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Strategic Review of Retail Banking Business Models

Final report

December 2018

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1 Executive summary

The accelerating pace of change from regulatory and technological developments brings unprecedented potential to transform retail banking.

In our Progress Report, we noted that historically the market shares of the major banks have been high and stable, and that the personal current account (PCA) and branch network have been a key competitive advantage.

In this final report, we have extended our analysis beyond the PCA. Our analysis confirms our view that the PCA is an important source of competitive advantage for major banks. PCAs bring cheap funding from customer deposits and additional revenues from overdraft fees and other charges:

- Many customers have been with their PCA provider for many years despite better deals being available. Many customers including those with so-called 'free-if-in-credit' accounts receive little or no interest on balances and pay high overdraft charges.
- Many PCA customers also hold instant access savings with their PCA provider, paying very low rates of interest.
- Major banks with large PCA networks have a net advantage even when the costs of providing the PCA and branch network are taken into account.

Major banks also benefit from advantages in lending activities, where they generate higher yields and enjoy relatively low capital requirements. The overall result is that major banks earn higher underlying returns on equity than small retail banks and building societies.

This competitive imbalance has contributed to outcomes for many consumers and small businesses in the form of little or no interest on credit balances in current and savings accounts, high overdraft charges, high transactional charges and pricing models that can work against loyal customers.

We are already taking actions to improve consumer outcomes in several areas. Alongside publication of this report we are publishing proposals on overdrafts. We are working with firms on the issue of mortgage prisoners, and we are consulting on potential measures in cash savings.

We have used our analysis to inform our view of emerging scenarios in retail banking and their impact on business models and consumers. This shows that increased competition has the scope to improve outcomes for many consumers, but progress is uncertain and may take time.

As a result of this review we will initiate work in 3 areas: payment services, SME banking, and monitoring of retail banking business models. In addition, we have identified 3 potential areas which may require co-ordinated action in the future to ensure a retail banking sector that works well for consumers:

- continued access to banking services
- the appropriate use of consumer data
- system resilience and effective prevention of financial crime and fraud



The FCA's role in the evolving future of retail banking

Major banks with large PCA networks have competitive advantages over other business models...



Lower interest rates on deposits in PCAs and savings accounts



High transactional banking charges



Higher yields on lending products, including overdrafts

...but a combination of economic, social and technological changes are affecting retail banking services.

Regulatory change

PSD2/Open Banking
Reformed Real-Time-Gross-settlement
Interventions in cash savings, overdrafts, mortgages, and SME banking

Fintech innovation

Cloud computing
Blockchain
AI/ machine learning
New entrants, platforms, partnerships

Accelerating technological take-up

Smart phone penetration
App-based banking
Contactless payments

Data revolution

Big data/ Data analytics
GDPR
Monetisation of data

Environmental factors

Ageing population
Interest rates
Post-Brexit economy
Public trust and expectations

Innovative business models and competition could deliver better value and enhanced customer service



PCA Unbundling

Cheaper or more convenient payment or overdraft solutions separate from current accounts



Use of data

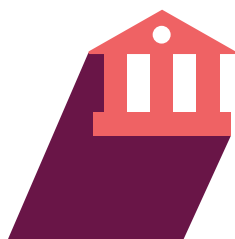
Budgeting and money management tools based on analysis of customer data



Search and switch

Enabling consumers to search for better deals on savings and lending, and potentially switch to new providers

The changing landscape also raises issues which may require co-ordinated action in the future to ensure that retail banking works well for consumers.



Access

Access to branches and cash
Financial and tech inclusion
Shared service obligations



Use of data

Use of data by firms
Open Banking take-up
New industry revenue models



System resilience

IT resilience
Financial crime and fraud
Digital IDs



The traditional retail banking model faces challenges

- 1.1** The Retail Banking sector performs a vital role in the economy. There are around 73 million current accounts and 4 million business accounts in the UK, and retail deposits – including current accounts, savings accounts and SME accounts – total around £1.5 trillion. Retail lending is a key driver of economic activity; UK households owe around £1.4 trillion in mortgages and £198 billion in consumer credit.¹
- 1.2** The traditional retail banking business model has historically combined processing around 40 billion payment transactions made by UK consumers each year alongside deposit taking and lending services to households and small and medium sized business customers. Current accounts have been at the heart of both; providing an instant-access account in which to store money as well as the ability to send and receive payments.
- 1.3** Banks have relied on current accounts as a source of lower cost and stable funding with which to fund their lending activities, as well as deriving income from transaction charges, overdraft charges, and interchange revenue. Cross-selling of savings, lending, and insurance products to current account customers has historically been a feature of business models. However, technological and regulatory changes have meant that alternative business models are beginning to emerge, taking a very different approach, and one of their key differentiators is that they seek to realise value by understanding customers' data.
- 1.4** This is an important moment for us to take a step back and look at where aspects of the traditional banking model are likely to be challenged, how it might change, and where our regulatory approach may need to adapt in coming years.

Major banks still have competitive advantages over other business models

- 1.5** Major retail banks have competitive advantages over other banks, explaining why market shares have remained high and stable over a sustained period and which in combination mean that major banks generate higher underlying profits than other banks and building societies. Underlying profits measured on a return on equity basis for major banks' UK retail banking activities were 28% compared to 6% and 11% for small retail banks and building societies respectively.
- 1.6** The uplift in ROE from small retail banks and building societies to major banks is generated by two significant factors.
- 1.7** First, major banks have large transactional banking businesses, including personal and small business current accounts (PCAs and BCAs) in which competition is weak and customer engagement is low. The result is that these banks have lower funding costs and higher levels of transactional fees and charges than other banks and building societies, and earn high yields on overdrafts:
- Major banks have a **lower cost of funding** because they have more 'on-demand' deposits – including current account and instant access savings balances - and pay lower rates of interest on them. In a higher interest rate environment, this funding advantage would likely be even greater.

1 Sector Views: Mortgage Lending Statistics, 2018, FCA.



- PCAs and BCAs bring **higher levels of transactional revenues and charges** including from interchange, foreign exchange, and packaged account fees and charges. These types of charges come with low marginal costs and little additional capital requirements.
- Major banks earn **high yields on overdrafts** associated with their PCA and BCA businesses.
- **These cost and revenue advantages are not outweighed by higher operating costs** such as those associated with large branch networks, legacy IT systems, and provision of traditional functions such as cheque and cash handling.

1.8 Second, major banks obtain **higher yields on lending and, at the same time, hold proportionately lower capital** than small retail banks and building societies. Major banks maintain a lending portfolio that incorporates more higher yield unsecured lending whilst at the same time benefiting from capital advantages, particularly in residential mortgage lending, such that their overall risk weighted assets are lower. The lower capital amplifies the impact of the higher lending yields, such that we estimate that in combination they contribute a significant uplift on ROE for major banks.

