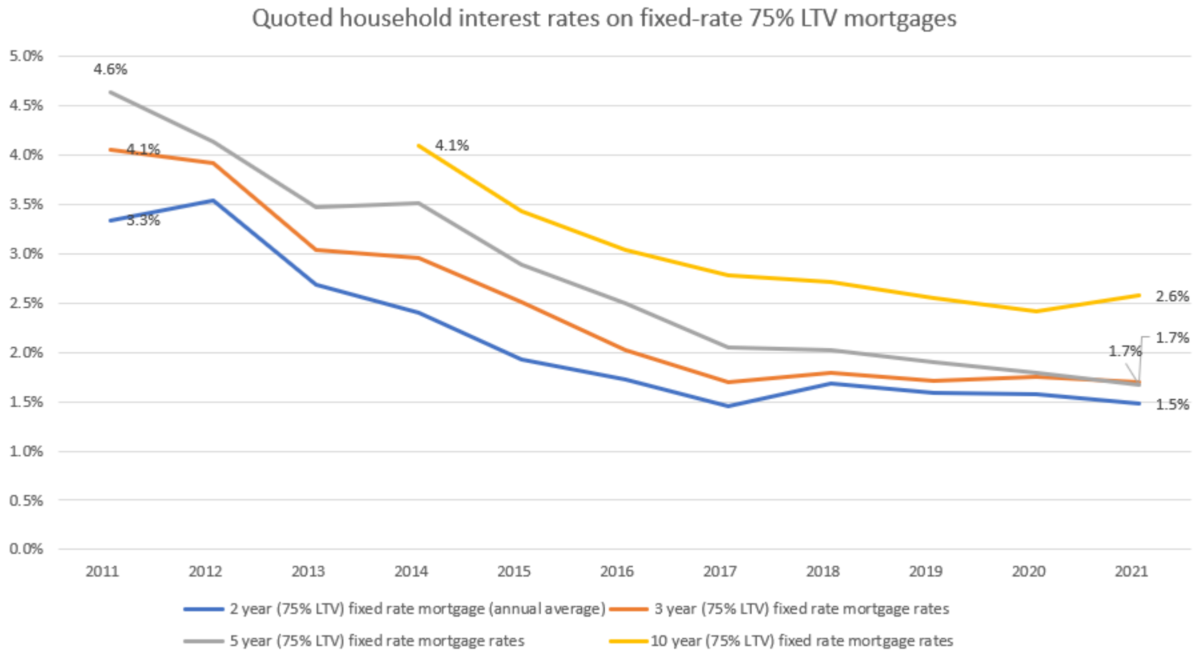
Note: Includes BTL mortgages

39 See 2020 FCA Financial Lives Survey

35. As noted in figure 3.6, the SVR proportion of mortgage balances have reduced since 2015 for all archetypes, the above figure reflects that the proportion of consumers on Variable-Non-SVR rates has also fallen since 2015 from 19% of mortgages to 10%.

36. As 2 year fixed rate and 5 year fixed rate mortgage products have converged in price in recent years, which can be seen in figure 3.9 below, more consumers have been opting to buy longer dated fixed rate mortgages. The Bank of England published research through their Bank Overground[40] website in July 2020, showing that 5 year fixed mortgages represented 50% of new mortgages in 2019.

Figure 3.9 Quoted household interest rates on fixed-rate 75% LTV mortgages



Source BOE data - Quoted household interest rates

37. In April 2014 we introduced a package of reforms to the UK mortgage market through the Mortgage Market Review (MMR). The MMR strengthened affordability assessments to prevent consumers from taking on unaffordable mortgages and required firms to consider the impact of a likely future interest rate increase on affordability.

38. In June 2014, the Financial Policy Committee (FPC)[41] introduced recommendations to regulators. These limited the proportion of new mortgages with high loan to income (LTI) ratios and specified a stress interest rate for lenders when assessing a prospective borrower's ability to repay a mortgage.

39. The FPC affordability stress test required lenders to assess whether borrowers could still afford their mortgage if, at any point over the first five years of the loan, mortgage rates were to be 3 percentage points higher than the contractual reversion rate.

40. At the December 2021 FPC meeting[42] the committee decided to maintain the LTI flow limit recommendation, alongside the FCA's affordability testing under its Mortgage Conduct of Business framework. However, the FPC will consult, in the first half of 2022,

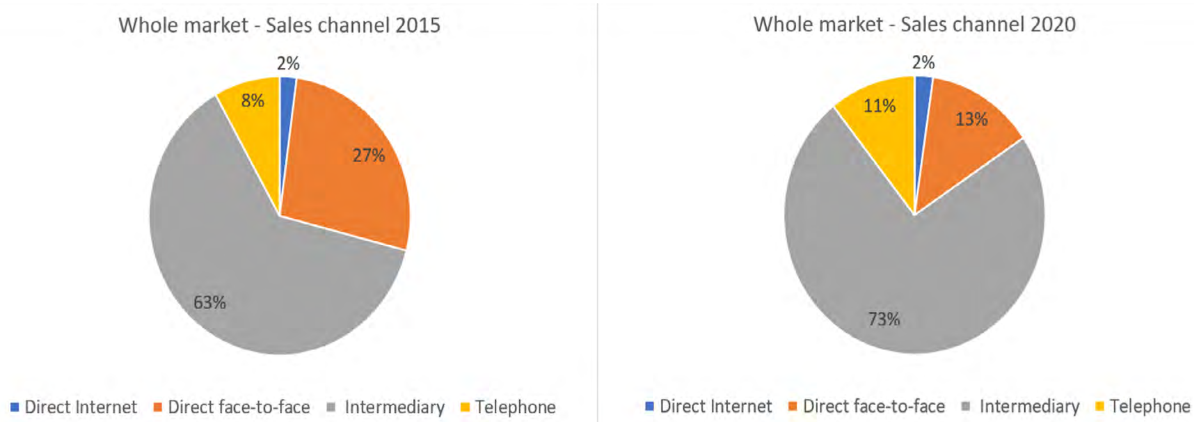
40 See July 2020 BOE Bank Overground analysis - Why are more borrowers choosing long-term fixed-rate mortgage products?
41 See July 2020 BOE Bank Overground analysis - Why are more borrowers choosing long-term fixed-rate mortgage products?
42 See Interest rate stress test on FCA website

on withdrawing the FPC recommended stress-test. The FPC concluded that this 'ought to deliver an appropriate level of resilience to the UK financial system, but in a simpler, more predictable and more proportionate way'.

41. In relation to mortgage affordability UK Finance[43] recently reported that 52% of new mortgages granted in the first half of 2021 will have mortgage terms that extend beyond the borrower's age of 65. A longer mortgage term leads to lower mortgage repayments for the borrower, but the overall interest paid on the mortgage is greater, if no overpayments are made during the term.

The use of intermediaries has increased and cross holding has decreased

Figure 3.10 FCA Mortgages PSD Sales Channel data 2015 & 2020



Note this data excludes internal product transfers

42. Increasing use of intermediaries could be another factor behind the fall in numbers of consumers on reversionary rate products and the fall in prices and yields. FCA Mortgage Product Sales Data show that in 2015 63% of consumers obtained their mortgage through an intermediary and this has increased to 73% in 2020. The number of consumers obtaining new mortgages directly - including via internet and in person – fell from 29% in 2015 to 15% in 2020.

43. The 2018 FCA Mortgage Market Study – Interim Report[44] noted that 'consumers choose to go to an intermediary for a wide range of reasons such as convenience, reassurance, market knowledge and for help where their circumstances are unusual'. This is also reflected in the 2020 FCA Financial Lives Survey[45] where 79% of respondents 'Agreed' when responding to the statement 'My mortgage broker helped me to get a better deal than I would have on my own'.

43 See September 2021 Which? Article
44 See 2018 FCA Mortgage Market Study – Interim Report
45 See 2020 FCA Financial Lives Survey

44. The Mortgage Market Study also resulted in a rule change requiring advisors to justify why they weren't recommending the cheapest of the deals identified as suitable for a borrower.

45. Banks told us that they mainly compete on prices, but also on speed and accuracy of their decision making, which improves the service provided by the broker. Some banks have started to experiment with the use of open banking technology to reduce speeds in decision making by sourcing affordability information directly from the consumer's current account provider.

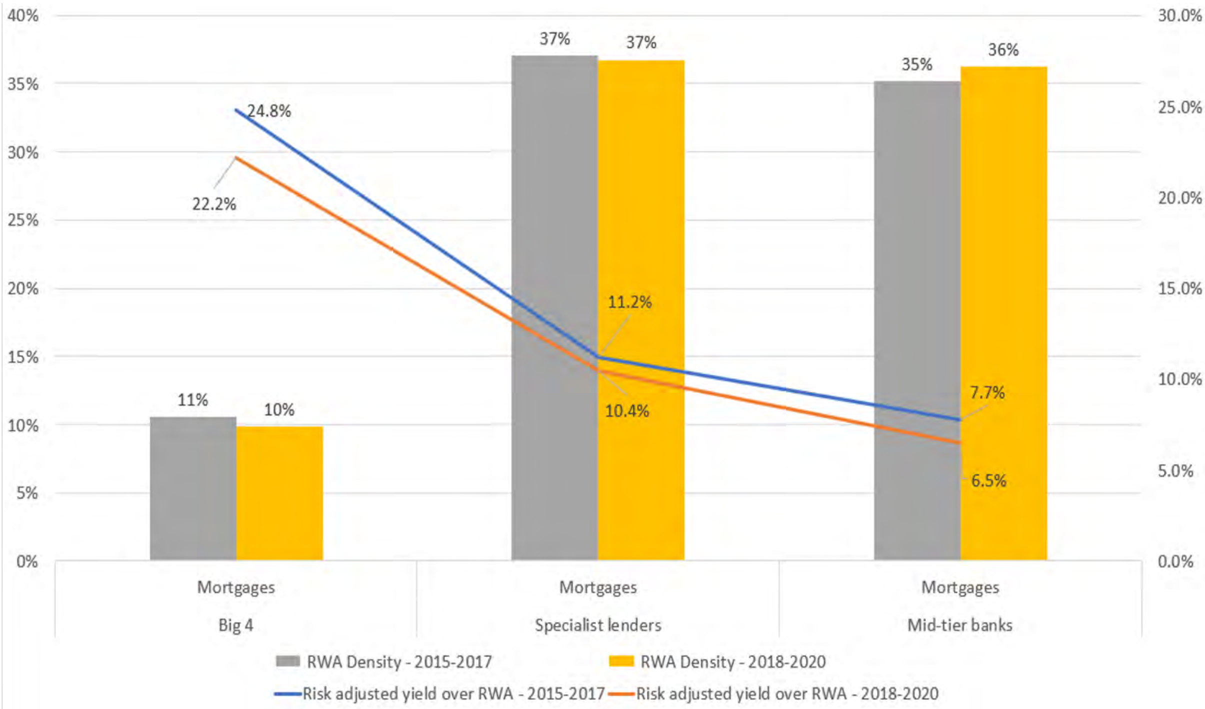
Risk adjusted yields on risk weighted assets have fallen, and remain highest for Big 4 lenders

46. While risk adjusted mortgage yields are comparable across business models (see figure 3.6), when compared to credit risk weighted assets, mortgage lending yields are significantly higher for Big 4 banks.

47. Figure 3.11 below shows RWA density and all-in risk-adjusted mortgage yields as a percentage of risk weighted assets (RORWA) for three cohorts. Over the two periods between 2015-2017 and 2018-2020 RORWA fell for all cohorts. Big 4 banks experienced a 2.6 percentage points fall in RORWA, from 24.8% to 22.2% between the two periods. Specialist lenders and mid-tier banks also experienced falls in RORWA but of a lower magnitude.

48. Observing the RWA densities between the two periods, we can see Big 4 banks RWA density decreased from 11% to 10%, while for other cohorts it was stable or increased. The lower RWA densities for Big 4 Banks reflect their advantages under the IRB approach to credit risk modelling, including a longer history of data.

Figure 3.11 Mortgages – Credit RWA density and risk adjusted yield over RWA (2015-17 & 2018-20)



Source – FCA analysis, weighted average for 2015-17 & 2018-20, sample includes 3 Big 4 banks, 3 mid-tier banks, 3 specialist lenders.
Credit Risk Weighted Asset density calculated as average Credit RWAs divided by average lending balances.
Based on mortgage credit RWAs as provided by firms.
3 Big 4 Banks within the sample employ IRB in 2020. The remaining lenders employ the standard method.
Risk Adjusted yield over RWA calculated as the sum of gross interest income and fee income minus impairment divided by annual Credit RWAs.
Analysis includes both BTL and Owner-Occupied Mortgages.

49. Larger banks predominantly use their own internal models under the Internal Ratings Based approach (IRB) to determine credit RWAs, with smaller institutions generally applying prescribed risk weightings under the Standardised Approach (SA).

50. As observed in figure 3.11 these differences in approach influence the lower risk weightings for Big 4 banks in mortgages. Lower risk weights increase Big 4 banks' RORWA on mortgages compared to smaller retail banks and specialist lenders.

51. The PRA noted in their recent consultation paper on 'Internal Ratings Based UK mortgage risk weights'[46] that the average IRB UK mortgage risk weight is just under 10%, having fallen from c.13% in 2014. By comparison, the lowest SA UK mortgage risk weight is 35%.

46 See PRA Consultation Paper | CP14/20 Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture – 30 September 2020

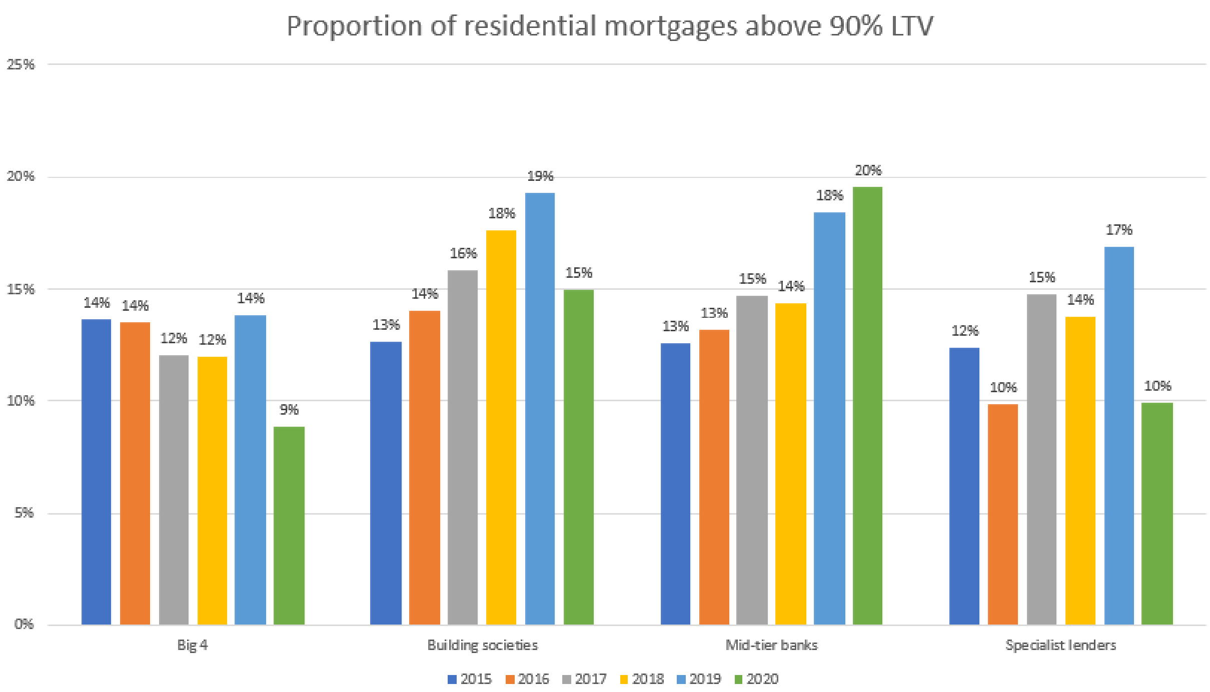
52. The PRA[47] are addressing these differences in risk weight calculation methods with policy changes that will come into effect in January 2022. One of which will be to set a minimum exposure-weighted average risk weight of at least 10% for all UK residential mortgage exposures to which a firm applies the IRB approach. Secondly, the PRA will consider the calibration of the incoming Probability of Default (PD) and Loss Given Default (LGD) parameter floors for mortgage exposures as part of the implementation of the Basel 3.1 standards[48].

Smaller banks have increased riskier lending

53. The Big 4 focus on prime residential mortgages is illustrated in the figure below as the proportion of their new residential mortgage lending above 90% LTV has remained relatively stable between 12% and 14% between 2015 and 2019. 2020 was an anomalous year due to the Coronavirus pandemic as many lenders restricted their new mortgages to below 90% LTV, particularly in the first half of 2020.

54. This contrasts with other lenders which have increased the proportion of new loans originating above 90% LTV, with the building societies, in this sample, increasing the share to 19% in 2019 from 13% in 2015.