These competitive advantages have impacted outcomes for many consumers

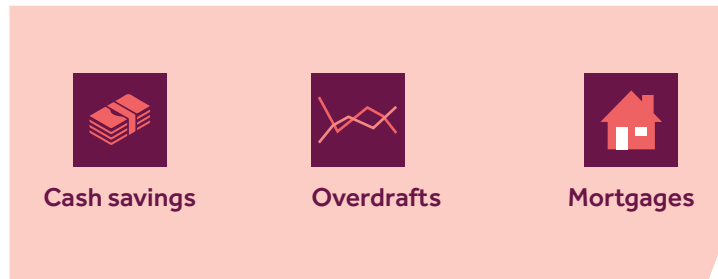
1.9 The competitive advantages currently enjoyed by major banks have contributed to the following outcomes for significant numbers of consumers:

- Many customers stay with their main PCA provider for years despite better deals often being available from other providers. So called 'Free-if-in-credit' (FIIC) banking is paid for by many consumers receiving **low or no interest on PCA deposits**; by high **overdraft charges**; and by interchange and other fees and charges such as foreign exchange that may not be transparent to consumers.
- **Many banks have adopted pricing models that appear not to advantage loyal customers.** As well as savings accounts paying very low interest rates, particularly to long-standing customers, some banks charge high standard variable rates on mortgages outside fixed-term deals; and higher interest rates on credit cards outside initial offer periods.
- **Banks' levy high charges on BCAs, and pay very low interest rates on deposits held in BCAs and savings accounts.** Many small business customers open BCAs with their main PCA provider without shopping around.

1.10 **Levels of innovation by major banks have until recently been low.** Traditional banks have until recently not built capability to enable them to look holistically at the data they hold on customers and develop related propositions, for example to assist customers in budgeting and managing their financial wellbeing at different stages in their lives.

We are already taking action to deal with harm

1.11 We are taking steps to act on identified and potential harms. We are in the process of considering interventions in three areas:



- We are working with mortgage lenders to tackle the problem of so-called '**mortgage prisoners**' who may be trapped on an expensive mortgage and unable to switch to a new mortgage.²
- We are proposing interventions to address harm in **overdraft charges** as part of our work on **high cost credit** (see CP18/42).
- We have published a [discussion paper](#) on the **cash savings** market, setting out a range of options to address issues faced by longstanding customers who tend to receive lower interest rates than those who opened their accounts more recently, including potentially introducing a basic savings rate (BSR).

Regulatory initiatives and technological developments may cause unprecedented change to business models

1.12 This review has allowed us to look broadly at retail banking business models to consider the impact of the unprecedented combination of economic and demographic shifts, regulatory change, data revolution, fintech innovation and accelerating technological take-up. We have also considered the implications of these changes on FICC banking.

1.13 In September 2018, we held a conference with key industry stakeholders to discuss how retail banking business models could evolve in response to these changes. We focused on three scenarios, including the prospect of increased disintermediation ('Banks as Utilities'); increased switching ('the Big Switch'); and the entry of big technology firms ('Platform Providers').

1.14 While the consensus was that it is too early to predict exactly how the market will evolve, or how quickly it will do so, our analysis suggests that in the near term:

- We are likely to see **increased 'unbundling' of the PCA** as new business models seek to offer services to customers that provide enhanced functionality using customer data and capture profitable revenue streams such as interchange, foreign exchange, and overdrafts.

² See Correspondence between Andrew Bailey and the Rt. Hon. Nicky Morgan MP, 24 July 2018.



- **Use of data by firms and consumers will be a key determinant of how retail banking markets will evolve.** New entrants are developing digital propositions using data in ways that help consumers, for example to manage their money or to get better deals. This could encourage more consumers to interface directly with a third party in the future, rather than their bank.
- **Switching could increase**, if new business models succeed in capturing the customer relationship. Traditional banks could become increasingly distant from their customer base, potentially eroding brand loyalty and encouraging more consumers to look around for better deals. For this to happen, new business models need to engage consumers and make the prospect of switching more appealing than it has been.

PCA unbundling
New business models could offer cheaper or more convenient payment or overdraft solutions separate from current accounts.

Use of data
New business models could harness customer data to help with budgeting and money management.

Search and switch
New business models could help consumers to search for better deals on savings and lending, and potentially switch to new providers.

1.15 Major banks are relatively well positioned to address future competition, subject to reconfiguring legacy IT systems. They are investing in fintech: for example, in developing aggregator apps to allow customers to view data from multiple accounts. Further, rising interest rates may squeeze margins for challengers and make it more difficult to attract new customers, potentially reducing their ability to constrain major banks.

1.16 Delegates felt that major platform providers ('bigtech') are most likely to focus on engaging with new business models in financial services to the extent that they support or develop the functionality of the core platform offering.

Free-if-in-credit banking is unlikely to disappear quickly as a result of our overdraft proposals, but may become less widely available in future because of other factors

1.17 FIIC remains a key component of the traditional retail banking model. We do not expect our proposed changes to overdraft pricing to affect the availability of FIIC banking because of the other advantages that this model gives to banks.

1.18 FIIC PCAs depend on banks generating funding benefit from balances, as well as earning fees on overdrafts, interchange revenues, and other fees and charges. Our analysis of account-level data shows that the majority of FIIC accounts make a positive contribution to bank profits from a combination of these sources of value. A small subset of consumers – around 10% - are responsible for 60% of the value that banks derive from PCAs. This subset of consumers mostly either hold high balances in their current accounts or are heavy overdraft users.

- 1.19** However, FIIC PCAs may become less widely available in the future for other reasons: for example, if new business models encourage consumers to move balances out of PCAs and erode their value as a source of low cost, stable funding or drive unbundling of interchange, foreign exchange, or overdrafts as described above. This might lead to the introduction of fees for PCAs and/or charges per transaction. Such change remains possible but FIIC is unlikely to disappear quickly. The speed of change may increase if interest rates rise and drive a wedge between the interest rates on savings accounts and PCAs, which encourages consumers to move their balances.
- 1.20** New charging structures could be positive for competition if they are transparent and fair. However, it's possible that they could lead to charges falling disproportionately on vulnerable or low-income consumers and we will need to monitor any new charging structures to avoid such harms arising.

Areas for further work

- 1.21** Consumers could gain a great deal from increased competition and innovation in retail banking. Platforms acting as marketplaces could help consumers select the best deals on savings and lending products; aggregation and analytics services could help consumers and small businesses better understand their financial affairs, with budgeting and money management; and new payments service providers have the scope to reduce costs in the payments value chain. In addition to mass-market propositions, technology could also help to solve problems of financial exclusion, access for disabled consumers, and indebtedness. And technology can reduce the costs of regulation, as set out in our recent work on [Digital Regulatory Reporting](#).
- 1.22** However, new business models and changes to existing models also bring new potential sources of harm and need to be well regulated to promote trust and confidence in financial markets. Our consideration of these potential sources of harm has highlighted 3 key areas where we need to initiate further work in the near term, and 3 areas which may require us to collaborate with others in the future. Further details about these areas are set out below.