Figure 3.12 Proportion of residential mortgages above 90% LTV



Source – FCA Mortgage Product Sales Data
Sample includes Big 4 banks, 5 Building Societies, 3 Mid-Tier banks and 4 Specialist Lenders

47 See PRA Policy Statement | PS16/21 Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture July 2021

48 See December 2017 - Basel III: Finalising post-crisis reforms

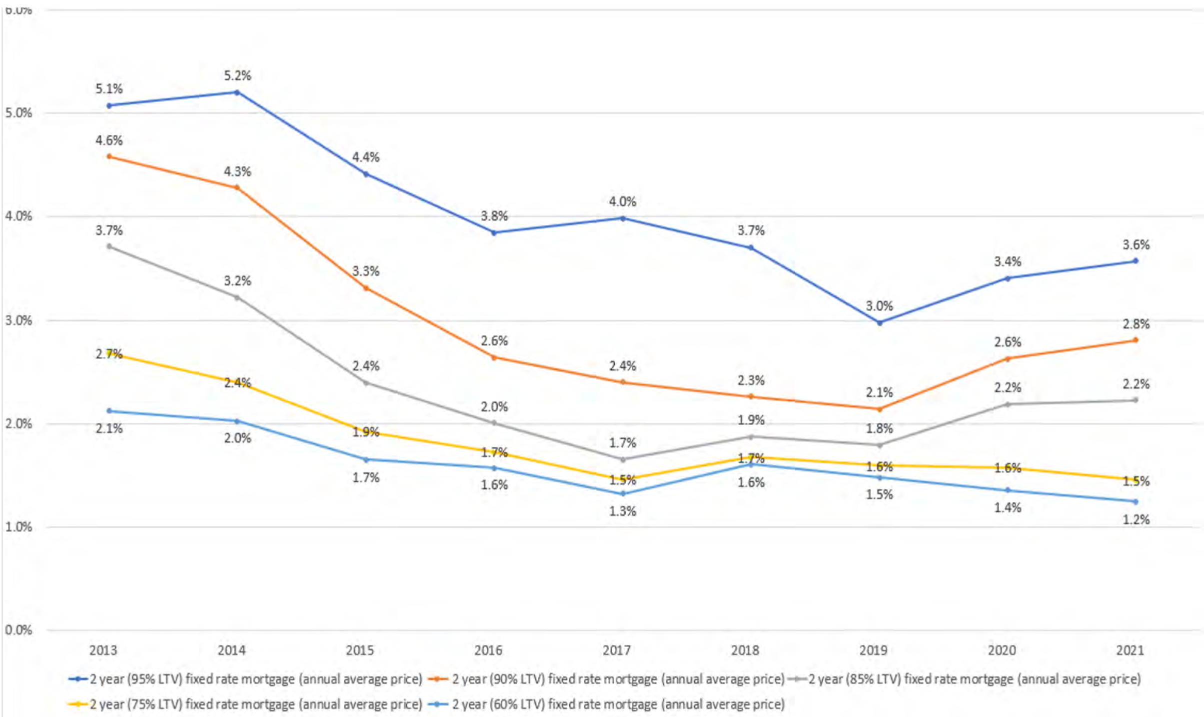
55. The FPC[49] recently noted in their December 2021 meeting record that the share of new mortgages issued at high loan-to-value (LTV) ratios had increased in recent months, towards pre-pandemic levels. In 2021 Q3, around 16% of new mortgage lending to owner-occupiers was at an LTV ratio of 90% or above, compared with 10% in 2021 Q2 and 20% in 2019 Q4.

56. The share of new mortgage lending at loan-to-income (LTI) ratios at or above 4.5 was 8.5% in 2021 Q3, compared to 10.6% in 2021 Q2 – well below the FPC's limit of 15%.

57. The increase in lending towards riskier areas of the market for small firms can be explained by the higher yields this can generate for the lender. This can be seen by charting 2 year fixed rate mortgages across differing LTVs. See figure 3.13. The average price on a 95% LTV residential mortgage was 3.4% in 2020, which was 200bps more than a 2 year fixed rate mortgage with a 60% LTV.

Figure 3.13 - 2 Year Fixed Rate mortgage prices across LTVs

58.



Source - BOE Data - quoted household interest rates on 2 year fixed-rate mortgages

Some small lenders have exited

59. Partly due to the competitive constraints outlined in the sections above, between 2019 and 2020 several mid-tier banks decided to exit the mortgage market either by selling their entire mortgage book or a proportion of it. Other banks decided to stop new lending to allow their current mortgage book to run off. This is reflected in our data, where the market share of new residential mortgages fell from 5% in 2018 to 3% in 2020 for mid-tier banks. See figure 3.4

49 See Financial Policy Summary and Record of the Financial Policy Committee Meetings on 29 November and 9 December 2021

60. In February 2019 Secure Trust Bank[50] decided to cease origination of new residential mortgages and the portfolio was eventually sold in July 2021. The sale was in line with STB's strategy to focus on specialist lending segments offering higher yields.

61. In September 2019 Tesco Bank[51] confirmed the sale of their entire mortgage portfolio to Lloyds Bank. The sale is in line with Tesco Bank's strategy of focusing on a reduced number of products and services that will reduce operating and funding costs. In the same month Sainsburys Bank[52] announced it will immediately stop offering new mortgages to further focus on consumer credit and also reduce operating costs.

62. In December 2020 Metro Bank[53] sold a portfolio of owner-occupied residential mortgages valued at £3.045bn to Natwest Bank, representing around a one third of Metro's residential mortgage loan book. The sale was in line with their strategy to increase their portfolio mix and expand their unsecured lending portfolio and specialist mortgage offerings.

63. In our discussions with mid-tier banks, they have told us they have found it difficult to compete in the mortgage market due to a combination of factors, including higher funding and operating costs and lowering margins. Capital requirement differences mean smaller banks on the standardised method of calculating risk-weighted assets have to hold a higher amount of capital, reducing ability to earn a comparable return on equity. We demonstrated this in our 2018 Strategic Review of Retail Banking Business Models Final Report[54], see figure 3.23.

64. There have also been signs of entry in to the mortgage market, as Starling Bank[55] acquired a specialist buy-to-let mortgage lender, Fleet Mortgages, in July 2021.

65. Alongside this we have seen challenger banks enter into forward flow agreements with non-bank specialist lenders, allowing the banks to fund mortgages indirectly and benefit from operational cost savings that would have come from originating the new mortgages. Other banks also participate in the mortgage market by acquiring higher yielding mortgage books or through securitisation sales from non-bank lenders.

Consumers have benefited from increased availability of products

66. The total number of residential mortgage products across all LTVs has increased from 4,091 in October 2016 to 5,315 in December 2021[56]. This has eclipsed the pre-pandemic high in March 2020 of 5,222 and is the highest since March 2008.

67. The number of products above 95% & 90% LTV has also increased since the most recent lows of 8 and 88 in December 2020 to 353 and 706 respectively in December 2021. This indicates a return of risk appetite for firms, assisted by the help to buy and mortgage guarantee schemes. The availability of such products further enhances consumer choice.

50 See July 2021 Secure Trust Bank PLC Press Release
51 See September 2019 Tesco Bank Press Release
52 See September 2019 Sainsburys Bank Capital Markets Day
53 See Metro Bank Press Release
54 See FCA 2018 Strategic Review of Retail Banking Business Models Final Report
55 See Starling Bank acquires buy-to-let specialist mortgage lender, Fleet Mortgages
56 See Moneyfacts website

Annex 4
UK consumer credit

Prior to 2020, there were signs of competition in credit cards and personal loans. Risk adjusted yields fell in both products between 2015 and 2019, suggesting that the margins banks were making were falling, while balances rose as a result of increased consumer borrowing.

This led to a decline in market share for Big 4 banks and some of this was driven by increased price competition from scale challengers and mid-tier banks.

During the pandemic, we found that unsecured consumer credit markets contracted in 2020, as consumers saved more and spent less. As a result, bank lending balances of credit cards, overdrafts and personal loans fell, reversing the pre-pandemic trend for growth in consumer borrowing from banks.

In response to the pandemic, FCA interventions were put in place in 2020 to protect consumers. In April 2020 we published temporary guidance for lenders that allowed customers to request payment deferrals of up to three months on credit products and for an arranged interest-free overdraft of up to £500 on their main personal current account.

In addition, in April 2020 our overdraft rules came into force, meaning that banks were required to align their pricing of arranged and unarranged overdraft products. We found that unarranged overdraft yields fell significantly following the implementation of our rules.

On arranged overdrafts, yields rose between 2015 and 2019. Part of this was likely driven by the impact of our interventions – banks changed their pricing strategy over this period, and many opted for rates that led to arranged overdraft customers on average paying more. In 2020 yields on arranged overdrafts also fell as many banks decided to automatically apply the £500 interest free overdraft for many customers.

We expect the new rules will lead to greater levels of price competition in the future and have seen evidence of challenger banks offering lower rates. We will publish a full and formal evaluation of the effect of our interventions in 2022.

We see some evidence of banks adapting to the threat of Buy Now Pay Later (BNPL) entry, although a range of business models exist in this sector and banks did not currently see a substantial threat from these new firms to their existing business.

Introduction

1. Most people at some point will rely on unsecured finance through credit cards, personal loans and/or overdrafts. Unsecured finance can meet a variety of financial needs, including funding large purchases, spreading payment costs, accessing rewards and benefits, and in some cases to consolidate existing debt.

2. In this report, we focus on deposit taking banks competing in consumer credit markets. These markets also include a variety of non-bank lenders, peer-to-peer platforms and BNPL providers, many of whom compete directly with banks in these markets. We consider the impact of these other business models in the market through our analysis of banks, particularly where we see evidence of competitive pressure feeding through into the strategies that banks adopt.

3. The pandemic has had the effect of dampening consumer demand, leading to lower spending and greater saving – total consumer credit balances declined as consumers repaid a net £16.6bn, with December 2019 to December 2020 balances falling 7.5%.[57] In contrast, at the onset of the pandemic net household deposits[58] increased by an average of £19.9bn a month between March and August 2020, this is compared to pre-pandemic monthly flows of £5.5bn. However, household savings have not been equally distributed across households with evidence suggesting that higher savings appear to have been concentrated in high-income households.[59]

4. Regulatory changes were key drivers impacting bank consumer credit lending and yields. In April 2020 we introduced new overdraft rules[60] to align the prices consumers pay on arranged and unarranged overdrafts, to price overdrafts using simple interest rates, and for banks to provide prices in APR format to enable comparison across products. These interventions followed our work to explore outcomes for consumers of high cost credit[61].

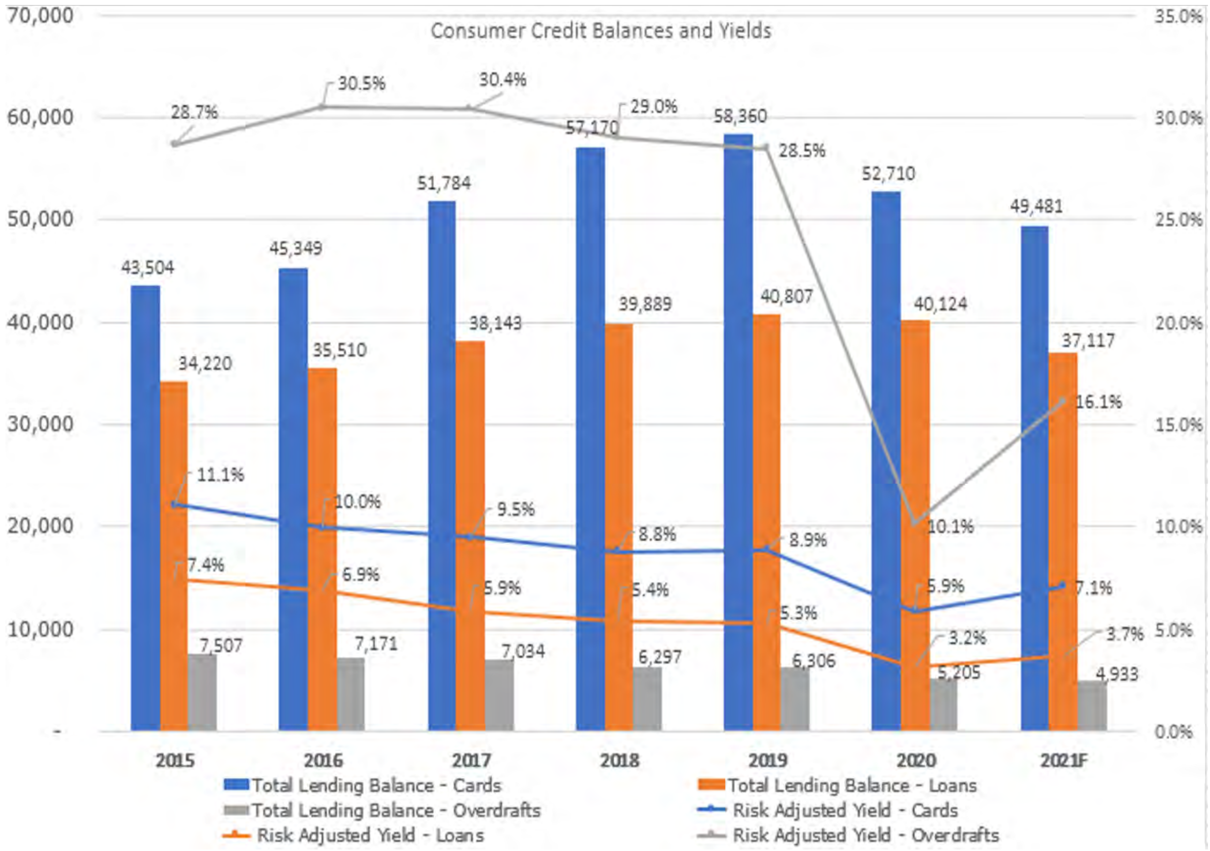
5. The pandemic, and our response measures, also had a substantial impact on consumer income and their potential ability to meet their existing credit obligations. In April 2020 we published temporary guidance for lenders to offer consumers affected by coronavirus a three-month payment deferral on personal loans and credit cards. The scheme was extended in June 2020, allowing consumers to request a three-month holiday until 31 March 2021, as long as total deferrals do not exceed six months. Firms were also to allow customers who are negatively impacted by coronavirus and who already have an arranged overdraft on their main personal current account, up to £500 charged at zero interest for three months.[62]

6. The combined impact of these interventions, the pandemic, alongside factors such as competition and the fall in the base rate, meant that consumer credit lending yields fell in 2020. Risk adjusted yields fell in Overdrafts from 28.5% to 10.1%, in Credit Cards from 8.9% to 5.9% and in Personal Loans from 5.3% to 3.2%.

7. Figure 4.1 shows bank consumer credit balances and yields across overdrafts, personal loans and credit cards between 2015 and 2021 (2021 data is projected).

57 See BOE December 2020 Money and Credit report
58 Including NS&I accounts
59 See November 2020 BOE Bank Overground research 'How has Covid affected household savings?'
60 See FCA confirms biggest shake-up to the overdraft market for a generation
61 See High-cost credit review
62 See Coronavirus: information for consumers with personal loans, overdrafts and other forms of credit

Figure 4.1 - Consumer credit lending balances and risk adjusted yields



Source – FCA analysis

Note 2021 are forecasted figures provided by firms

Sample includes big 4 banks, 4 scale challengers, 4 mid-tier banks and (2 specialist lenders for personal loans only)

Risk-adjusted all-in-yields calculated as gross interest income plus non-interest income minus impairments divided by average annual lending balances

8. Banks expected yields to recover in 2021, although forecasted a continued decline in lending balances. Consumer credit demand is driven by many external factors, such as the level of demand for products and services, and overall consumer confidence. Other factors such as the nature of consumer spending patterns and attitudes to taking on debt may be different in the future as a result of the pandemic. Banks told us they were cautious on the prospects of their consumer credit products as the recovery takes shape.

9. This section outlines the key developments in consumer credit lending and how they have impacted retail banking business models and competition.

Our interventions reduced overdraft borrowing costs in 2020

10. Overdraft lending is an important source of finance for consumers. 26% of consumers were overdrawn at some point in 2020[63], and the average balance of consumers in an overdraft in 2019 is estimated to be £500. Consumers access overdrafts through their personal current account (PCA) either in a primary account, or through secondary accounts.

11. Overdrafts are also an important source of revenue for banks, although the contribution of overdrafts to overall PCA value was declining as a share. We found that over 2018-2020 overdrafts contributed 27% of revenue banks earn from PCAs on average for Big 4 banks – this would be greater for individual consumers currently in their overdraft.[64] This was down from 35% over the period 2015-2017. We previously found that overdraft pricing – particularly unarranged overdraft pricing – means that a disproportionate proportion of the revenue banks make came from consumers in potentially vulnerable circumstances.

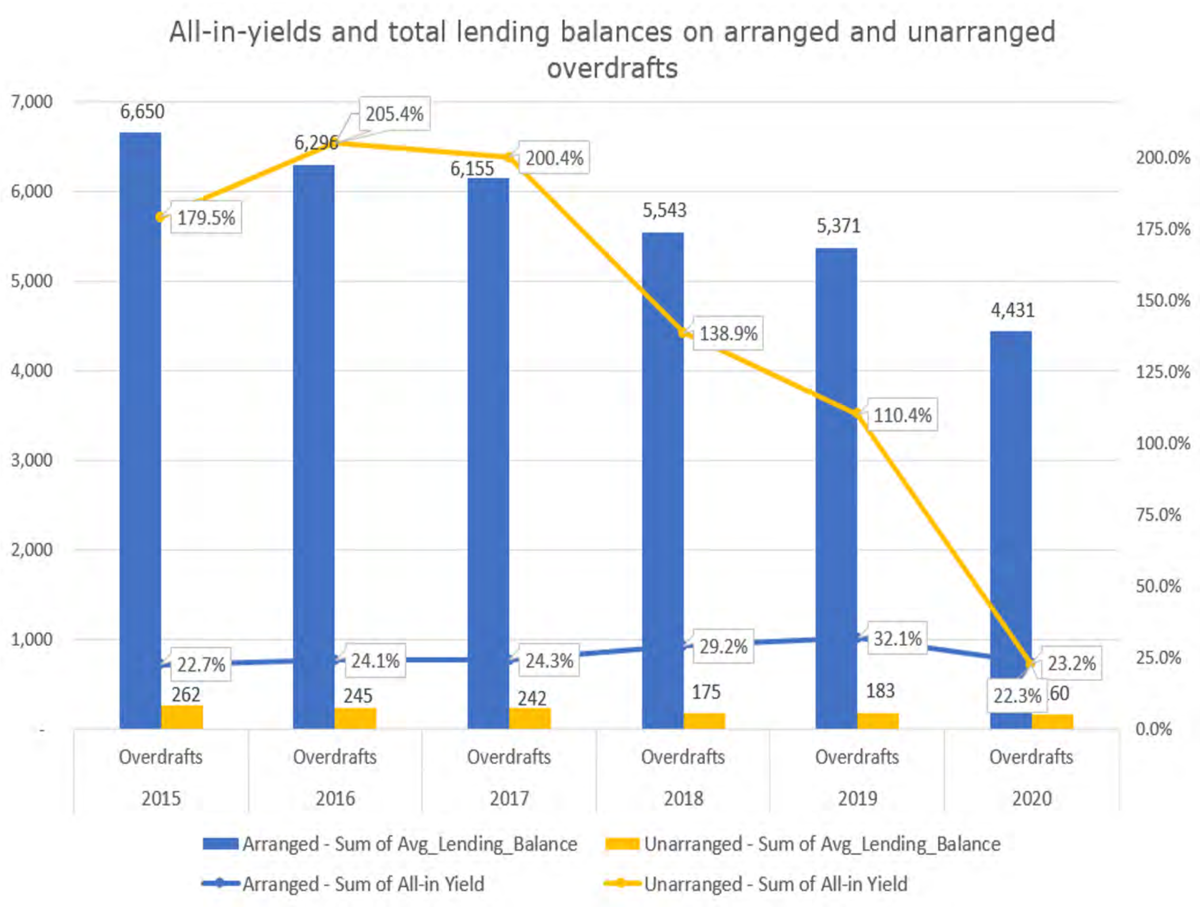
12. In 2020, the yields banks made on overdrafts fell, see Figure 4.1. Our interventions to bring unarranged overdraft pricing in line with arranged overdrafts led to a decline in the all-in-yield (the rate consumers pay including interest and fees) for unarranged overdrafts from 110.4% to 23.2%, between 2019 and 2020. See Figure 4.2.

13. The pandemic-related temporary guidance we issued in April 2020 and updated subsequently during the year meant that many banks offered many customers, in some cases all, up to £500 interest free on their arranged overdraft balance that could begin between 14 April and 31 October 2020. Banks told us this was a key driver in yields on arranged overdrafts falling from 32.1% to 23.2% from 2019 to 2020. Figure 4.2 shows the total annual balances and the average all-in-yields split by arranged and unarranged overdraft lending.

63 See Financial Lives, 2020

64 Net of impairments, and funding costs paid out on PCAs. See Appendix 2 - Personal Current Account (PCA) and Savings Market

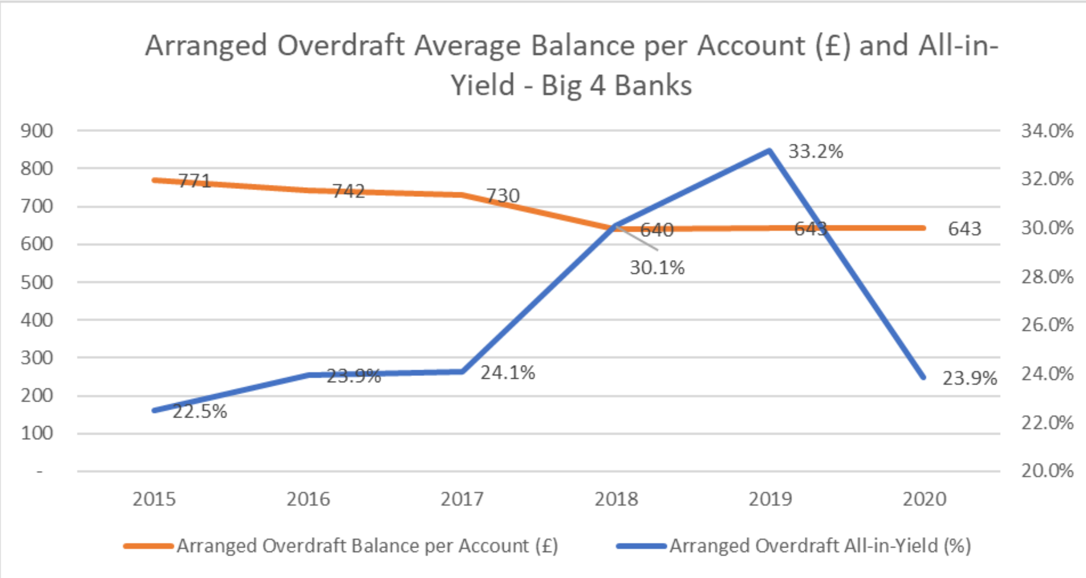
Figure 4.2 - All-in-yields and total lending balances on arranged and unarranged overdrafts



Source: FCA analysis
Sample includes big 4 banks, 3 scale challengers, 2 mid-tier banks and 2 digital banks
All-in-yields calculated as gross interest income plus non-interest income divided by average annual lending balances

14. We looked in further detail at all-in-yields on arranged overdrafts at the Big 4 banks prior to the pandemic, between 2015 and 2019, see figure 4.3. We found that yields rose from 22.5% in 2015 to 33.2% in 2019, a rise of 48%. We found that borrowing per account fell over the same period about 17% – the average arranged overdraft balance at a Big 4 bank fell from £771 in 2015 to £643 in 2019. The combined impact led to revenue per arranged overdraft account rising from £174 to £214 between 2015 and 2019.

Figure 4.3: Arranged overdraft average balance per account (£) and all-in-yield



Source: FCA analysis, sample big 4 banks
All-in-yields calculated as gross interest income plus non-interest income divided by average annual lending balances
Arranged overdraft balance per account calculated as average annual lending balances divided by average annual account numbers

15. This analysis does not explore in detail the impact of our interventions on banks' overdraft pricing, although we have considered at a high level some of the potential drivers behind the increasing yields we are seeing.

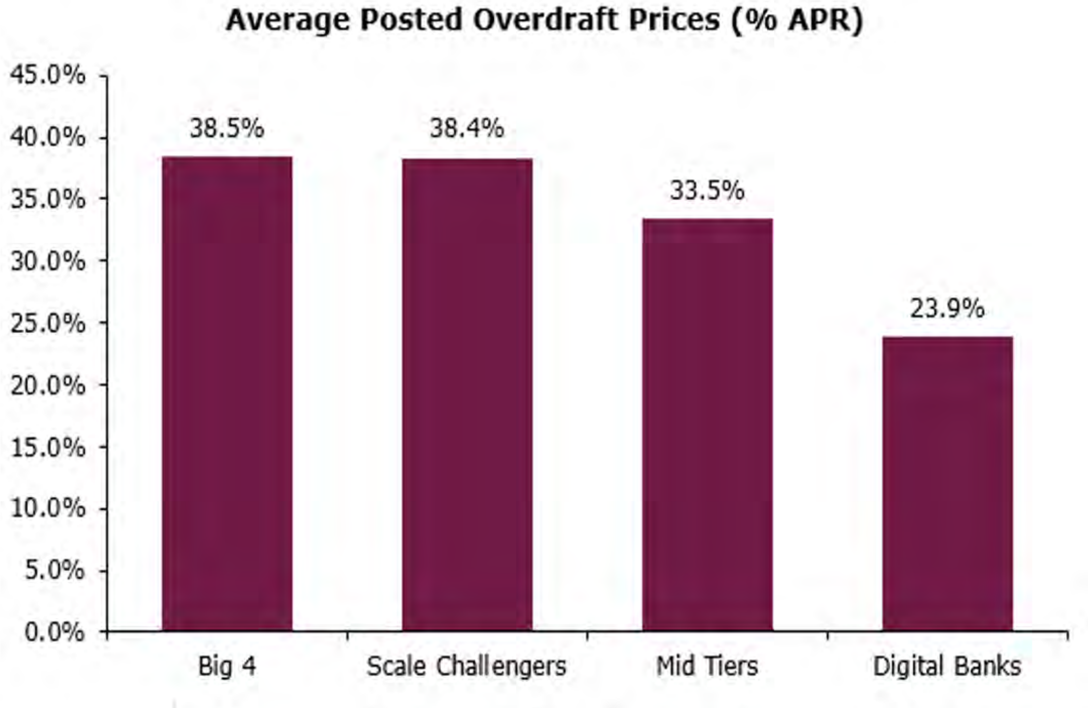
16. We found in our analysis of Personal Current Accounts that historically competition in PCAs has been weak, and that challengers have struggled to gain market share, which has traditionally been a driver of higher overdraft pricing. Customers in an overdraft may also find it more difficult to switch provider than non-overdrawn consumers.

17. Our broader findings suggest that the entry of digital banks has spurred competition to deliver benefits to some consumers in PCAs. And although many consumers have the option to switch to a digital challenger, overdraft facilities at these banks were launched more recently than the main account, and as a result our findings are less strong in overdrafts. The level of overdraft borrowing per account at digital banks was relatively low in 2020, at £146 compared to £534 per account at the Big 4.

18. The low level of overdraft borrowing at digital banks and challengers relative to the Big 4 is despite the relatively cheaper rates available. A review of prices in 2021 found that prices on average at the Big 4 were higher than at challenger banks. We found that the average APR % available at a Big 4 bank (weighted by market share of accounts) was 38.5%, compared to 38.4% at scale challengers, 33.5% at mid-tier banks, and 23.9% at Digital banks. Additionally, we found that consumer satisfaction with overdrafts was slightly higher at digital banks, compared to the Big 4.[65]

65 See CMA Satisfaction scores via Ipsos Mori

Figure 4.4: Average posted arranged overdraft prices (% APR)



Source: FCA analysis via banks' websites in August 2021
Includes big 4 banks, 4 scale challengers, 4 mid-tier banks and 2 digital banks

19. Our rules on overdraft pricing have forced firms to make their overdraft prices more transparent and easier to compare with other products. Overdraft charges continue to be higher than personal loans and credit cards. In July 2020 we also announced that we wrote to firms in January 2020 asking them to explain their overdraft pricing decisions. Given the evidence we received, we decided not to open a formal investigation. We will continue to monitor how prices develop as competitive conditions normalise, and we require firms to publish information on their overdraft pricing alongside information they already publish about current account services.

20. Later this year, we will carry out a post-implementation evaluation of our overall package of overdraft remedies.[66] The analysis captured in this chapter is not intended to replace or supplement this formal follow up work.

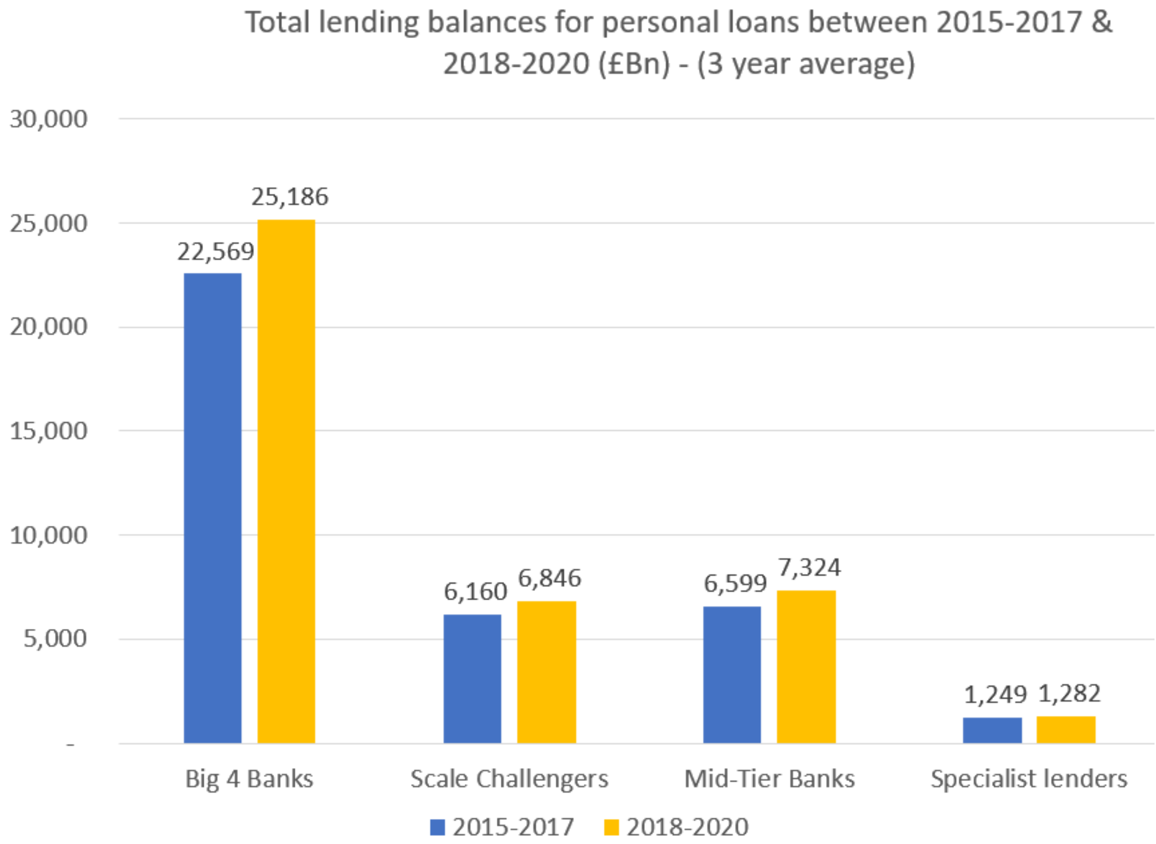
Prior to the pandemic, consumers were taking on more personal loan debt

21. Consumers take out personal loans for a variety of reasons, including to consolidate debt, to finance purchases, such as a new car, and for home improvements.[67] Consumers borrow from both retail banks, specialists and non-bank providers, including peer-to-peer loan providers. Personal loans can be a relatively cheaper source of finance for consumers; however, the price consumers pay and their eligibility varies on the banks' assessment of the relative risk of the consumer, the length and size of the loan, and whether the loan will be secured.

66 See FCA Website: FCA gives update on banks' overdraft pricing decisions and plans to support consumers
67 See Mintel - Unsecured Loans, UK - January 2021

22. Figure 4.5 below shows the 3 year average lending balances across the different banking cohorts between 2015-2017 and 2018-2020. For the Big 4 banks, total personal loan balances grew 12% (£22.6bn to £25.2bn) between the two periods. For Scale Challengers and Mid-Tier Banks the increase was marginally less, rising 11% for both cohorts over the same period. Consumer loans as a share of total consumer credit balances remained around 40% between 2015 and 2020.

Figure 4.5: Total lending balances for personal loans 2015-17 and 2018-20 (£bn). (3 year average)



Source – FCA Analysis

Sample includes big 4 banks, 4 scale challengers, 4 mid-tier banks and 3 specialist lenders

23. There are several factors driving the overall increase in lending. We found that more consumers were turning to personal loans to fund car purchases. In 2020 32% of consumers took out a loan to finance a car purchase[68]. Increasingly we also found that consumers taking out an unsecured loan are consumers with an existing form of debt. The percentage of consumers taking out a new loan who were borrowing in addition to an existing loan rose from 18% to 29% between mid-2019 and mid-2021.[69]

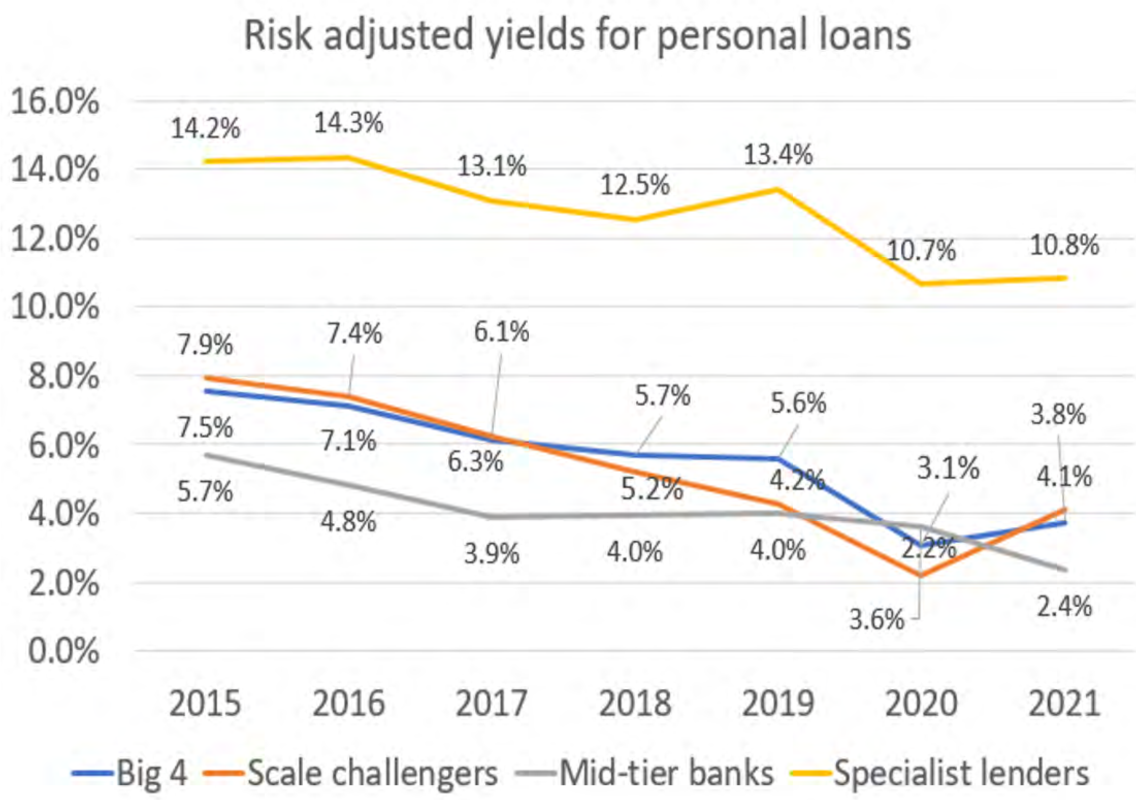
24. There's some evidence that price competition appears to have driven down yields over the same period. We found that risk-adjusted all-in-yields on personal loans fell between 2016-2020, from an average of 7.0% to 5.3%, across the cohorts in our sample. As in other lending products, risk adjusted yields fell sharply by higher levels of impairments during 2020 due to the Covid-19 pandemic. However, as discussed in the

68 Source: Ipsos MORI FRS. Data shown is for the six months ended 31st August 2020, based on 1,510 interviews (All taking a new unsecured loans in last 12 months). *Fieldwork is a mixture of online and offline interviews, with the offline methodology changing from face-to-face to telephone in April 2020.