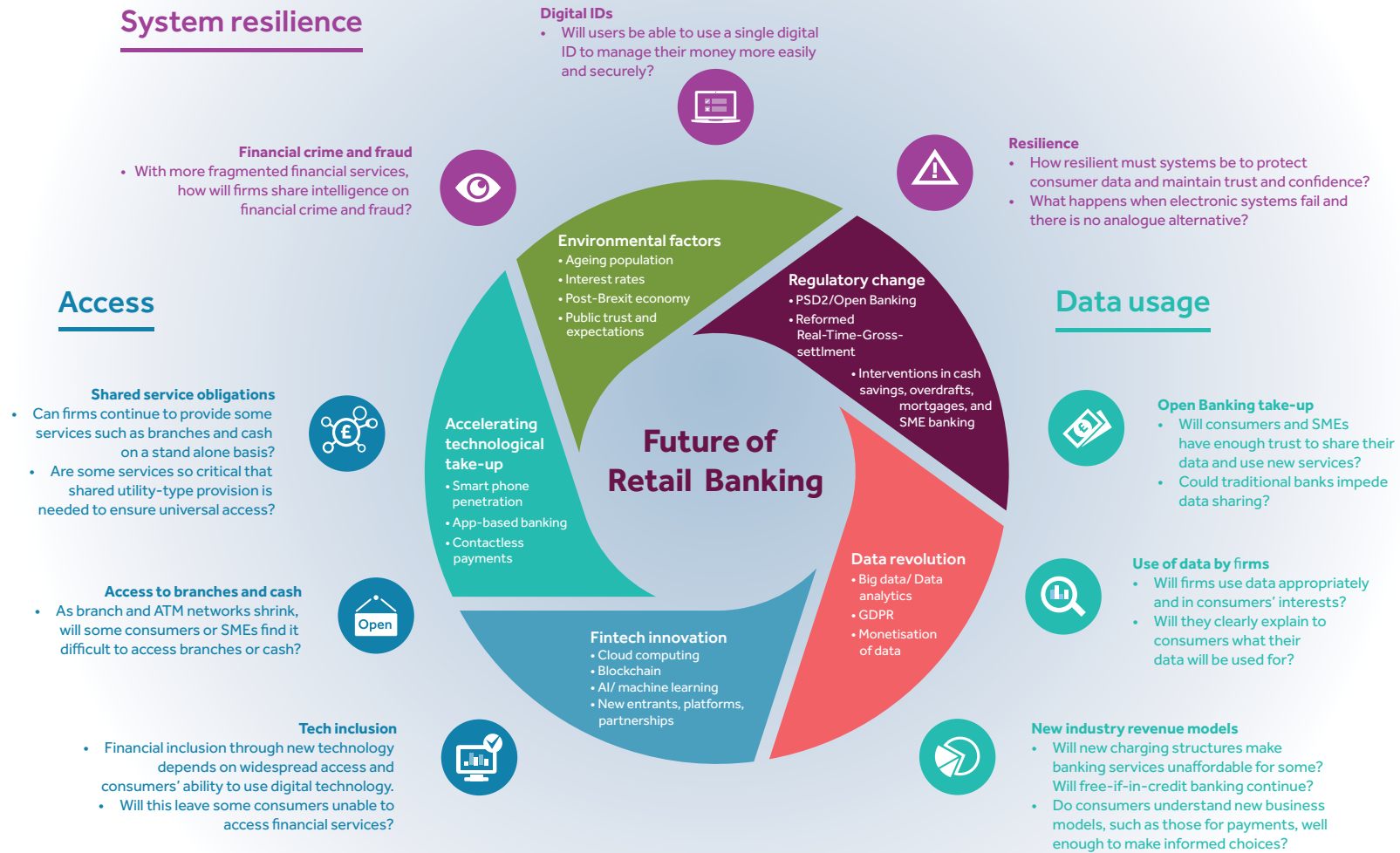
Work we will initiate

- 1.23** This review has put us in an excellent position to monitor change in retail banking business models and consider its impact on conduct and competition. We have now established a baseline from which to assess emerging harms so we can act swiftly and decisively when required. Our business model analysis will form a key part of our identification of harm and our future strategy for regulating the retail banking sector.
- 1.24** In line with our [Approach to Supervision](#) we will conduct a programme of analysis to understand the value chain in new **payments business models**. We will use this work in a similar way to the business modelling work in this Strategic Review.
- 1.25** We will also be **monitoring retail banking markets** on an ongoing basis using the business model analysis approach we have developed in this Strategic Review. This will enable us to understand how our interventions are having an impact, how existing business models are changing, and how new and emerging business models are developing. We will do this by collecting updated data in 2019 and beyond and tracking changes against our existing data set.
- 1.26** Our work has highlighted the value that banks derive from business current accounts (BCAs) and business deposit accounts paying very little interest; comparatively high transaction charges on BCAs; and comparatively high fees and charges for other services such as foreign exchange. This evidence and our consideration of future scenarios has raised questions as to whether SMEs are well served by retail banking offerings and whether the evolution of competition is going to improve outcomes. For example, SMEs are significant users of cash and the declining role of branches and cash could create access issues for some micro-businesses in the future. This has reinforced our view that, whilst recognising our limited regulatory reach in SME banking, we need to understand further how retail banking models are changing their service propositions to respond to the changing needs of SME businesses. We will therefore be announcing in due course **exploratory work to better understand these aspects of SME banking** in further detail. We welcome the PSR's plans to review the market for card-acquiring services alongside this work.

Work we will collaborate on

- 1.27** We have identified 3 overarching issues – access to financial services, use of data, and system resilience – which could result in less favourable consumer outcomes in the future as the landscape evolves. These issues may require co-coordinated action with industry, Government, other regulators, charities, and consumer bodies to achieve good outcomes for consumers in the future. In addition, some of these issues could be addressed through the development of regulatory technology. These areas are set out in the infographic below, explaining the main drivers of change and the key questions that are likely to be posed as the retail banking landscape evolves.
- 1.28** We look forward to receiving submissions in response to this report. We will be engaging directly with a wide range of firms and consumer organisations to discuss some of the points raised, but are also keen to hear from other stakeholders. Please send written submissions to StrategicReviewofRetailBanking@fca.org.uk by 15th February 2019. If you would like to discuss alternative ways to provide input, please contact us using the same email address.

As retail banking evolves it will create issues that may require co-ordinated action by industry, government, and regulators





2 Introduction

- 2.1** Retail banking has seen significant regulatory and technological change alongside shifts in consumer behaviour in recent years. These changes have already had significant implications for the way the retail banking industry operates. Further changes are likely in the near future, with the potential for a more fundamental transformation of the industry in the longer term.
- 2.2** In this section we describe some of these changes in further detail and explain the motivation for our study.