69 Source: Ipsos MORI FRS. Data shown is for twelve six months ended 31st August 2021, based on 1,510 interviews (All 18+ taking a new unsecured loan in the last 12 months) and compared against twelve months ended data for the periods as indicated.

main report, some of these impairment provisions have since been revised following improving macroeconomic conditions in 2021. Figure 4.6 shows the risk-adjusted yields on personal loans between 2015 and 2021, across the cohorts.

Figure 4.6 – Risk adjusted yields for personal loans



Source – FCA analysis (note 2021 are firm forecasted figures)

Includes big 4 banks, 4 scale challengers, 4 mid-tier banks and 3 specialist lenders

Risk-adjusted all-in-yields calculated as gross interest income plus non-interest income minus impairments divided by average annual lending balances

25. There are some factors that are potentially driving greater competition in unsecured personal lending. Open-banking technology has become increasingly important in assessing the affordability for personal loans. This may help to increase competition in the personal loan lending market, particularly through price comparison website (PCW) channels and marketplace apps.

26. There have been some instances of new entry and expansion into personal lending. Virgin Money launched their personal loan business in July 2020 while in August 2020, Metro Bank purchased RateSetter. Zopa, previously a peer-to-peer lender, received a banking license in June 2020 and subsequently launched a credit card offering in October 2020.

27. We also found consumers consistently cite that a low interest rate is the most important feature when researching for a new personal loan indicating they are price conscious (second was holding another product, such as a PCA, with the chosen provider).[70]

70 Source: Ipsos MORI FRS. Base: All new unsecured loans taken in the last 12 months: August 2021 (n=710).

28. However, there are some factors that continue to work in favour of incumbent banks. Consumers expect it to be more likely they will be accepted by a provider they have dealt with before.[71] In our previous report, we found that a potential driver of higher yields at larger banks was the higher levels of cross holding for personal loans among their PCA customer base.[72]

29. We also explored the role of personal lending in other banking cohorts. Mid-Tier banks generate the lowest yields as they look to further concentrate their lending within consumer credit. A potential driver of this is the increased appetite to grow in consumer credit, given the high levels of price competition in mortgage lending in 2019 and 2020. Digital banks have recently entered the personal loan lending market - the data suggests yields have fluctuated since entry, as they continue to grow their lending businesses. Specialist lenders generate higher yields because they are competing for higher risk consumers not typically served by the traditional retail banks, such as those with impaired credit history. Higher prices are charged on these products to compensate for the risk.

Credit cards remain important to banks, despite growth of BNPL

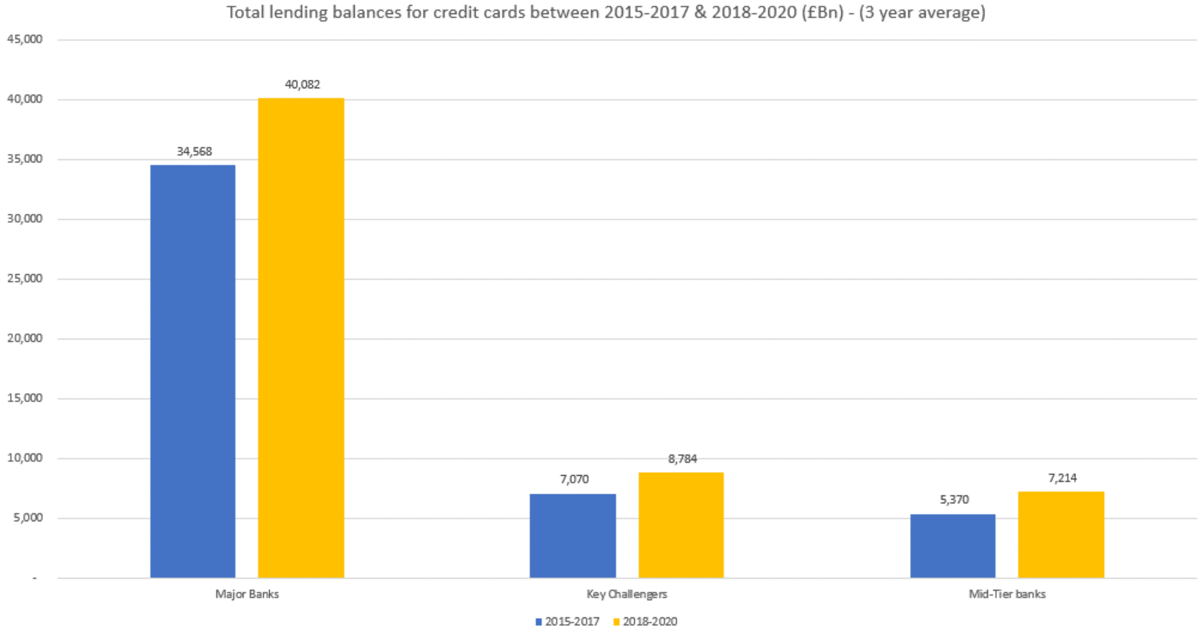
30. In 2015 we looked at competition in consumer credit cards[73] and found that in most areas, competition worked fairly well in the interest of consumers. We found that consumers valued the flexibility offered by credit cards and used them in different ways, such as making secure payments, collecting rewards, spreading purchase costs, emergency spending, debt management or building a credit profile. Banks told us that for younger consumers in particular, other forms of credit and payment services were becoming popular. Buy-now-pay-later (BNPL) in particular was seen as an increasingly important method of short-term finance.

31. We found that credit cards continue to form an important revenue source for banks. In 2020 credit card balances represented 30-60%[74] of total consumer credit and 56% of consumer credit revenue for the firms included in our sample.

32. As in personal loans, credit card lending balances were increasing year on year until 2019 (See Figure 4.7). Credit Card balances at the Big 4 rose around 16% from £34.6bn to £40.0bn on average between the periods of 2015-2017 and 2018-2020. While balances at Scale Challengers and Mid-Tier Banks increased further by 24% and 34% respectively.[75]

71 See Mintel - Unsecured Loans, UK - January 2021
72 See FCA 2018 Strategic Review of Retail Banking Business Models Progress Report
73 See FCA Credit Card Market Study
74 Interquartile range of credit card average balances/total consumer credit balances in 2020
75 Note our sample does not include non-bank credit card lenders

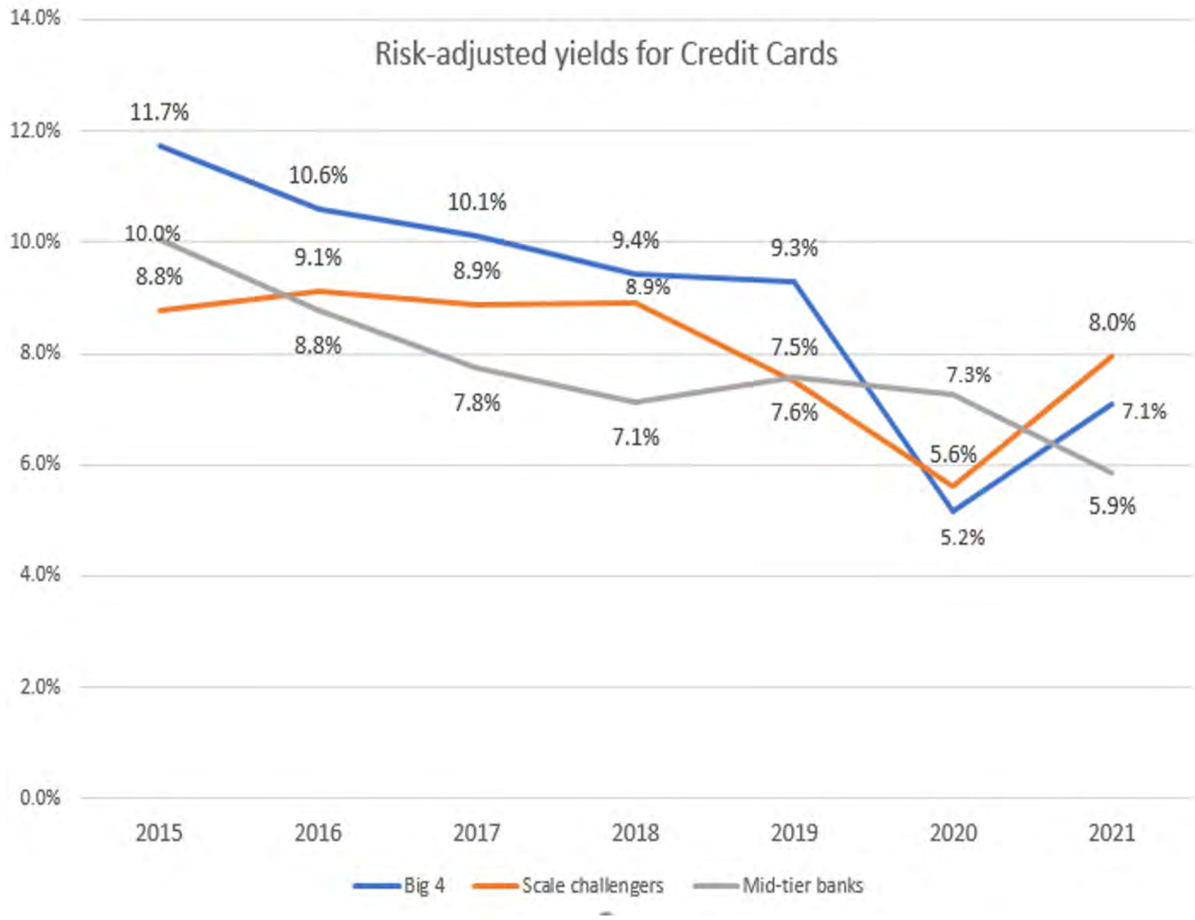
Figure 4.7 - Total lending balances for credit cards between 2015-2017 & 2018-2020 (£Bn) - (3 year average)



Source – FCA analysis
Sample includes big 4 banks, 4 scale challengers and 4 mid-tier banks

33. As in personal loans, we also found that the risk-adjusted yields banks earned on credit cards, fell between 2015 and 2019. For the Big 4 yields fell from 11.7% to 9.3%, for Scale Challengers yields fell from 8.8% to 7.6%, and for Mid-Tier Banks yields fell from 10.0% to 7.6%. Yields fell further in 2020 as a result of rising impairments. Figure 4.8 shows the risk-adjusted all-in-yields across different banking cohorts for credit cards.

Figure 4.8 – Risk-adjusted all-in-yields for credit cards



Source – FCA analysis – note 2021 are forecast figures

Sample includes big 4 banks, 2 scale challengers and 4 mid-tier banks

Risk-adjusted all-in-yields calculated as gross interest income plus non-interest minus impairments divided by average annual lending balances

34. Prior to the pandemic, yields at the Big 4 were higher than at challenger banks. One factor is the greater need for challenger banks to compete beyond their PCA customer base – requiring lower prices to attract customers who are willing to open a credit card with a provider they don't hold an account with. Consumers tend to first seek information from their main PCA provider on credit card offers before turning to a price comparison website.[76]

35. However, there are some signs that consumers remain relatively price sensitive when shopping around. When comparing different providers, consumers cite a low introductory interest rate and low fees as a driver of choice, similar to that of personal loans.[77] We found that 12% of customers used a PCW to research a credit card, compared to 5% in personal loans.[78]

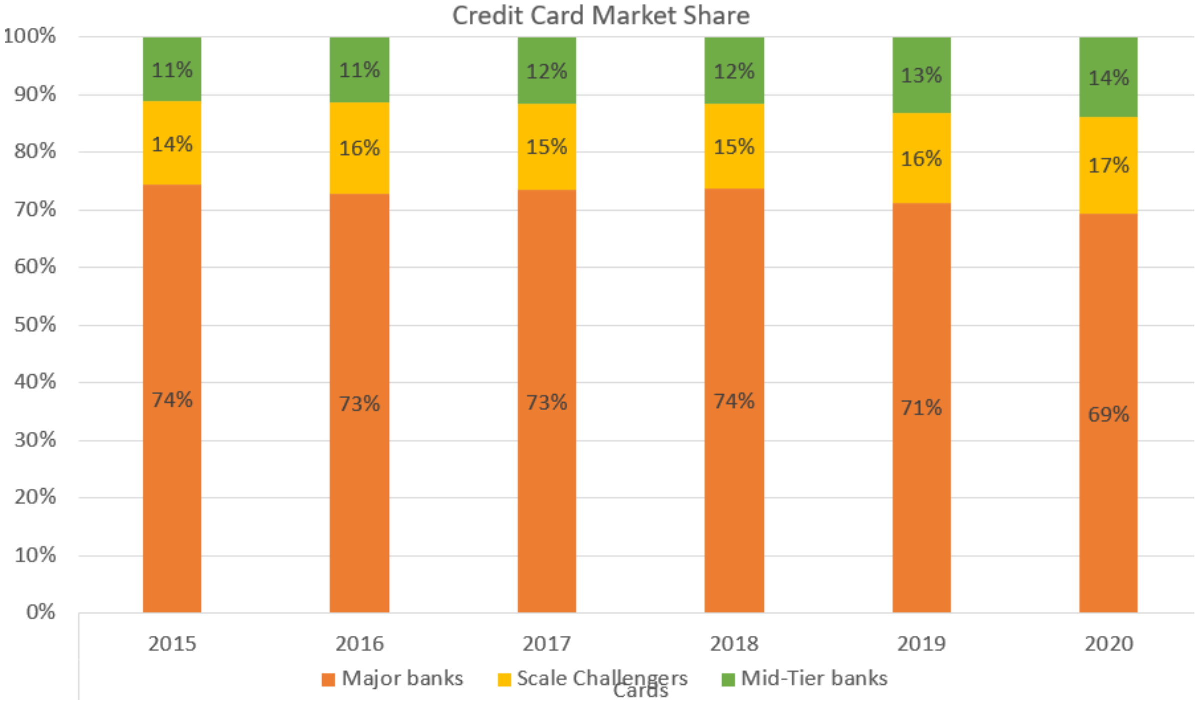
76 See Mintel Credit Cards: Inc Impact Of Covid-19 - UK - September 2020

77 Source: Ipsos MORI FRS. Base: All new Credit Cards opened in the last 12 months, *'not asked' removed, August 2021: (n=3,204). Time period: 6 months rolling.

78 See Mintel Price Comparison Sites In Financial Services, UK 2021

36. The impact of price competition appears to have driven a decline in the market share of the Big 4, measured by lending balances, which fell by 5% between 2015 and 2020. Big 4 banks still hold a relatively high market share and as discussed above, generated higher margins prior to 2020. This is due to several factors including their historic brand value, their ability to offer a broader choice of credit cards and their competitive advantage of having a larger PCA customer base translating to higher levels of cross holding of credit cards. These are all factors we noted in the previous Strategic Review of Retail banking progress report. Figure 4.9 shows credit card market share between 2015 and 2020, by lending balance.

Figure 4.9: Credit card market share, measured by total lending balances



Source – FCA analysis

Sample includes big 4 banks, 4 scale challengers and 4 mid-tier banks

37. We also considered future prospects for the credit card sector. The pandemic has had a substantial impact on consumer spending. We identified several ways in which they impacted the credit card market:

- Consumers postponed spending on holidays and purchases which can drive balances up
- Banks initially restricted new credit card applications during the most uncertain periods of the pandemic
- Consumers increasingly shopped online, where non-bank competitors such as Paypal, Klarna & Clearpay offered convenient payment methods at the point of sale

38. Some of these trends we expect to be temporary, such as reduced spending on holidays and similar purchases. And despite the pandemic we find credit cards are an important source of yields for banks, as well as offering benefits in terms of how banks efficiently allocate their capital, depending on the method used for calculating risk-weighted assets.

39. However, we expect some developments to be more permanent. We find:

- Younger consumers in particular are less likely to opt for credit card lending to fund small purchases, and instead are preferring BNPL and point-of-sale credit providers. Many of these firms are capturing the relationship with the retailer, meaning they are able to access data on consumer spending patterns.
- Banks have sought to compete with BNPL products by allowing existing cardholders to create fixed instalment plans for individual purchases.

40. So far, these changes appear to have had some impact on overall yields and balances (although the pandemic makes this difficult to evaluate).

41. We have found that digital challengers such as Monzo and Starling have not launched credit card offerings. However, there is evidence of competition to BNPL providers, such as the launch of Monzo's Flex facility, which offers interest free credit to existing current account holders.