Regulatory change

- 2.3** In payments markets, over recent years, European regulators and governments have sought to tackle the dominance of the large clearing banks, through initiatives such as PSD2 and the Interchange Fee Cap. In the UK, the Payments Systems Regulator was established in April 2015 to promote competition and innovation in payments. Major regulatory initiatives such as separation of ownership of the payments infrastructure from the traditional clearing banks has been undertaken with a view to ensuring fair and open access to third parties. PSD2 has recently been implemented in the UK with the objective of encouraging new non-bank payments providers to enter the market, mandating that banks share customer account data with regulated third parties, where the customer has given permission. The Real Time Gross Settlement System is being overhauled to enable direct access to non-bank payments providers. These changes have introduced a real possibility for payments services and/or personal current accounts to be provided separately from savings and lending services.
- 2.4** Regulators and government have also sought to tackle the dominance of the large clearing banks in deposit taking and lending markets. Some key actions include:
- In March 2013, the FCA and PRA began a review of the authorisations regime, making it easier, cheaper, and more transparent for prospective banks to become authorised. Our forthcoming ex-post evaluation of these changes will consider the extent to which this has encouraged new firms to enter the retail banking market.
 - In 2014 the Competition and Markets Authority recommended or imposed a series of remedies to improve competition. These included the Open Banking Initiative, which augments the provisions in PSD2 by standardising the format in which the nine largest banks share current account data with third parties. Other measures included a maximum monthly charge on unarranged overdrafts, and measures to require banks to publish standardised information on service quality.
 - In 2019 funds are expected to start to be awarded to challenger banks under the Alternative Remedy Package (ARP) agreed between HM Government and the European Commission. This aims to increase competition in SME banking, to offset the state aid Royal Bank of Scotland (RBS) received from the UK government in 2009. The ARP consists of two elements:



- A £425m Capability & Innovation Fund to provide grants to challenger banks and new entrants to help them improve their banking capabilities for SMEs; and
- Up to £275m for an Incentivised Switching Scheme to provide funding to Eligible Bodies, to incentivise RBS (former Williams & Glynn) SME banking customers to switch their business current accounts to the eligible challenger banks.

In addition, measures have been introduced to improve consumer outcomes by enhancing consumers' awareness of charges in retail banking markets including:

- rules to force banks to set up an alert system to help customers avoid unnecessary overdraft charges.
- rules to help consumers understand the charges that they face on credit card debt. These changes provide more protection for credit card customers in persistent debt or at risk of financial difficulties.
- rules to improve disclosure to customers about interest rates on cash savings products, including information on interest rates offered on cash savings products as well as clearly reminding consumers about changes in interest rates or the end of an introductory rate.

Customer data

- 2.5** GDPR and PSD2/Open Banking are in combination causing traditional banks to take a new role in the way they own and manage consumer data. The principle of both regulations is that individuals own their own personal data and should be able to choose how they are used and with whom they are shared. PSD2/Open Banking mean that third parties will be able to access PCA data directly, with customer consent, and use banks' payment infrastructure to initiate payments.
- 2.6** It is too early to predict the exact outcomes but it could involve traditional banks losing the information advantage that they have had in the past over other providers, for example when assessing eligibility for loans. It could ultimately lead to traditional banks losing the direct relationship with customers and 'platform' style businesses intermediating between them instead. We discuss these possibilities further in Chapter 4, Fintech Revolution or Incumbent Evolution.
- 2.7** Banks have historically been custodians of customer data but have not fully exploited this resource. With the advent of fintech and PSD2/Open Banking banks are under pressure to innovate quickly to avoid losing customer relationships. Many banks are partnering with fintech companies to facilitate this.

Technological change

- 2.8** Technological change is having profound effects on many aspects of the retail banking market, including how consumers pay for goods and services and interact with their bank, as well on banks' internal systems and process.



- 2.9** The use of debit cards for payments overtook cash for the first time in Q4 2017, due to the decline in cash usage and increasing use of contactless payments. UK Finance predicts that debit card payments volumes will grow by a further 49% over the next 10 years.³
- 2.10** Smart phone penetration is rising rapidly in the UK, and is now estimated at around 87 per cent of the adult population⁴ and consumers are increasingly using smartphones to access banking services. 71% of the adult UK population – 38 million people – accessed their bank via an online browser or a mobile banking app in 2017, according to UK Finance.⁵ Of these, almost 22 million regularly used mobile banking apps to access their accounts, a figure that has more than doubled over the past four years. Mobile banking interactions increased by 354% between 2012 and 2017, to 1.4bn.⁶
- 2.11** Branch usage for day to day banking needs is declining as electronic forms of payment become more popular. However, many consumers still visit branches to open current accounts or apply for credit and many SMEs rely on branches to deposit cash. Branch interactions fell by 42% between 2011 and 2016.⁷
- 2.12** Banks are closing branches across all regions of the UK in response to this trend. People are having to travel further to reach branches. Older consumers and those on lower household incomes may be most affected as they tend to use branches more. Digital banking, banking through the Post Office, and use of ATMs may provide alternative solutions for some customers. The details of our analysis of bank branch closures, looking at the potential impact on vulnerable consumers can be found in Annex 1: Impact of Retail Bank Branch Closures.
- 2.13** Technological change is also changing the way the industry works, reducing entry costs as new digital-only banks establish themselves without the need for a branch network. These banks plan to operate with low operating cost models involving fewer service channels (typically app based only) and with flexible, scalable, cloud-based IT systems that could allow them to provide customer friendly service for a fraction of the cost of established banks.
- 2.14** Investment into UK fintech is reported by KPMG at £12bn in the first half of 2018, representing more than a quarter of all global fintech investment in the same period.⁸ New business models are spanning a diverse range of consumer and SME banking and payments propositions, crypto-assets, P2P lending and insurance categories.

Structure of this report

- 2.15** Our review considers the potential effect on retail banking business models of technological and regulatory changes described above and the implications for the FCA.
- 2.16** This Final Report builds on the work published in our Strategic Review of Retail Banking Business Models Progress Report in June 2018.

3 Uk Payments Markets Summary, 2018, UK Finance.
4 Global Mobile Consumer Survey: The UK Cut, 2018, Deloitte.
5 The Way We Bank Now, 2018, UK Finance.
6 Appetite for Banking Report, 2017, BBA.
7 Help at Hand Report, 2017, BBA.
8 Pulse of Fintech, 2018, KPMG.



2.17 We received a number of responses to our Progress Report from financial institutions, trade bodies, academics and private individuals. In general respondents welcomed the work the FCA is undertaking, and offered a variety of information and suggestions to enhance the quality and scope of the review. We are grateful to everyone who took the time to reply, and we encourage further dialogue in response to this report.

2.18 This report is based on four types of analysis:

- Business model analysis and understanding the implications of change for different business models. Our work has been informed by information from around 40 firms active in retail banking, including major banks, small retail banks, a selection of building societies, specialist lenders and digital banks. In September 2018 we held a conference with a selection of firms and consumer representatives to discuss the future of retail banking (we refer to this subsequently as our September Conference). This analysis is set out in Chapters 3 and 4 of the report.
- An analysis of bank branch closures, looking at the potential impact on vulnerable consumers. This analysis is set out in Annex 1.
- How FIIC PCAs are paid for and whether that leads to concerns about the distribution of profits from different types of consumers or different products. This work was performed using an account level data set comprising data on one million current accounts held with major banks. The analysis is set out in Annex 2 of the report.
- Analysis of switching behaviour based on account level data. This analysis is set out in Annex 3 of the report.

2.19 The remainder of this report is structured as follows: Chapter 3 sets out our views on the strengths and weaknesses of traditional retail banking business models. Chapter 4 looks at potential change scenarios and implications for traditional and new business models. The annexes include detailed analysis on the impact of retail bank branch closures, PCA distributional analysis, analysis of switchers' characteristics, which we draw on throughout the report.

2.20 We are very grateful to everyone who has helped us with this review.



3 Strengths and weaknesses of different retail bank business models

- 3.1** In this chapter, we look at aspects of the business models of different types of banks and their relative strengths and weaknesses, with a view to evaluating the potential for change and the impact of that change on business models.
- 3.2** This work expands on the analysis set out in our Progress Report, in which we identified that PCAs had played a key role in sustaining competitive advantage, bringing benefits from:
- large numbers of customers holding balances in PCAs and associated savings accounts paying low rates of interest;
 - significant additional income from fees and charges on PCAs, particularly overdraft charges;
 - the ability to cross-sell lending products to PCA customers;
 - BCAs and associated savings accounts, which are often opened with the business owners' PCA provider.
- 3.3** In our Progress Report, we noted that we had not yet fully explored the interplay of the benefits from PCAs with the additional costs incurred in providing them and the associated branch networks.
- 3.4** We expand on this analysis below as follows:
- We examine the differences in margins between different types of banks and the reasons for these differences, including yields on lending as well as funding costs;
 - We consider the cost base, including:
 - how the overall cost to asset ratio varies between different types of bank;
 - how aspects of the cost base such as branch networks and IT costs differ between different types of bank;
 - the relationship between the cost of offering PCAs and the funding advantage it provides.
 - We look at the interplay of net interest margin (NIM) and costs and the implications for return on assets and return on equity for different types of banks.

A note on methodology

- 3.5** In the work that follows we have used data provided to us by around 40 firms. We sought data from a number of firms of different types: major banks, small retail banks,

building societies, specialist lenders, and new banks.⁹ We included Nationwide in the major bank category, reflecting its relatively large scale and diversification compared to other building societies.

- 3.6** We recognise that many bank business models are idiosyncratic and that within categories there is diversity in business models. We have commented on this where relevant. Notwithstanding this, these categories help us to understand some of the major differences facing institutions of different sizes; with different ownership models; and with varying focus on specialist lending.
- 3.7** In our analysis, we have relied on information provided by banks on a 'best endeavours' basis. Firms were asked to complete a data template to the best of their ability, recognising that they hold financial information in different ways and could not always extract information in the way we asked for it. Because not all firms report on their retail banking segment on a stand-alone basis, they may not have been able to reconcile the numbers with existing management information or with audited figures. The results presented here are largely on an 'as reported' basis; and although we have made checks on the data to identify obvious errors and outliers, we are aware that there are some challenges with the data quality from some firms. Using data across a relatively large number of firms and categories of firms helps to ameliorate the effect that this has on our analysis and our interpretation of it.

Net Interest Margins

- 3.8** Managing Net Interest Margins (NIMs) has been an important goal for traditional commercial banking models seeking to maximise shareholder value. That is, by securing funding as cheaply as possible and achieving the best yields on lending possible (for a given risk tolerance), the spread that the bank earns widens.
- 3.9** In the work that follows we look at how major banks earn higher net interest margins than small retail banks and building societies and some of the demand-side factors underpinning this, including:
- Low customer engagement in PCAs, meaning many customers have been with their main PCA provider for years despite better deals often being available from other providers;¹⁰
 - A high level of customer inertia results in many PCA customers holding instant-savings accounts with their PCA provider. These accounts pay low interest rates in comparison to other types of account and pay very low interest rates to long-standing customers;¹¹
 - On the lending side, customer inertia results in a number of customers gravitating from low introductory rates (fixed rate mortgages, or balance transfer deals on credit cards) onto higher rates over time;

9 The firms in each category are set out in Annex 1 of the FCA's Strategic Review of Retail Banking Business Models Progress Report (2018). Not all firms were included in our analysis. Major banks include Nationwide.

10 Retail Banking Market Investigation Final Report, 2016, CMA.

11 Price Discrimination in the cash savings market, 2018, FCA.



- Cross-selling from the PCA has historically been a feature; many PCA customers have savings balances with their PCA provider, and a significant number also take out credit cards, loans and mortgages. Customers of major banks have on average 2 products with their bank.

3.10 Whilst many traditional banks offer relatively attractive deals to new customers, 'loyal' or 'inert' customers who stay with the bank for a length of time without taking action are often not getting good value for money. In many retail banking markets (mortgages, credit cards, savings) this pricing dynamic has become entrenched. The pricing dynamic exists in other markets too. The Competition and Markets Authority is investigating concerns that people who stay with their provider often pay significantly more than new customers.¹²

3.11 In the work that follows, we set out aspects of our analysis to illustrate these points, as follows:

- We explain how major banks achieve low funding costs by paying lower rates on retail deposits, including PCA and BCA balances and savings balances.
- We look at differences in lending yield, explaining:
 - how major banks earn higher average yields on lending than small retail banks and building societies, primarily by advancing more unsecured lending and achieving higher yields on it;
 - why specialist lenders have higher yields than other banks;
 - how different types of banks have varying proportions of mortgage balances on standard variable rate on which they achieve higher yields than on their mortgage portfolio as a whole.

Retail deposits

3.12 In our Progress Report we set out that retail deposits are the most important source of funding for banks, comprising around 80 to 90% of total funding requirements. These can be withdrawn 'on-demand' in the case of PCAs and instant-access savings balances, or deposited for a fixed term.

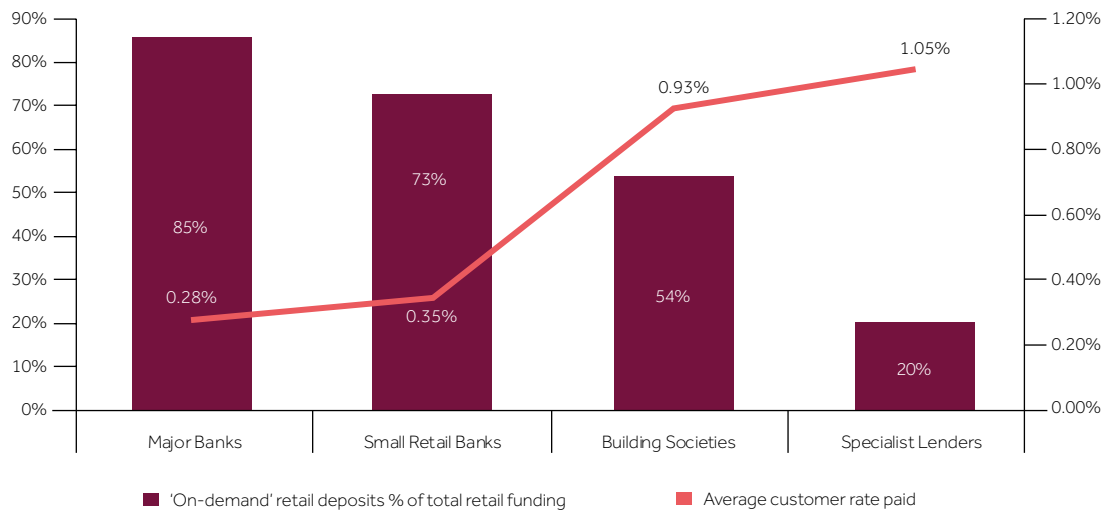
3.13 Major banks and small retail banks have a greater proportion of 'on-demand' deposits, including PCAs, BCAs, and instant-access savings accounts, and pay lower interest rates on them than building societies and specialist lenders. Building societies and specialist lenders pay rates on 'on-demand' savings that are on average 3 times higher than those of major banks.