42. In some cases, the business models of 'BNPL' firms differ from those of a traditional lender such as a bank. Firms such as Klarna, for example, act as payment methods for particular retailers, and earn commission from the retailer in their role. By contrast, banks continue to target interest income, non-interest income paid by consumers, and interchange fees earned through the card-schemes. We are doing further work to understand the potential risks and need for oversight of the BNPL in combination with HMT.[79]

79 Regulation of Buy-Now Pay-Later, HM Treasury October 2021

Annex 5
UK small business banking

- Microbusinesses in the UK have a variety of banking needs, and it's important that these organisations are able to benefit from competition and innovation. When the market for banking services to microbusinesses works well, microbusinesses are better able to make choices reflective of their own needs, and also to focus on the needs of their own customers.
- Many banks offer BCA banking to consumers, as it is a valuable part of their business model and provides them with funding benefit, revenues from fees and charges and opportunities to cross-sell products to small businesses.
- New entrants have historically found it difficult to enter and grow in this market. Incumbents have benefited from a large base of loyal customers, existing branch networks and strong brands. Many of these benefits continue to persist.
- Despite these challenges, digital challengers have been growing rapidly, particularly in 2020. They have benefited from the unusual market conditions presented by the pandemic.
- Digital challengers have undertaken significant innovation which incumbent banks are starting to respond to. For example, some larger banks have launched new digital first business banking products, with features such as Open Banking integration. However, they are not yet driving incumbents to significantly lower their fees and charges.

Introduction

1. In 2020, there were nearly 6m Small and medium-sized enterprises (SMEs) in the UK. The majority of these are very small - 96% are microbusinesses (defined as having 0-9 employees and a turnover of approximately less than 2m euros), and fall into our regulatory perimeter for small business banking. Microbusinesses make a significant contribution to the overall economy - collectively accounting for 21% of total UK business turnover and 33% of employment.[80] 76% are owner managed and run and have no employees.

2. Many retail banks, including Big 4 banks, Scale Challengers, Mid-Tier Banks, and Digital Challengers, compete to offer Business Current Account (BCA) services to SMEs. BCAs allow SMEs to store money and make transactions. They often also provide other related services which may include overdrafts and access to a relationship manager to provide them with support and advice. Through offering BCAs, banks access a low-cost source of deposit funding, derive revenue from fees and charges, and cross-sell products.

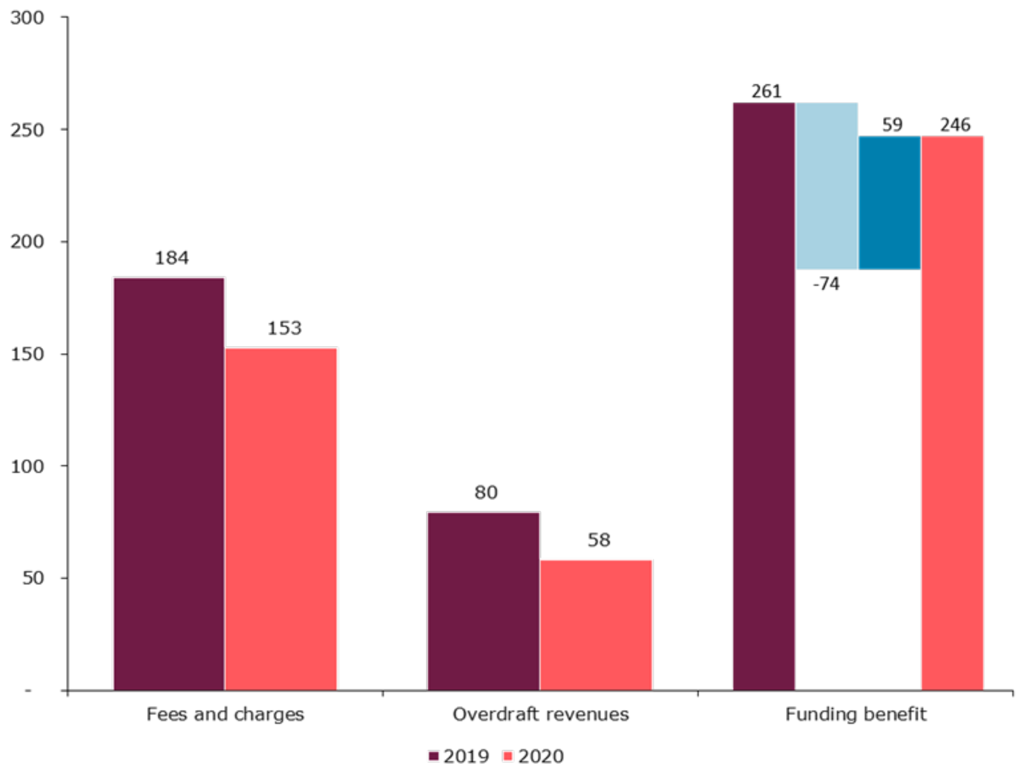
80 There were 5.725m micro-SMEs in the UK in 2020. Our sample covers banks reporting 5.25m BCAs (92% of the total)

3. The SME banking market has been evolving in recent years, due to increased digitisation, the impact of competition and regulatory interventions as well as the pandemic and associated response measures. This section outlines these changes and how they have impacted competition for BCAs for microbusinesses. Our detailed analysis across banking and lending is focused on 2019 and 2020 – we changed the definitions used in our data collection to exclude large SMEs in order to focus on microbusinesses as explained above. This means our ability to analyse changes over a longer period is limited. Our survey data also includes a number of non-bank digital providers. When we refer to both digital banks and non-banks, we refer to them collectively as 'digital challengers'. We use the term 'digital banks' to refer specifically to deposit taking banks.

BCAs are an important and valuable part of most banks' business models

4. Figure 1 shows the value that the Big 4 BCA providers obtain from a typical account. As shown below, the largest value is derived from low funding costs (funding benefit) followed by fees and charges and overdraft revenues. Across all three sources, the annual contribution per account was £457 in 2020, which was down from £525 in 2019. This is around 5 times larger than the contribution per PCA which was £88 between 2018-2020 (as outlined in the main report).

Figure 1 – BCA contribution breakdown (£ per BCA)



Source: FCA analysis of the Big 4 banks. Fees and charges refer to income from monthly and transactional fees. Funding benefit refers to the value banks place on the balances held by microbusinesses.

5. BCAs provide banks with funding benefit as they represent a source of low cost and stable funding to support their lending activities. The magnitude of this benefit depends on factors such as the size of deposits, how long these deposits are likely to be held at the bank, as well as prevailing interest rates.

6. Using estimates of funding benefit provided to us by the Big 4 banks, we found that the average funding benefit per account fell slightly from £261 to £246 between 2019 and 2020. This is because banks reduced the rate at which they value funding (known as the fund transfer price) as lending yields fell. This reduced funding benefit by around £74 per account. However, BCA balances rose from £16,533 to £20,290. The pandemic is likely to have increased microbusiness risk aversion and the associated desire to hold larger balances in their current account as a safety net. The additional balances contributed an additional £59 per account in funding benefit. As a result, the net impact on BCA funding benefit was a decline of £15 per account.

7. BCA providers also generate value through fees and charges. BCAs typically have monthly fees associated with them, as well as a range of contingent charges including charges for receiving automated credits, paying direct debits, and standing orders, as well as cash based transactions such as deposits or withdrawals. The proportion of revenue banks earned from different types of fee depends on their pricing structure, as well as the turnover of microbusinesses and the types of transactions microbusinesses undertook.

8. Across all banks, income from monthly fees accounted for around ~45% of gross revenue from microbusiness customers, and income from transactions (including card interchange revenue, cash transaction charges, international transaction income, and other transaction charges) accounted for ~45% of income. The remainder of income sources (including commission, refused payment fees and miscellaneous charges) accounted for around 10% of income. There was little change in these proportions between 2019 and 2020.

9. Some banks earned more from monthly fees relative to transactions. One Big 4 bank earned around 80% of revenue from monthly fees, with the remainder from transactions. By contrast, digital banks earned very little revenue (<5%) from monthly fees. Revenue for digital banks mostly came from card interchange income and other transaction charges.

10. We explored further the individual drivers of microbusiness revenue. For this analysis we calculated the average fees and charges (excluding overdraft and funding benefit income) per account by dividing the total revenue earned from BCA fees by the number of active, fee paying accounts. We look at these accounts to reflect more closely the amount microbusinesses actually pay. We focus primarily on the Big 4 banks, as we did not receive enough data from other banks to create representative averages. Around 93% of accounts are non-dormant, and 75% of accounts are non-dormant and fee paying.

11. The average revenue per fee paying account fell 17% (£42) for the Big 4 banks between 2019 and 2020. Transactions derived revenue per account fell 18%, reflecting the impact of the pandemic on transaction activity – for 3 of the Big 4, transactions fell 7.5% and for one bank transactions fell substantially, around 43%. Monthly fee revenue fell 14%.

12. Fees earned per domestic transaction varied between 3p and 42p (in 2020, similar in 2019) for the banks we had data for. This likely reflects the variety of transaction types microbusiness undertook (such as cash, automated credits, direct debts, CHAPS etc) and the range of prices per transaction.

13. Digital banks earned less from fees and charges than other banks. Neither Starling or Monzo charge annual fees for their basic product (although Monzo did for its premium account). Instead both banks derived the majority of their income from fees and charges from card interchange income, and the remainder from cash transaction fees (Post Office derived fees), and non-standard digital payments.

14. Further BCA pricing analysis is presented from paragraph 52.

15. Overdraft revenues per account fell from an average of £80 per account in 2019 to £58 per account in 2020, primarily as a result of falling overdraft borrowing (see Figure 1). Again, these values are significantly higher than overdraft revenues per PCA which were £25.60 on average across 2018-20.

16. BCA providers also often benefit from being able to leverage their existing relationships with microbusinesses, or information they hold about them, to cross-sell other products. In 2020 34% of microbusinesses held an instant access deposit account with their main BCA provider.[81] These accounts can provide the bank with additional funding benefit, although micro-businesses hold a smaller fraction of their overall wealth in instant access accounts than personal customers. We estimate that the additional funding value of cross-holding instant savings accounts was on average about £41 per account in 2020.

17. BCA providers can also cross-sell other products - for example, in 2020 10% of microbusinesses held a payments or merchant service account and 4% held business insurance with their main bank.[82]

18. We also looked at the overall contribution of BCAs (not on a per account basis) compared with PCAs. While BCAs generate a greater contribution than PCAs on a per account basis, due to the larger average account balances and the levels of fees and charges, the aggregate contribution of the BCA business is lower than the PCA business. The total PCA business contributes on average 3 times more than the BCA business, although this gap narrowed in 2020 as PCA overdraft income fell.

19. We recognise that contribution, as calculated above, does not take account of the costs of running BCAs. These costs are difficult to assess, and a large proportion are likely to be common costs across the bank which we have been told are difficult to allocate. Therefore, we do not consider that we are able to accurately assess profitability per account. Nevertheless, the fact that per account contribution is so high implies that BCAs are a valuable part of a bank's business model.

81 MarketVue Business Banking from Savanta, YE Q4 2020 Data. Data weighted by region and turnover to be representative of businesses in G.B. Base size: 3461.

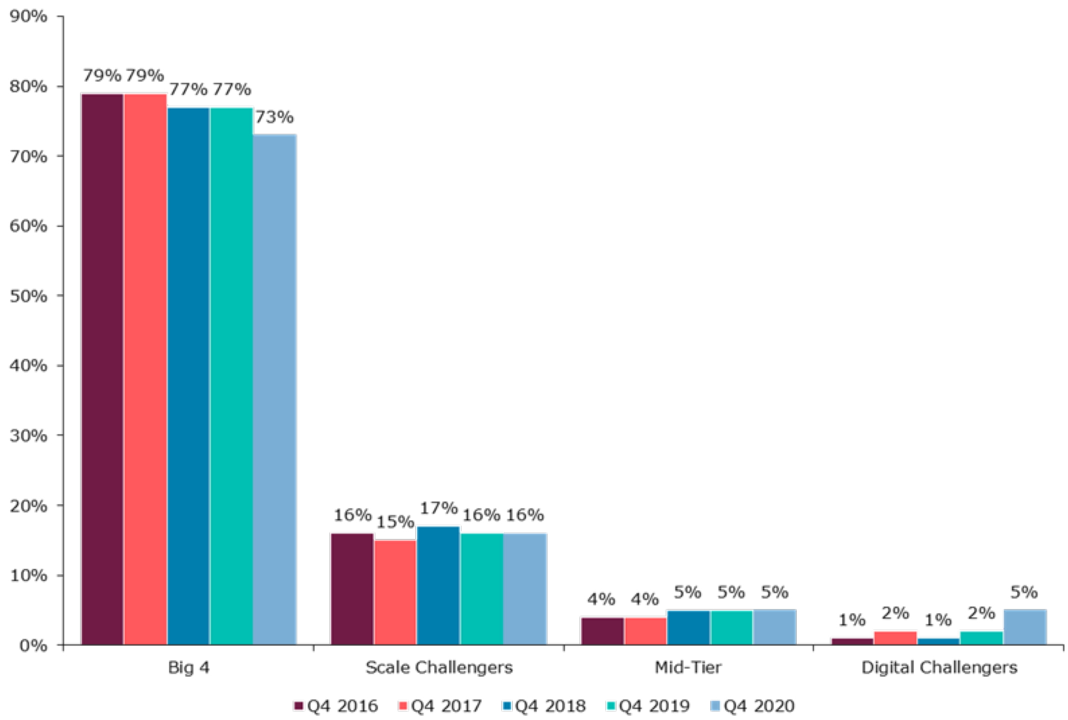
82 MarketVue Business Banking from Savanta, YE Q4 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base Size: 3461.

Incumbents have historically held significant advantages – whilst these remain, there is evidence they are reducing

20. In its 2016 Market Investigation, the CMA found that new providers faced challenges in entering and growing in the BCA market as low SME engagement meant it was difficult for them to attract customers. They found that many SMEs were not effectively shopping around and switching, despite there being gains from doing so. They also noted that incumbents gained advantages from their ability to offer a branch network and strong brands.

21. As shown in Figure 2, the market share of the Big 4 BCA providers remains relatively high. However, their market share has been gradually reducing from 79% in 2016 to 77% in 2019, before falling more sharply in 2020 to 73%. Mid-tier banks slightly increased market share (in 2017 and 2018) as have digital challengers, particularly in 2020. Market share has been broadly static for scale challengers.

Figure 2 – Microbusiness BCA Market Share (%)



Source: MarketVue Business Banking from Savanta, YE Q4 2016 - 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base sizes: 2016 – 9265, 2017 – 9,599, 2018 -10,152, 2019 – 10,694, 2020 – 11,313. Digital banks were not included explicitly 2016 – 2019, therefore we have imputed their market share as the remainder between the cohorts we have data on, and non-included providers.

22. Overall switching rates for BCAs have remained low and stable over time at 3%. The proportion of microbusinesses who say they have considered switching, but then did not do so was 13% in 2019 and 2020.[83] About 55% of all microbusinesses have been with their existing BCA provider for over 10 years and this rises to 62% for those with accounts with the Big 4.[84] Those who did switch in 2020 cited the incentivised switching scheme (26%), level of charges (13%) and poor service (13%) as the top

83 MarketVue Business Banking from Savanta, YE 2016 – 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Bases size in 2020: 8,727.

84 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 8727. Roughly how long has the business banked with (MAIN BANK)? 55% of SMEs in this sample said they had been with their main bank for 10.1 or more years.

reasons for switching away from their previous bank.85 The main reasons for selecting another bank included free banking (22%), convenience and locality (20%) and service (15%).[86]

23. Overall, shopping around by start-up microbusinesses remains limited, although it was slightly increasing before the pandemic. It increased more markedly in 2020, most likely due to the unusual market conditions presented by the pandemic and many banks being closed to new customers. Start-up microbusinesses contacted an average of 1.59 BCA providers before making a choice in 2016 but this increased to 1.65 in 2019 and 1.89 in 2020. Start-up microbusinesses have also been increasingly considering smaller BCA providers. Between 2016 and 2019, the proportion of start-up microbusinesses contacting mid-tier banks and scale challengers increased slightly. Notably, in 2020, 16% of start-up microbusinesses contacted digital challengers – this was the first time this group were included in the survey. The proportion contacting the Big 4 has remained broadly constant at about 70%.[87]

24. While there have been some improvements in shopping around, a significant proportion of new start-up microbusinesses continue to open a BCA with their PCA provider. Between 2016 and 2019, about 40% of new businesses did this, although this reduced to 32% in 2020.[88]

25. Branches have historically been important for many microbusinesses when selecting a BCA provider and extensive branch networks have been a source of competitive advantage for incumbents. However, while branch counter use remains high and is particularly important for some businesses, as shown in Figure 3 below, the proportion of businesses using this service has been falling between 2016 and 2020 from 77% to 61%. In branch self-service also fell over the same period, from 62% to 50%. At the same time, mobile banking usage increased substantially (from 33% to 54%) and online banking use also increased (from 87% to 90%). There has been a consistent trend away from branches and towards digital methods, which was particularly accelerated in 2020 due to the pandemic.Relationship management access also fell over the period, from 45% to 33%. We also found ways in which businesses interact with their relationship manager was changing. Three of the Big 4 told us they were investing in self-service technology for microbusinesses. One bank provided targets for a reduction in face-to-face relationship management, although planned to increase the number of customers who had access to a relationship manager through other channels. Larger banks planned to prioritise more costly service to more complex, or higher value businesses.