3.14 The figure below shows the amount of 'on-demand' retail deposits that different types of banks have and the average rates that they pay on these deposits. These include personal and SME deposits without a contractual maturity and which allow the depositor to withdraw funding at any time. Major banks and small retail banks hold

¹² Loyalty penalty super-complaint, 2018, CMA.

higher levels of these types of deposits (between 73-85%) and pay much lower rates (28bps to 35bps) compared to building societies and specialist lenders.

Figure 3.1: Retail 'on demand' funding – composition and average customer rates (2017)



Source – FCA analysis, 2017 weighted average by lending balances, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.
'On demand' funding includes SME deposits.
Cost of funding calculated as gross interest paid divided by average funding balances.

3.15 The greater proportion of 'on-demand' retail deposits held by major banks and small retail banks, reflects the propensity for PCA customers to leave balances in PCAs and associated instant access savings balances rather than shop around for a better deal. Our [Discussion Paper](#) on price discrimination in the cash savings market notes a propensity for consumers to hold their current account and savings accounts with the same provider.

3.16 Competition in PCAs has been historically weak and customer engagement has been low. The CMA found that 90% of PCA customers with standard and reward accounts could gain financially from switching to a cheaper product and that the average gain from switching was around £92 per year. For customers with packaged accounts, the CMA found that around 50% of customers could gain an average of £170 per year from switching.¹³

3.17 Switching rates on PCA accounts remain extremely low: our analysis of PCA account level data indicates that around 2.4% of PCA customers switched bank account between 2015 and 2016. We found the median tenure for PCA account holders was 10 years. Most PCA switching has been between major banks rather than to challengers: our analysis indicates that 90% of switching using CASS¹⁴ was between major banks in 2015/16. Further details of this analysis can be found in Annex 3: Analysis of switchers' characteristics.

3.18 Inertia and low levels of engagement also applies to cash savings products. In our Discussion Paper on Price discrimination in the cash savings market, we note that many consumers received lower interest rates on easy access savings products opened a long time ago compared to accounts opened more recently. For example, only 9% of consumers switched savings providers within the last 3 years and 66%

¹³ Retail Banking Market Investigation Final Report, 2016, CMA.

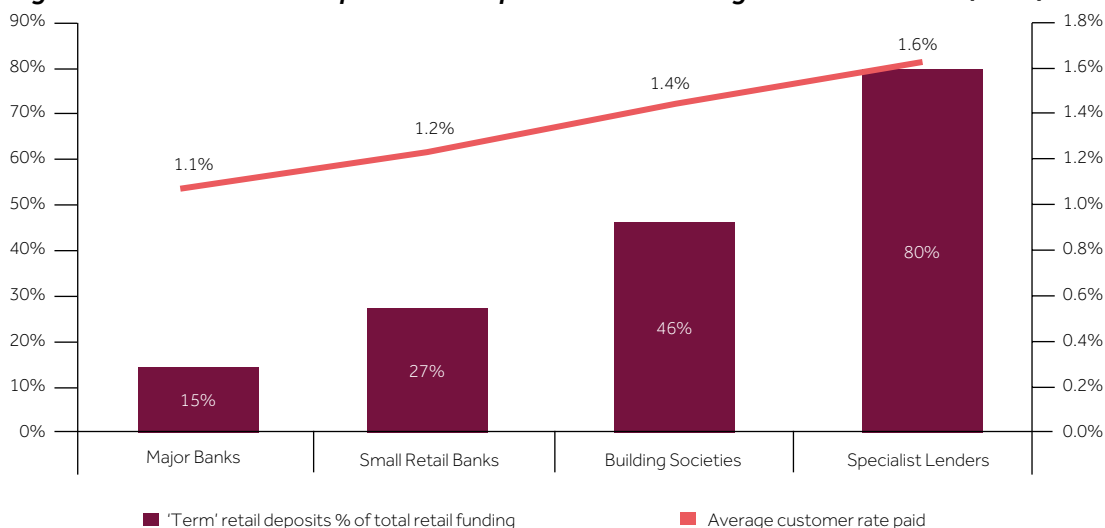
¹⁴ Switching data does not capture so-called 'partial' or 'soft' switches where consumers open accounts with other providers without closing their main bank account.



of consumers with a cash savings account held it with their main current account provider. We have started a discussion on options to improve outcomes for these customers, including a Basic Savings Rate for longstanding customers.

3.19 Building societies and specialist lenders are much more reliant on fixed term deposits than PCA banks. The figure below shows the amount of 'term' retail deposits that different types of banks have and the rates that they pay on these deposits. This shows that 'term' deposits comprise only 15% of retail funding for major PCA providers compared to 80% for specialist lenders. The figure also shows that major banks paid the lowest rates on these 'term' deposits at 1.1% compared to 1.6% for specialist lenders and 1.4% for building societies. This likely reflects how specialist lenders and building societies source retail deposits, being much more dependent on 'best-buy' tables to acquire customers than banks with large PCA networks, many of whom place their savings with their PCA provider. However, we acknowledge that average rates can also be influenced by the duration of term products – all things equal longer term products will usually carry higher rates. Due to data limitations, we were unable to split average rate by different term products and have instead analysed them as single product.

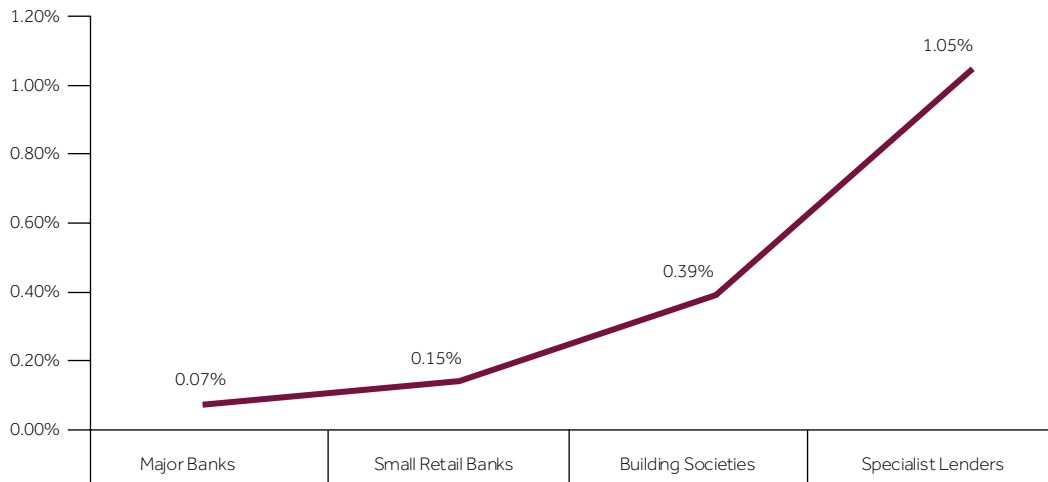
Figure 3.2: 'Term' retail deposits – composition and average customer rates (2017)



Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders. 'Term' funding includes SME deposits. Cost of funding calculated as gross interest paid divided by average funding balances.

3.20 Major banks obtain significant amounts of funding from SME deposits in BCAs and business savings accounts (around £130bn in 2017). Most banks pay lower rates on SME deposits than on retail deposits. The figure below shows that major banks paid an average interest rate of just 0.07% on SME deposits, compared to 0.28% on retail 'on demand' deposits. Specialist lenders paid a much higher average interest rate, at 1.05%.

Figure 3.3: SME deposits average customer rates (2017)



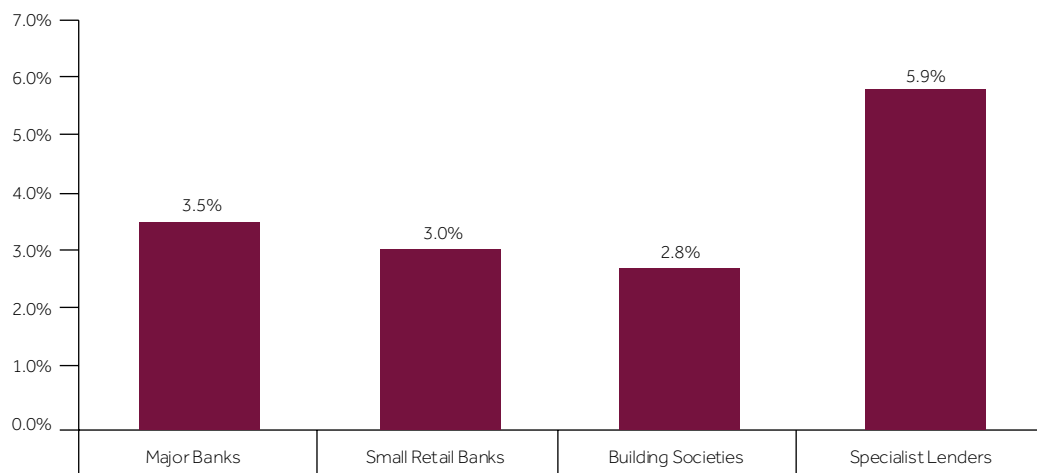
Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders. Cost of funding calculated as gross interest paid divided by average funding balances.

Lending yields

3.21 Major banks earn higher average all-in yields on retail lending products than small retail banks and building societies, where all-in yields are calculated as the sum of gross interest income and fee income divided by average lending balances. The figure below shows that in 2017 major banks earned an average all-in yield of 3.5% on lending compared to small retail banks at 3.0% and building societies at 2.8%. Specialist lenders' average all-in yield was 5.9%, higher than at other banks.

3.22 We explore some of the reasons for the differences in these yields in paragraphs 3.23 - 3.39 below.

Figure 3.4: All-in yield (2017)



Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders. All-in yield calculated as the sum of gross interest income and fee income divided by average lending balances. Excludes non-lending fee income.

3.23 Loan book mix is an important driver of all-in yield, because different types of lending attract different prices. Secured lending is usually priced below, and generates lower

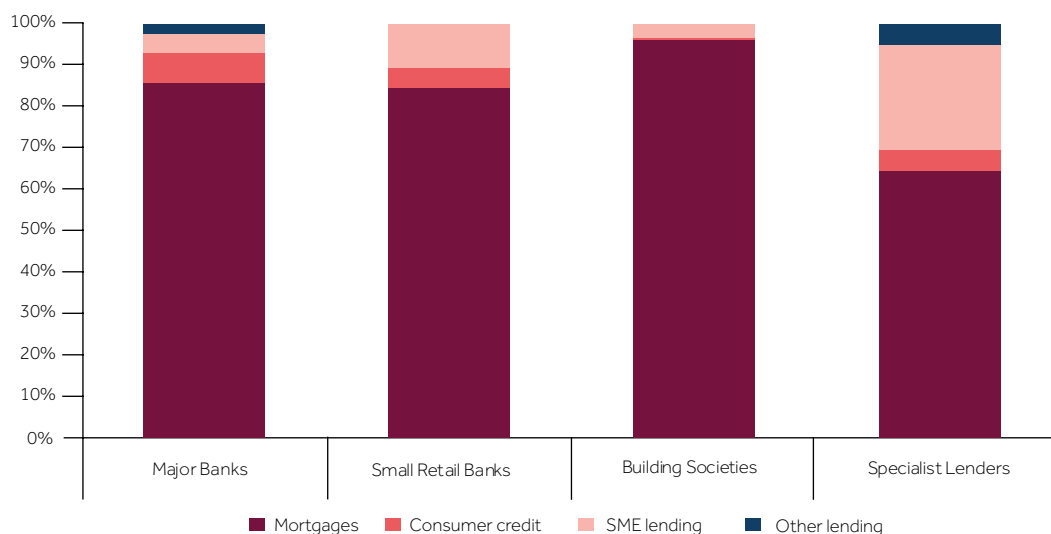


yields than unsecured lending. Further, within secured lending, higher quality collateral will tend to lower the yield. Residential mortgage lending tends to be lower yielding than consumer finance and SME lending. This helps to explain why building societies earn a lower yield than small retail banks and major banks, because they are almost entirely focused on mortgage lending.

3.24 The figure below shows loan book composition for different types of banks in 2017. Major banks and small retail banks have relatively similar loan book compositions – comprising around 84-86% of mortgages, 5-7% of consumer finance (including credit cards, personal loans and overdrafts) and 5-11% of SME lending (including both secured and unsecured lending). Building societies' loan books are comprised of around 96% mortgages and 3% SME lending.

3.25 Specialist lenders have a notably different lending book to other banks and building societies, with a larger proportion of Buy-to-let (BTL) and specialist mortgages, motor finance, and specialist SME lending, including asset and invoice finance. This is consistent with the higher yields that they earn on their lending books. We consider the profitability of the specialist lenders further in paragraph 3.75.

Figure 3.5: Loan book composition (2017)



Source – FCA analysis, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.
SME Lending includes both secured and unsecured lending. SME definitions may not be consistent across firms and firm categories.
Mortgages includes both Owner-Occupied and BTL Mortgages.
Consumer Credit includes personal loans, credit cards and overdrafts.
Other Lending includes Motor and Wealth Banking (where included within retail banking divisions).

3.26 Differences in default risk within the same loan category can also drive differences in yield; for example – holding other things equal – for a given type of lending, firms lending to 'prime' customers with good credit records and low expected default rates should expect to earn lower yields. Impairments are one indicator of default risk. Our analysis covering three years indicates that impairment ratios, calculated as in-year impairment provisions divided by average lending balances, were lowest for building societies and highest for specialist lenders, potentially explaining some of the difference in yields between these two firm types. However, impairment ratios were broadly similar for major banks and small retail banks, so do not explain the yield differential between them.