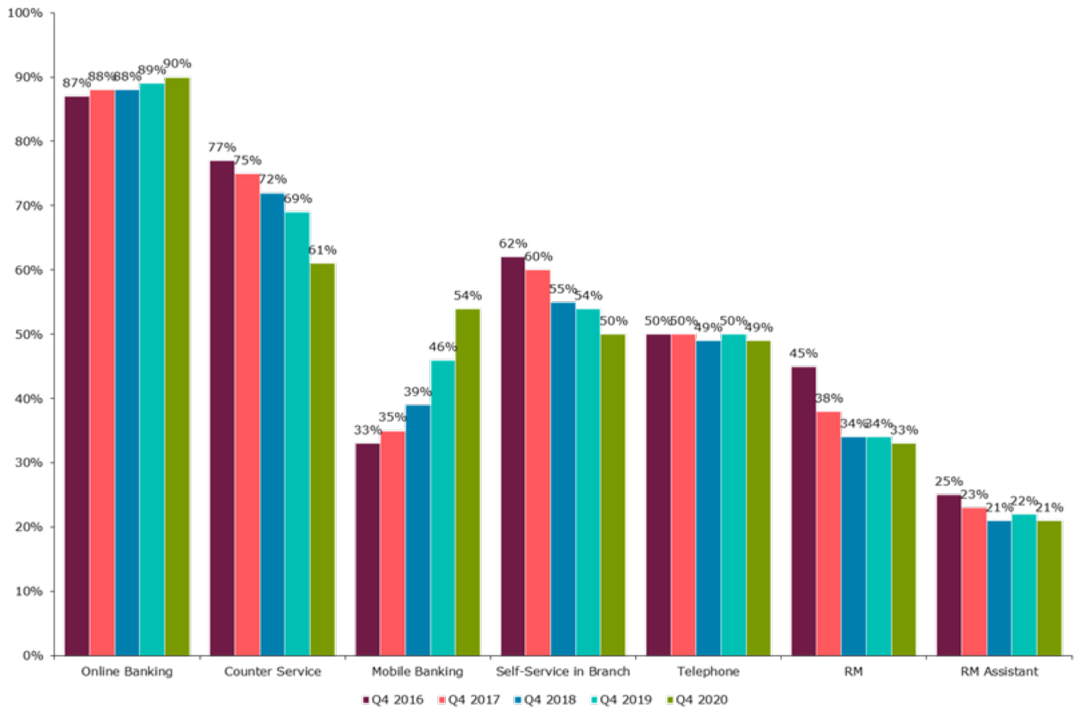
85 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 239. What was it about your former main bank that encouraged you to move away from them as your main bank?

86 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size: 239 in 2020. What was it about your main bank that made you choose them as your new bank? Excluding SU from Q1 2020.

87 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 538

88 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size: 367

Figure 3 – Microbusiness banking channel usage by year (% of microbusinesses using channel to carry out business banking)



Source: MarketVue Business Banking from Savanta, YE 2016 – 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base sizes: 2016 -7769, 7477, 7085, 6897.

26. Although branch usage is declining, the evidence suggests that convenience and availability of branches remained an important factor in who microbusinesses choose to bank with. 12% of start-up microbusinesses cited the availability of a local branch as an important factor in their choice of main bank, as did 20% of microbusinesses switching provider. This rose to 28% of banks switching to a Big 4 provider. Only the offer of free banking (23% of start-ups and 22% of switchers) or an existing PCA relationship for start-ups (25%) and was seen as more important for start-ups or switchers.[89]

27. One bank provided us with analysis on the preferences of more cash intensive businesses. They found that these businesses were more likely to use a branch weekly than online banking, and their preferences were driven both by their customers' preferences, the ease of branch usage, and an aversion to digital. Another bank also suggested that prior to Covid, many businesses had an aversion to digital banking. These businesses also depended on branches for other services to cash deposits, such as withdrawing cash, checking balances, and paying bills.

28. Citizens Advice reported in 2020 that as banks exited high streets, the usage of Post Office banking services had doubled between 2017 and 2020, with 1 in 5 small businesses surveyed stating they had used these services.

29. Many microbusiness expect to continue using cash post-Covid. As reported in our research paper 'Cash acceptance within SMEs', undertaken jointly with Savanta, we found almost 8 in 10 businesses say they are 'very likely' to accept cash over the next 5 years. The top motivation for accepting cash, as stated by nearly 29% of

89 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 239 switchers, 367 start-ups, 72 switching to a Big 4 provider.

respondents, is to provide customers with choice over payment type. Nearly all (98%) small businesses agreed that their 'business would never turn a customer away if they needed to pay in cash'.

30. Trust and brand recognition remain reasonably important to microbusinesses when selecting a BCA provider. 25% of new microbusinesses in 2020 cited the fact the bank was their personal bank as the reason they chose them for business banking. This rose to 37% for microbusinesses who chose a Big 4 provider. 10% cited recommendations from a friend or colleague and 6% cited other previous experience as important. Among switchers, 13% cited the image or reputation of the new bank as an important reason for switching.[90]

31. Branch availability and a previous PCA relationship was less important for start-up microbusinesses opening accounts at digital challengers, reflecting their primarily digital service (Starling accepts cash deposits via Post Office branches) and smaller PCA network. Instead, start-ups were likely to cite the free banking service (35%) and ease of account opening (24%). 15% of start-ups cited recommendations as a reason to open an account with a digital challenger.[91]

32. For microbusinesses who switch to digital challengers, the image and reputation of these banks was the most important factor (cited by 22%) after the offer of free banking (35%) and their online banking service 30%). Service quality was also a factor for 20% of microbusinesses switching to digital challengers, compared to only 11% switching to a Big 4 bank.[92]

33. Overall, after price considerations (such as free banking introductory offers), microbusinesses continued to value branch, service quality and reputation, including a previous relationship with a bank, such as through a PCA. Many Big 4 providers retain advantages, particularly in branch availability, that might make it more difficult for challengers to further expand in this market. However, for many microbusinesses, reputation and service quality, as well as online banking quality, was a factor in switching to a digital bank, and part of the modest but positive rise in the market share of digital banks over the past two years.

34. Despite these positives, the Big 4 remain substantially better known than challengers, deriving from the very strong brands built up over years of operation. When asked to think about financial organisations providing services for businesses, 95% of microbusinesses named at least one Big 4 provider, while only 37% named a scale challenger, 10% a mid-tier bank and 8% a digital challenger. When looking just at start-ups, microbusinesses awareness of digital challenger rose to 23% (and for mid-tier banks it was only 6%, and for scale challengers 34%).[93]

35. Some scale challengers and mid-tier banks have struggled to increase their share of the market. For some brands market shares fell between 2016 and 2020, although some made gains in 2020 as microbusinesses attempted to access loan schemes.

90 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 367 start-ups, 210 at Big 4, 239 switchers.

91 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 80.

92 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 63.

93 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 6896, 367 start-ups.

Santander, TSB, and Clydesdale (Virgin Money) were accredited under BBLs, as were Metro Bank, the Co-op, and BOI, Danske Bank and AIB.

36. This is despite competition remedies to encourage microbusinesses to switch away from Nat West Group, following the failed divestment of Williams and Glynn. £275m was made available to banks including Clydesdale Bank, the Co-operative Bank, Metro Bank, Santander UK, Starling, TSB and Nationwide to incentivise, and cover costs of, switching. The available dowry ranged between £1,250 for the customers with under £15,000 turnover, and rose to £13,125 for the largest microbusinesses (with under £2m turnover). While the scheme drove some switching (13% of microbusinesses who switched suppliers cited the scheme as a reason for switching in 2019, and 26% in 2020[94]), one bank told us that firms had not taken full advantage of the incentive funding. In March 2020 Nationwide withdrew its intended entry plans into BCA banking and returned the grant it had received.

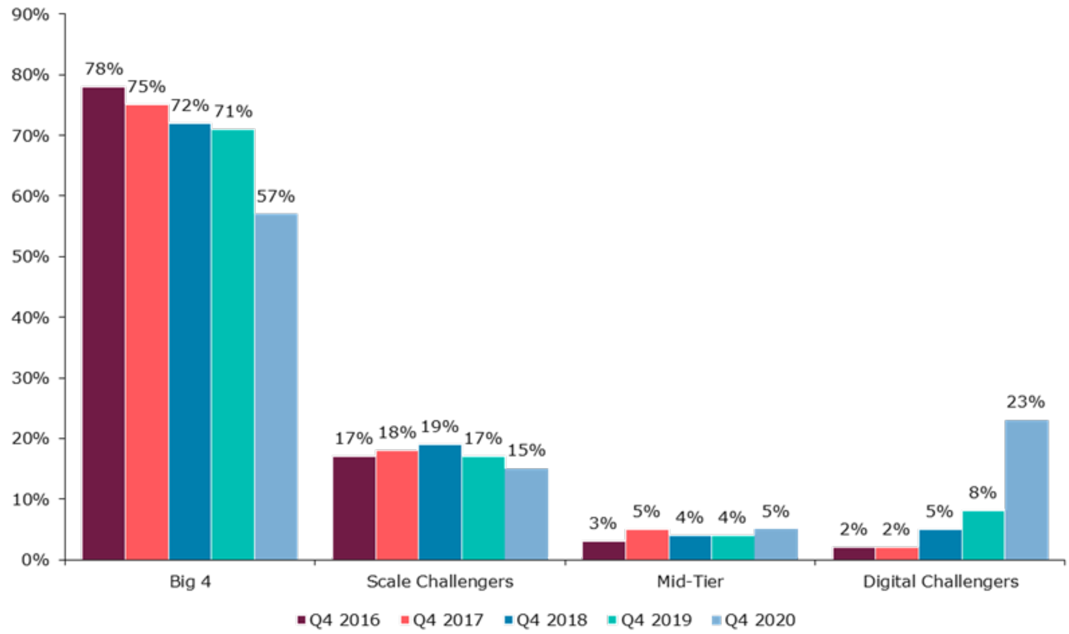
Digital challengers have been growing significantly during 2020 by winning start-ups

37. There were many new start-up business in 2020, and many existing business owners opened a business current account for that business for the first time. Despite the advantages many larger, more established banks hold, we found that digital challengers (of which the largest include banks like Starling Bank and Monzo, and E-money providers like Tide and Revolut) have been increasing their share of this group of customers, collectively overtaking scale challengers and mid-tier banks.

38. Figure 4 shows that the Big 4's share of providing BCAs to start-up micro-businesses has fallen steadily from 78% in 2016 to 71% in 2019, before falling sharply to 57% in 2020. In 2020, the market share of digital challengers amongst start-up microbusinesses increased significantly to 23% from 8% the previous year.

94 MarketVue Business Banking from Savanta, YE 2019-2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size 2019-2020: 252, 239.

Figure 4 – Start up Microbusiness BCA Market Share (%)



Source: MarketVue Business Banking from Savanta, YE Q4 2016 - 2020. Data weighted by region and turnover to be representative of businesses in G.B. (Digital Challengers estimated Q4 2016 - Q4 2019) Base size 2016-2020: 2016-2020: 2234, 1571,1161, 541, 538.

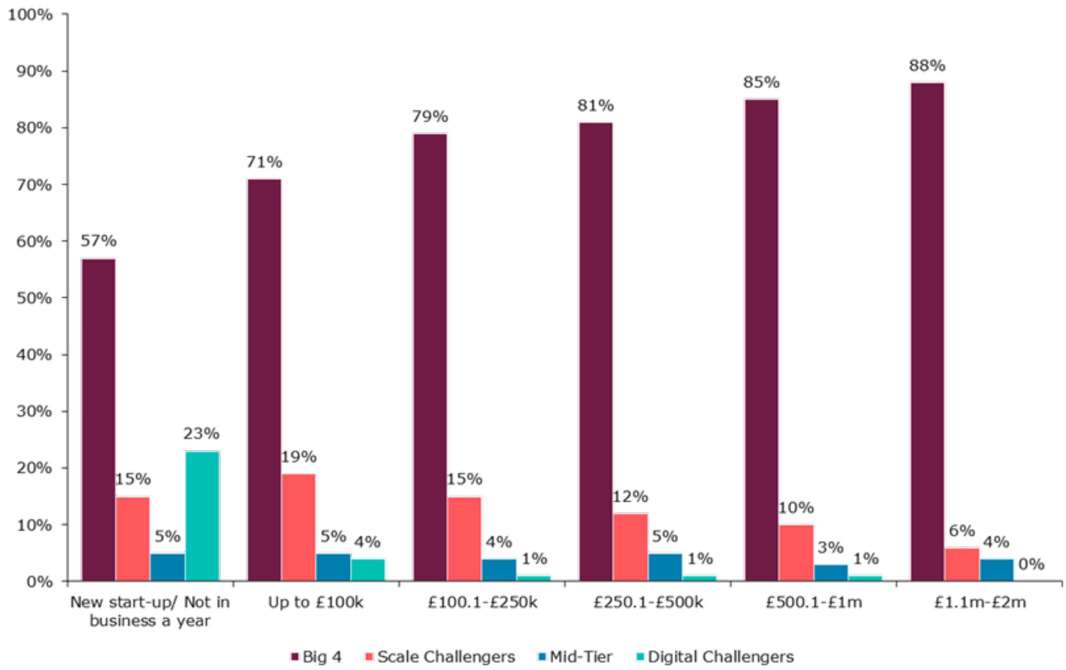
39. The growth of digital challengers accelerated in 2020 due to the unusual market conditions presented by the pandemic. Many larger banks (Big 4, and larger scale challengers) prioritised operational capacity to deliver Government Support Scheme loans (CBILS and BBLS) to existing customers, and reduced the availability of BCAs to new customers. In addition, some digital challengers became accredited lenders of the CBILS and BBLS schemes which enabled them to increase their BCA base rapidly as other banks were closed to new customers.

40. These digital challengers offer microbusinesses the opportunity to manage their accounts entirely through mobile and online channels and do not have a branch network (although some allow customers to deposit and withdraw cash through partners such as the Post Office). This allows them to operate with relatively low operating expenses as they do not have a branch network or legacy IT systems. They have also kept acquisition costs low by not offering monetary switching incentives or interest on balances, and by choosing to advertise largely by word of mouth. Many digital challengers have not charged monthly fees and have offered free digital transactions making them cheaper than some established providers.

41. Digital challengers also do not typically offer relationship management. They have likely benefited from many incumbent banks deciding to scale back their relationship management offerings in recent years and increasingly focus these on the largest and most valuable microbusinesses. The number of microbusinesses accessing services through a relationship manager fell from 45% in 2016 to 33% in 2020 (see paragraph 25). Digital challengers may be a viable alternative to incumbent banks for many microbusinesses, and particularly those who are relatively small.

42. The digital challengers have been predominantly serving start-up and very small microbusinesses. As shown in Figure 5, in 2020 23% of start-up microbusinesses and 4% of those with a turnover less than £100k used a digital challenger. In contrast, digital challengers had less than 1% share of businesses with turnover between £1.1m-£2m. This is driven in part by the narrower range of businesses digital challengers serve, and the additional services offered. For example, some of the more complex services (such as transactions administered by specific users, businesses with partnerships or complex ownerships) which are offered by many larger banks were not available at digital challengers during the time period we looked at.

Figure 5 - Microbusiness BCA Market Share by Turnover (%)



Source: MarketVue Business Banking from Savanta, Survey Period Q1 Jan 20 – Q4 Dec 20. Base size: 538, 8727, 3256, 1875

43. Accounts with digital challengers had an average balance of about £7,500 in 2020. This is considerably lower than the balances for all other types of banks which typically exceeded £15,000. This likely reflects the fact that the businesses who use digital challengers are smaller and more recently established than the customers of incumbent banks. Microbusinesses are likely to have been with their main Big 4 banking provider for 17 years. At scale challengers this was around 11 years, and for Mid-Tiers this was 8 years. At digital challengers the average tenure was under 2 years.[95]

44. Digital challengers appear to be winning start-ups who bank personally with a non-digital provider. 20% of PCA customers at Big 4 providers who opened a BCA in 2020 opened one at a digital challenger, as did 27% of scale challenger PCA customers.[96]

45. There appear to be differences between the needs of the businesses who select digital challengers as compared to those who choose Big 4 banks. The top reasons microbusinesses gave for switching to a digital challenger includes free banking (35%), online banking (30%) and reputation (22%).[97] In contrast, those who switched to a Big 4 bank did so because of convenience and locality (28%), relationship management (23%) and their previous experience with them (16%).[98]

95 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size 2020: 6675, 1480, 346, 154.

96 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size 2020: 364, 118.

97 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 63.

98 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 72.

46. Although multi-banking in microbusiness banking is relatively uncommon (the average number of accounts held was 1.1)[99], around 35% of microbusinesses whose main bank is a digital challenger held a secondary account with a non-digital in our sample, and 25% were with a Big 4 provider as well as their digital challenger.[100] It is possible these accounts attract fees, even when not in regular use (for example from monthly fees). Around 4% of microbusinesses whose main bank is not a digital challenger also hold a digital challenger BCA as a secondary account.

SMEs are starting to benefit from increased innovation

47. In their Market Investigation, the CMA found that innovation levels were low in business banking. They also found that there was significant variation in the price and quality of BCAs, but these were not reflected in changes in market share.

48. Since our last review in 2018, we have found that there has been innovation in the BCA space, including in: digital functionality and user interfaces; tools to help SMEs better manage their money; the ease and efficiency of onboarding new customers; and the ability for customers to more easily integrate banking data with accountancy packages using Open Banking.

49. However, innovation in BCAs has continued to lag behind that in the PCA market. Digital challengers have launched BCA products later than PCA products, and these elements of digital functionality are only starting to be adopted by incumbent banks. In meetings with us and in their strategy documents, incumbent banks have been increasingly recognising the need to improve their digital services, in some cases in direct response to innovations by challengers. They have also outlined their belief that the overall pace of innovation is likely to have been accelerated by the pandemic as many microbusinesses have become more comfortable with using digital channels.

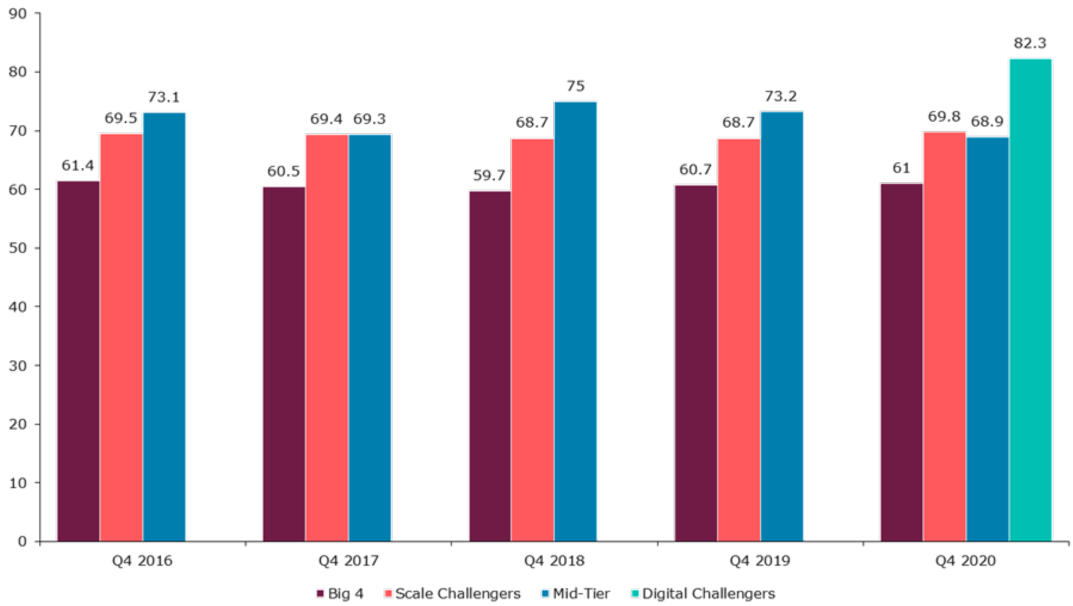
50. Figure 6 shows that overall satisfaction is lowest amongst customers of the Big 4 and has not materially changed over time. On the other hand, digital challengers have the highest reported quality of service. A key driving factor is the convenience of banking with digital challengers. Digital challengers scored an average of 86% on this metric, relative to 56-62% at the Big 4, Mid-Tiers and Scale Challengers.[101]

99 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 9265.

100 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 262.

101 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size in 2020: 163, 5229, 284, 1134.

Figure 6 – Overall Quality of Service Mean Score – Savanta



Source: MarketVue Business Banking from Savanta, YE 2016-2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size: 6897, 7041, 7085, 7477, 7769. Digital challengers only included in Q4 2020.

51. As shown in Figure 7, when asked what their main bank could do to improve, many customers of the big 4, scale challengers and mid-tier banks say they would like to see improvements in their bank branches, better communication and a more personal relationship with their bank. This is likely to reflect incumbent banks scaling back the bank branch and relationship management services which many of their customers would have been used to and valued. A number of customers across all banks would also like to see improved online offerings and mobile apps, which highlights the fact that these innovations are only recently being offered on a wide-spread basis. Customers of the digital challengers would like to see more products/services tailored to their needs and reflecting their recent expansion, a number of their customers feel it is too early to say what they could do better.[102]

102 What do you think your main bank could do better? (MarketVue Business Banking from Savanta, Survey Period Q1 Jan 2020 – Q4 Dec 2020). Base: SU and EST £0-£2m n = (Big 4 = 5219, Scale Challengers = 1130, Mid-Tier = 386, Digital Banks = 195) Included values where sample total is above 5% responders. Excluded Positive responses (25% Big 4, 33% Scale Challengers, 23% Mid-tier Banks, 48% Digital Banks).

Figure 7 – What could your main bank do to improve? Savanta (consolidated responses)

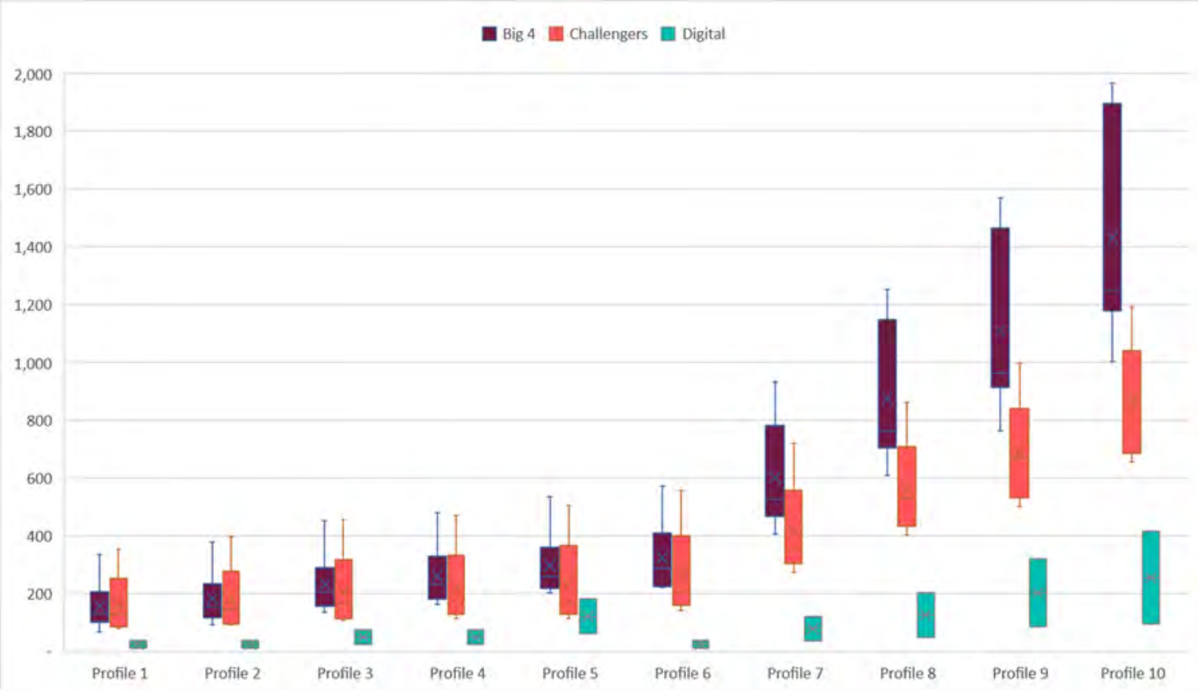
	Big 4	Scale Challengers	Mid-Tier Banks	Digital Challengers
Communication	22%	15%	11%	11%
Branch Related	20%	17%	9%	6%
Good / better understanding / support for business	10%	7%	4%	1%
Relationship / Business Manager	11%	5%	3%	1%
Bank Charges	9%	7%	6%	6%
Online banking / Mobile App	6%	11%	28%	7%
Call Centres / Telephone service	7%	4%	8%	4%
Customer Service General	7%	4%	5%	4%
Products services offered	5%	7%	12%	11%

Prices are dispersed in microbusiness banking, suggesting gains from switching might be present

52. Microbusinesses typically face a range of charges for BCAs, including monthly fees and transaction charges. The total cost they occur will therefore depend on their usage. To compare BCA providers on a like for like basis we calculated overall price for ten usage profiles. These profiles are designed to reflect typical usage patterns of microbusinesses in terms of the relative importance of electronic or cash-based transactions to the business.

53. These profiles make different assumptions about the volume of different transactions undertaken through a range of channels. We then calculated the total charges that each profile of SME would face per year across 10 different providers and 13 different tariffs (there were 130 profile and tariff combinations in total). We found for equivalent profiles, prices were consistently lower at digital banks and the difference in prices could be substantial, with the cheapest prices being under £70, to some priced at over £1000. The Big 4 banks were frequently higher priced (across all profiles the median Big 4 price was higher) and the dispersion of prices was wider for larger, more cash intensive businesses.

Figure 8 – Illustrative annual total prices for standard BCAs for a range of transaction profiles (£)

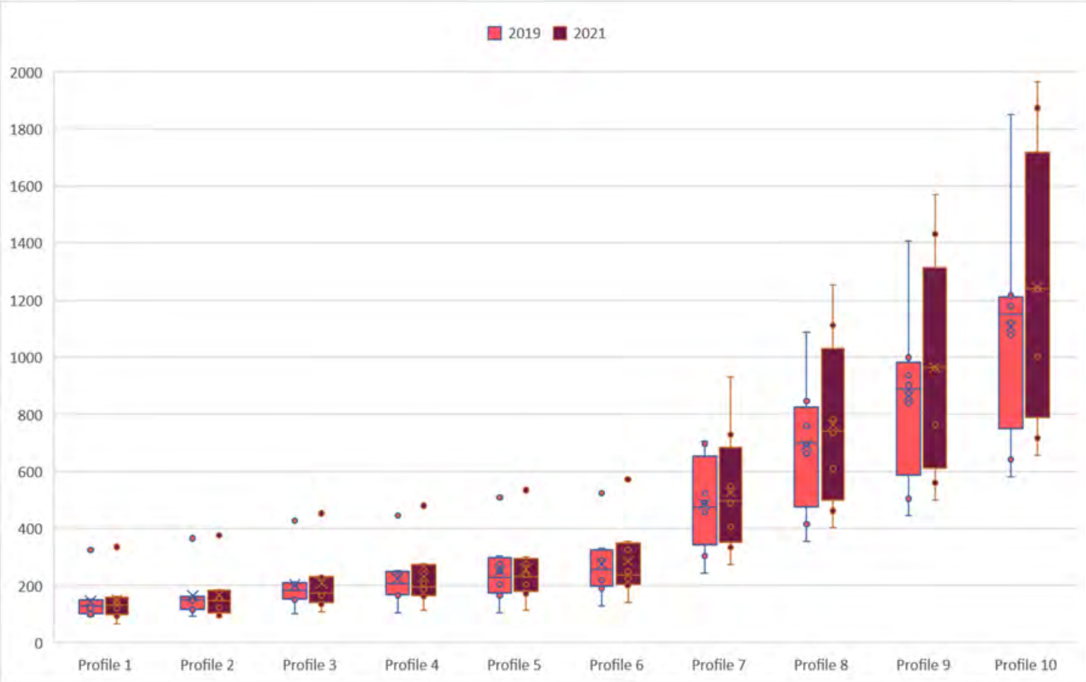


Source: FCA analysis of simple transaction profiles published by the CMA in 2015, and public BCA price data collected in October and November 2021. The profiles are accessible here, page C23. Challengers refers to a sample of scale challengers and mid-tier banks. All prices and profiles are unweighted and therefore illustrative, rather than representative of average prices.

54. The evidence also appears to suggest that many tariff prices have risen. This is despite the rate of switching remaining unchanged, and reductions in use of services such as relationship management and branches.

55. We also looked at the change in prices across the largest banks between 2019 and 2021 across the 10 profiles, and 8 tariffs (a total of 80 tariff profile combinations). The median price change (across all profiles and tariffs) was £24 and in 16% of cases, the price rise was in excess of £50. We also saw that the dispersion of prices, the difference between the cheapest prices and most expensive prices on at the largest banks, was growing.

Figure 9 – Illustrative annual total prices for standard BCAs at major banks for a range of transaction profiles (£)



Source: FCA analysis of simple transaction profiles published by the CMA in 2015, and public BCA price data collected in October and November 2021. The profiles are accessible here, page C23. This sample consists of five major banks. All prices and profiles are unweighted and therefore illustrative, rather than representative of average prices.

56. This is necessarily a simplification and does not, for example, account for quality differences across banks. However, we have not seen strong evidence to suggest that the lower prices offered by digital challengers have generated material price pressure on the prices available to existing and established microbusinesses holding accounts with Big 4 providers. We have seen some evidence of banks introducing new products with lower fees to compete more directly with challengers. For example, NWG introduced Mettle, and HSBC recently launched Kinetic.

Annex 6
UK small business lending

- Before COVID, microbusiness lending had been gradually becoming a less important part of the business model of the large banks. At the same time, challenger banks, specialist providers and non-bank lenders had been increasing their share of microbusiness lending – typically serving microbusinesses with specific needs.
- This trend was reversed during COVID. Microbusiness lending significantly increased, with the large banks doing about 80% of all lending under the government schemes. However, microbusiness lending still represents a relatively small proportion (~5-6%) of the overall lending portfolio of large banks.

Introduction

1. SMEs seek finance for a wide variety of reasons including to fund investment for growth, to purchase equipment and to meet cashflow requirements.

2. The market for SME lending is broad with a variety of firms with different business models providing financing options to SMEs, depending on their needs. These include banks, non-bank lenders and peer-to-peer platforms. SMEs can also gain funding from a range of other sources including mutual funds, government grants and personal finance. Whilst our focus is primarily on lending by retail banks, where appropriate we also consider the broader range of options available to SMEs. SMEs are a diverse group, therefore we have primarily considered microbusinesses, as this captures 96% of all SMEs and concerns around access to lending have historically been greatest for the smallest SMEs.

3. The SME lending market has been evolving due to the emergence of new business models and regulatory and competition initiatives. More recently, the pandemic has had an unprecedented impact on SME finance needs and has led to significant government response measures. This section outlines these changes and how they have impacted competition for SME lending.

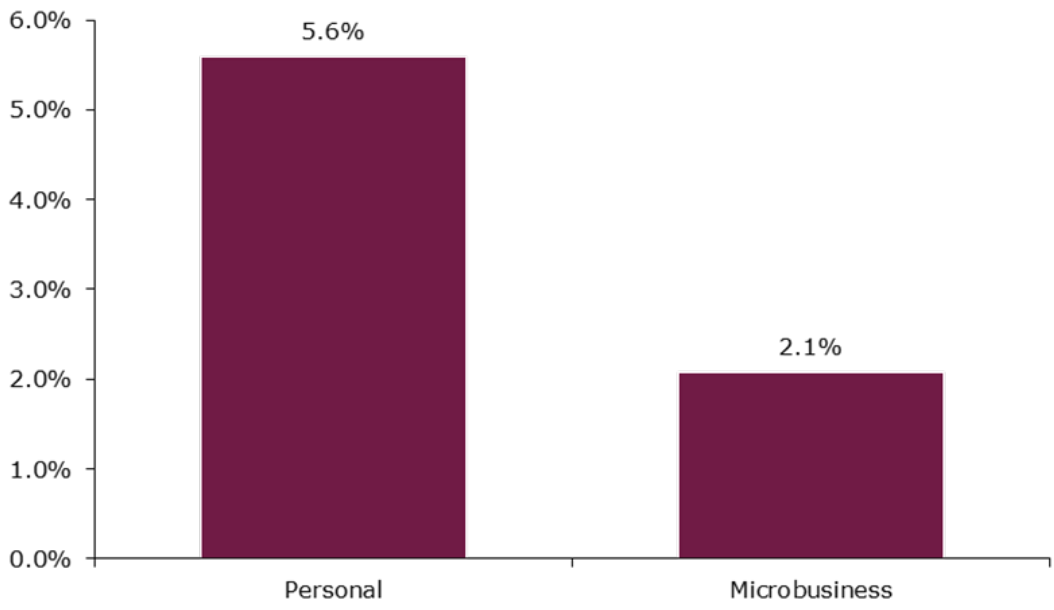
Pre-COVID, banks had been decreasing their SME lending, whilst challengers and specialists had been lending more

4. SME lending has been increasingly becoming a less important part of the business model of most banks. The Bank of England noted that there has been a steady decrease in the volume of corporate lending as a proportion of total bank lending from over 60% in the 1950s, to about 15% more recently. Amongst banks, gross new SME lending and total lending balances were stable between 2015 and 2018 according to the Bank of England, before increasingly slightly in 2019, whilst many small banks and

P2P lenders were net lenders. We find that the ratio of lending to deposits for SME customers was around 33% in 2019 whilst for personal banking the figure was 83%. This means that SMEs deposited on average about 3 times more than they borrowed. This is consistent with banks lending less money to small businesses relative to other types of customers.

5. A possible reason for this could be that big banks typically generate lower returns from microbusiness lending than other forms of lending. Figure 1 shows that in 2019, the risk-adjusted return for unsecured SME lending was lower across the Big 4 providers in the market than for unsecured personal lending. The risk-adjusted yield represents the interest and fee income they receive on the lending, subtracting the impairment.

Figure 1 – Risk-adjusted yields on unsecured term lending in 2019



Source: FCA Analysis of Big 4 lending yields.

6. In meetings with firms, and in their strategy documents, we have also heard that the costs of arranging and administering lending to SMEs can be relatively high. In addition to the costs of capital for SME lending we were told many SMEs typically expect to speak to an individual before borrowing. Some banks have also cited concerns about the reputational risks of lending to SMEs, particularly if they fall into arrears.

7. The nature and level of demand has also been a factor in the relatively low levels of bank lending, and the growth in specialist lending.

8. As reported by the British Business Bank, many SMEs naturally prefer to avoid incurring debt - about 70% of SMEs said that they would prefer to avoid incurring debt even if this meant forgoing growth opportunities. Others may not have sought finance assuming they would have a low probability of being approved.

9. We also found some non-banks have developed products to provide microbusinesses with working capital finance, which may be meeting demand outside of the banking sector. These products allow microbusinesses to borrow against future revenue, some of these services use Open Banking capabilities. Non-specialists in our sample offered similar style invoice finance products, but these were only a small part of the micro-business lending balance sheet (under 1% of total micro-business lending balance).

10. While lending by big banks to SMEs was falling before the pandemic; challenger banks and specialists had been increasingly lending to SMEs, as had non-bank lenders. The Bank of England reported that, in 2020, large UK banks accounted for just over half of outstanding SME debt, with about a third of this being held by small UK banks (including specialist lenders) and about 15% by non-bank lenders.

11. There are important differences between the business models of these lenders and the services they offer to microbusinesses.

- The most commonly held lending products in 2020 were credit cards, overdrafts and term lending. 40% of microbusinesses held an overdraft, and 39% held a credit card, and 21% held a business loan. These products were typically held with their main BCA provider - 91% of overdrafts held by SMEs were with their main BCA provider, as were 82% of credit cards.[103]
- Scale challengers, mid-tier and digital challengers have been growing in importance. Metro Bank and Virgin Money received grants as part of the Alternative Remedies package to develop new business current accounts and ancillary products, which included lending products. Some serve specific regions or sectors. Scale challengers and digital challengers were also developing propositions to help microbusinesses manage their cashflow in some cases exploring partnerships with non-bank lending providers, capital specialist firms and lending marketplaces.
- Specialist lenders (such as Aldermore, Shawbrook, Paragon and Close Brothers) typically offer secured lending and focus on non-term loan products (including asset finance, property finance and invoice finance). They are often sold through intermediaries and specialise in providing finance for particular business types or equipment. They typically do not offer BCAs but offer SME savings accounts. Specialist lenders tend to focus on particular niches, such as businesses in particular sectors, those who require specialist products or those who fall outside the risk appetite of major banks.
- Non-bank lenders represent a diverse range of business models. Like specialist lenders, they do not offer BCAs, but instead lend to businesses who have a BCA with an existing provider. In some cases, non-banks offer similar propositions with specialist lenders, for example in specialist sectors or in particular lending products (such as Asset Finance). Many of these non-banks similarly target larger SMEs, rather than micro-businesses, but some offered propositions targeting cashflow needs of microbusinesses. Some operate a peer-to-peer or platform-based model.

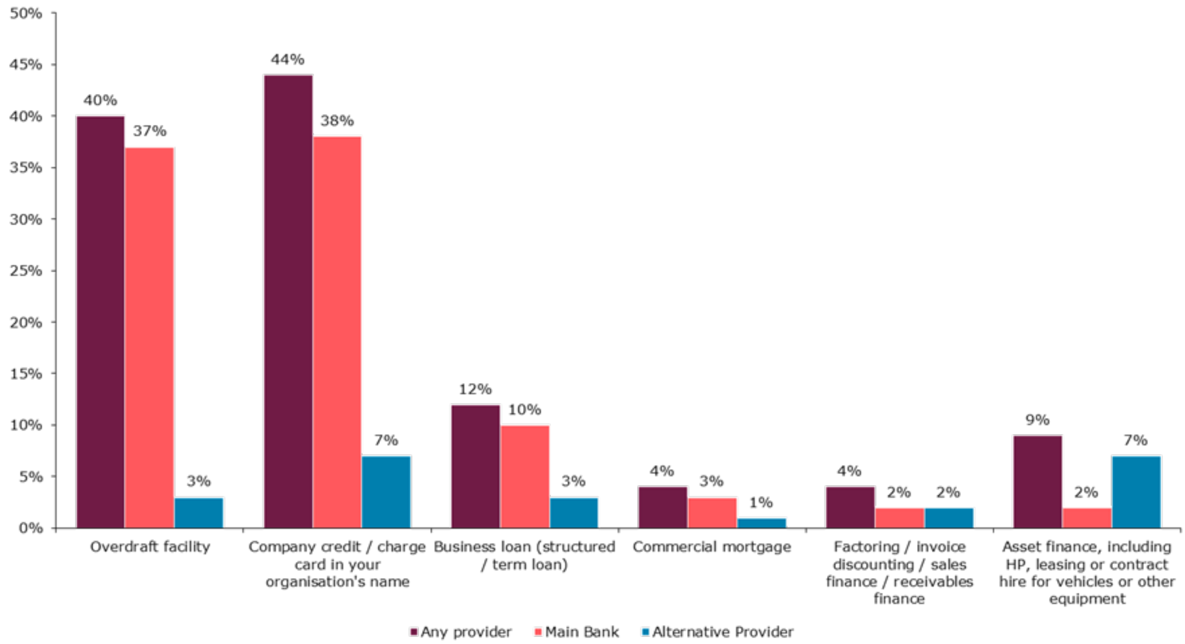
12. These challengers, specialists and alternatives were growing in importance before COVID, however, the Big 4 remained the largest providers of microbusiness lending in our sample. The Big 4 banks provided 61% of total lending in 2019 rising to 64% in 2020 through the impact of the Government Loan Schemes.

13. In its market investigation, the CMA found that weak SME engagement means SMEs are most likely to seek lending products from their BCA provider and this makes it difficult for other lenders to attract customers. Incumbent banks also likely benefit from informational advantages as they have access to considerable data about their SMEs which can inform both their decision to lend, and the terms they lend on, although initiatives such as Open Banking may be lowering barriers to alternative firms.

103 MarketVue Business Banking from Savanta, YE 2020 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size 2020: 3461

14. Figure 2 shows that, pre-COVID, the most popular funding options for SMEs were overdraft, credit card and business loan which significantly more SMEs accessed from their main BCA provider than alternative providers. Products such as asset finance and factoring/invoice discounting were slightly more likely to be taken out with an alternative provider. This likely reflects the fact that these products are more likely to be offered by providers outside the big banks.

Figure 2 – Lending via main bank and alternative providers (2019, prior to COVID lending schemes)



Source: MarketVue Business Banking from Savanta, YE 2019 data. Data weighted by region and turnover to be representative of businesses in G.B. Base size 2019: 3472

Lending, under the government schemes, grew significantly during the pandemic, with big banks doing most of this

15. SMEs were impacted significantly by the COVID pandemic. Two-thirds reported a reduction in sales of 50% or more due to the pandemic, with smaller SMEs being hardest hit. To support SMEs through the crisis, the government introduced a range of support measures, including three SME lending schemes delivered via the banks:

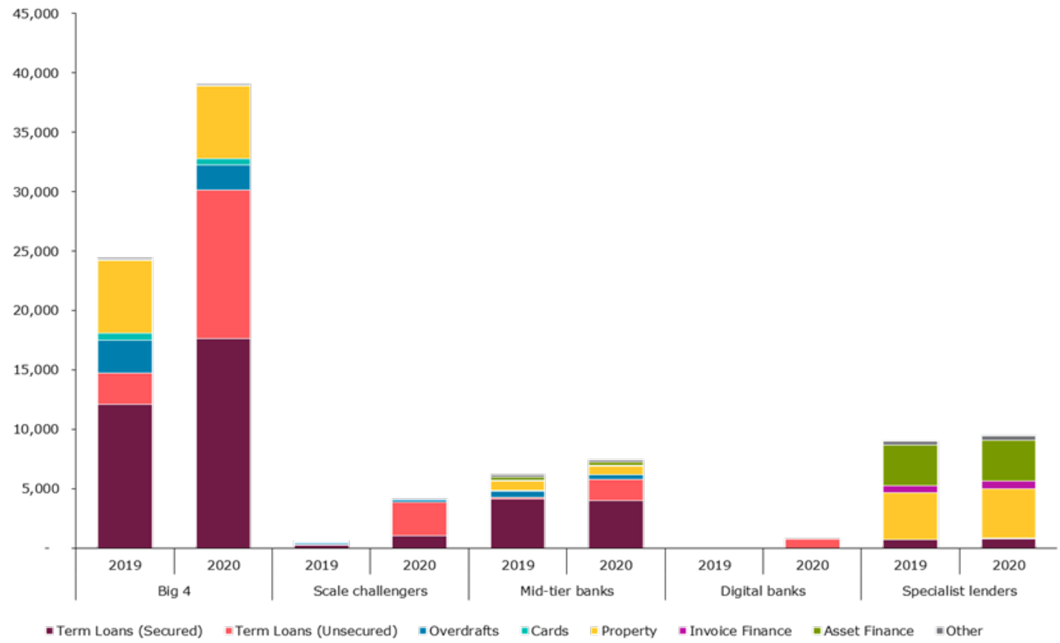
- **Coronavirus Business Interruption Loan Scheme (CBILS)** – this ran from 23rd March 2020 to 31st March 2021 and offered SMEs with a turnover of up to £45m access to up to £5m of borrowing through term loans, overdrafts, invoice finance or asset finance with an 80% government-backed lender guarantee through accredited lenders.
- **Bounce Back Loan Scheme (BBLS)** – this provided businesses with unsecured loans of up to £50,000, or a maximum of 25% of annual turnover, at a fixed rate of 2.5% and was offered through accredited lenders with a 100% government guarantee between 4th May 2020 and 31st March 2021.
- **Recovery Loan Scheme (RLS)** – this (until 30th June 2022) provides any size of business support to access loans and other kind of finance. Term loans and overdrafts between £25,001 – and £10m per business, and invoice and asset

finance products between £1,000 and £10m (limited to £2m from 1st Jan 2022). The government backed guarantee is 80% of the finance (reduced to 70% from 1st of Jan 2022). The impact of the RLS is not captured in the data we collected.

16. These schemes led to a significant overall increase in SME lending between 2019 and 2020. By the end of 2020 about 83,000 SMEs borrowed a total of more than £19bn under the CBILS scheme whilst under BBLs 1.4m SMEs borrowed more than £43bn. Many SMEs in the worst affected sectors found themselves with substantial debts – sometimes for the first time.

17. We looked at lending to microbusinesses. Figure 3 shows the total (estimated) value of microbusiness lending by different banking groups.

Figure 3 – Average Microbusiness Lending Balance by Product (£m)



Source: FCA analysis of firm data.

18. As shown, between 2019 and 2020, the Big 4 banks increased their lending balances by about 60%, from around £25bn to £40bn, mostly driven by an increase in term loans. In total they made about 72% of the loans made under the government schemes (CBILS and BBLS) by value. Scale challengers also increased lending from around £0.5bn to £4.1bn and accounted for about 10% of lending under the schemes.

19. The fact that big banks saw a much larger increase in lending is likely because SMEs were encouraged to contact their main bank in the first instance. The scope for borrowing from another lender was also limited as many banks decided to not offer loans to new business customers during the pandemic, citing operational overload and a preference to serve their own customers first. Furthermore, the fact that the terms of the BBLS loans were the same irrespective of choice of lender limited any potential gains from shopping around. The culmination of these factors likely reinforced the historical tendency of microbusinesses to seek funding from their BCA provider.

20. In previous work, the CMA found that the practice of bundling lending activities with BCAs was a constraint on competition and put in place undertakings on 8 banks to prevent this conduct, which the original investigation in 2002 found to be one of a number of barriers to switching SMEs face. The undertakings were subject to a review which concluded in 2016 with a decision to retain the bundling undertakings. The review found that strong linkages between BCAs and lending particularly continue to favour the largest established banks and that circumstances had not changed to substantially weaken this advantage.

21. During 2020 and 2021, the CMA identified a number of breaches of these undertakings in relation to banks' conduct in administering BBLs. The breaches related to the requirement for businesses to open and/or maintain a BCA with the bank to access BBLs. The CMA took action against 3 banks and agreed a number of remedial actions.

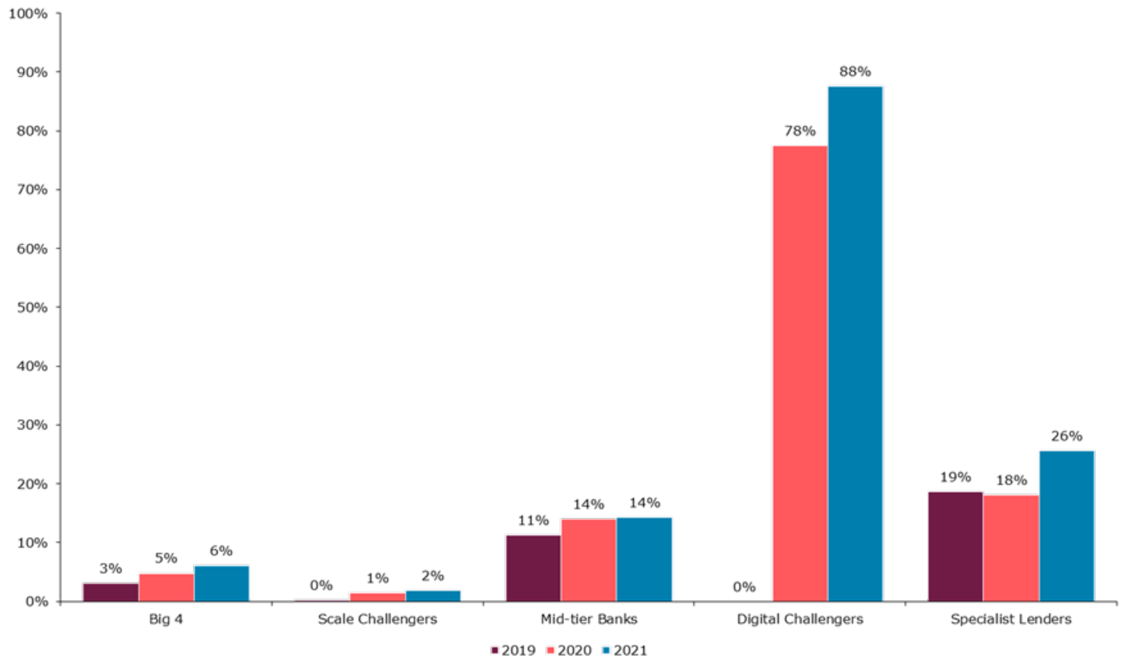
22. Given the CMAs active role in maintaining the bundling undertakings, we have not investigated this aspect of the market specifically. We continue to support the CMA in regard to these remedies to ensure that firms are able to compete on the merits for BCAs and lending activities independently.

23. Some smaller banks, such as Starling, Metro and TSB remained open to new business during the pandemic and allowed new customers to apply for loans under the schemes. The timing of the schemes was particularly opportune for Starling and Metro following BCR grants received.

24. By contrast, many specialist lenders without a BCA service did not increase lending during 2020. Non-bank lenders were often unable to access sufficiently low-cost funding to lend at the 2.5% BBLs rate. Some Specialist Banks told us that they did not have an appetite to supply government backed loans, unless their customers specifically asked for them.

25. Figure 4 shows that banks now have a greater share of microbusiness lending on the loan book, relative to other forms of lending. For the Big 4 microbusiness lending share of the loan book rose from 3% in 2019 to 5% in 2021, for Scale Challengers from 0% to 1% and for Mid-Tiers from 11% to 14%.

Figure 4 – % of balance attributed to microbusiness lending



Source: FCA analysis of firm data.

26. Despite the increased lending we have observed, for most of the larger banks, microbusiness lending remains only a small fraction of the lending balance. Many banks projected microbusiness lending to grow further as a % of the balance sheet in 2021. We will continue to monitor developments in this market to see whether the changes observed during the pandemic remain, or whether the trends of declining significance of microbusiness lending for the major banks will resume.

Annex 7
Abbreviations used in this paper

Abbreviation	Description
ATM	Automated Teller Machine
BBLS	Bounce-Back Loan Scheme
BCA	Business Current Account
BCR	Banking Competition Remedies Limited
BNPL	Buy Now Pay Later
BOE	Bank of England
BTL	Buy to Let
CASS	Current Account Switching Service
CBILS	Coronavirus Business Interruption Loan Scheme
CIF	Capability and Innovation Fund
CJRS	Coronavirus Job Retention Scheme
CMA	Competition and Markets Authority
FLS	Financial Lives Survey
HY	Half-year
HMRC	Her Majesty's Revenue and Customs
ISS	Incentivised Switching Scheme
LBG	Lloyds Banking Group
LTV	Loan-To-Value
MLAR	Mortgage Lending and Administration Return
NIM	Net Interest Margin
PCA	Personal Current Account

Abbreviation	Description
PRA	Prudential Regulation Authority
PSR	Payment Systems Regulator
RoE	Return on Equity
RWA	Risk-weighted asset
SMEs	Small and Medium-sized Enterprises
SVR	Standard Variable Rates

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Annex 8
Financial Research Survey

1. We use the Financial Research Survey (FRS) in the main report and appendices of our Review. The FRS is a syndicated survey carried out on behalf of 21 financial institutions* listed below for Ipsos MORI. The survey is carried out monthly among c.5,000 GB adults aged 16+ over the telephone (using RDD and quota sample) and online (quota sample). Survey data were weighted to be nationally representative of 16+ GB Adults.

2. Syndicate members during 2021: Ageas, Aviva, Barclays, Capital One, Co-op Bank, Co-op Insurance, Direct Line Group, Financial Conduct Authority, Goldman Sachs, Hastings Direct, HSBC, Legal & General, Lloyds Banking Group, Nationwide Building Society, NatWest, NFU Mutual, NS&I, Principality Building society, Royal Sun Alliance, Santander, Tesco Bank & TSB.

Month	Fieldwork Start	Fieldwork End	Sample Size
August	03/08/2020	28/08/2020	4,154
September	01/09/2020	27/09/2020	4,073
October	01/10/2020	28/10/2020	4,000
November	02/11/2020	23/11/2020	4,123
December	26/11/2020	17/12/2020	3,799
January	04/01/2021	26/01/2021	4,364
February	02/02/2021	22/02/2021	4,123
March	01/03/2021	22/03/2021	4,285
April	01/04/2021	26/04/2021	4,572
May	04/05/2021	25/05/2021	4,552
June	02/06/2021	23/06/2021	4,303
July	02/07/2021	22/07/2021	4.593
August	02/08/2021	25/0/8/2021	4593

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