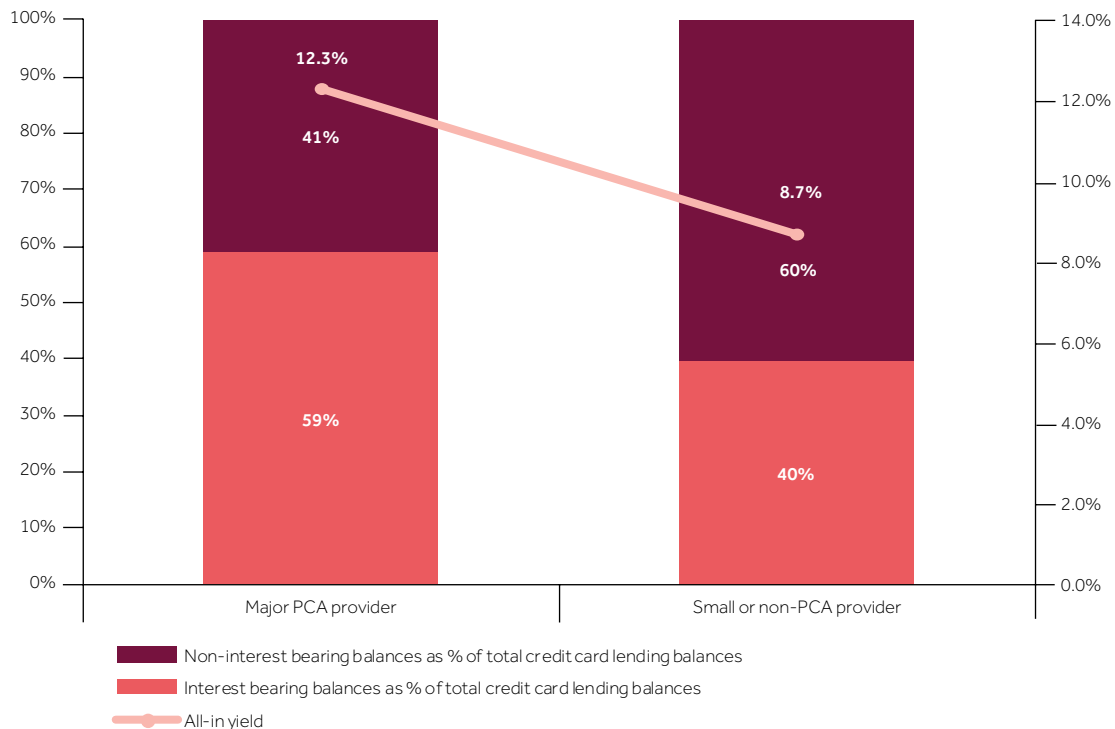
3.27 To look at the reasons for the uplift in yields for major banks compared to small retail banks, we first look at SME lending. Small retail banks have a greater proportion of

SME lending (both secured and unsecured) at 11% compared to major banks at 5%. However, major banks achieve higher all-in yields on SME lending compared to small retail banks.¹⁵ We find that these differences in SME lending are not a significant driver of the difference in overall lending yields between small retail banks and major banks.

3.28 To look further at the reasons for the uplift in yields for major banks relative to small retail banks, we examine the yield on consumer finance lending. Credit cards are the most significant component of consumer finance lending, contributing between 50-60% of the total income that major banks and small retail banks earned from consumer finance in 2017. We segment banks according to the size of their PCA network in this analysis, to examine the link between yields on credit cards and PCA provision.

3.29 We find that major PCA providers earn higher average all-in yields on credit cards than small or non-PCA providers. The figure below shows that major PCA providers generated average all-in yields on credit cards of 12.3% compared to an average of 8.7% for small or non-PCA providers. It also shows that major PCA providers had a larger proportion (59%) of interest-bearing balances on their credit card book, compared to small or non-PCA providers at 40%. Small or non-PCA providers have a high proportion of non-interest-bearing balances, potentially reflecting a greater number of customers on 0% balance transfer deals, or customers paying off their balance in full every month.

Figure 3.6: Credit Cards – Composition and all-in yield (2017)



Source – FCA analysis, weighted average for 2017, sample includes 5 major banks, 7 small retail banks.
All-in yield calculated as the sum of gross interest income and fee income divided by average lending balances.
Major PCA provider defined as any firm in the sample that has more than 1 million in total PCA accounts.
Small or non-PCA provider defined as any firm in the sample that has less than 1 million in total PCA accounts or no PCA offering.

¹⁵ Loan book mix could be a factor in this, for example if small retail banks have a higher proportion of secured SME lending compared to major banks.



3.30 Consumer inertia is likely to be a factor behind the higher yields achieved by major PCA providers on consumer finance. Higher levels of cross-holding can imply less shopping around for the best deal available on consumer lending products. In our Progress Report we noted that many PCA consumers hold credit cards with their PCA provider. For major banks, we found that 52% of consumers hold a credit card with their PCA provider. Customers of major banks have on average 2 products with their bank compared to an average of 1.4 and 1.5 for building societies and small retail banks, respectively.¹⁶ This evidence is also consistent with major PCA banks having a lower proportion of customers on 0% balance transfer deals.

3.31 In summary, we find that, in comparison to banks with smaller PCA networks, major banks:

- earn higher all-in yields on credit card balances;
- have a higher proportion of interest bearing balances as a percentage of their total credit card book;
- have a higher degree of cross-holdings.

3.32 This evidence is consistent with major PCA banks having a higher level of customer inertia, meaning that their customers are less likely to shop around for the best deal available on consumer lending products.

3.33 Overdrafts are also likely to play a part in the higher yields on consumer finance lending achieved by major PCA providers. The High Cost Credit Review on overdrafts¹⁷ found a lack of competitive pressure on overdrafts, leading to margins on overdraft lending that are higher than those on credit cards and unsecured personal loans. We found that all-in risk adjusted yields were around 14% on overdrafts compared to around 10% on credit cards and 7% for unsecured personal loans. These yields are calculated after impairment costs but before other costs.

Mortgages

3.34 Most banks and building societies operate a pricing model in mortgages in which customers pay low introductory rates for a fixed period, after which those customers who do not take a new fixed rate deal revert onto a higher rate. The rate onto which customers revert can be a rate over which the lender has control (also known as a Standard Variable Rate (SVR)) or a tracker rate which follows the Bank of England official Bank Rate or another interest rate measure.

3.35 Customers reverting onto SVR after the introductory period are likely paying more than if they were to take out a new fixed term deal. This is especially the case in the low interest rate environment over the last nine years in which the spread between fixed rate and SVR has widened.¹⁸

3.36 In our Progress Report, we showed that customers on SVRs are an important source of income for major banks, despite a recent decline in SVR balances. In this report, we have extended our analysis to look at the all-in yields that different types of firms generate from mortgage lending, and specifically the SVR book.

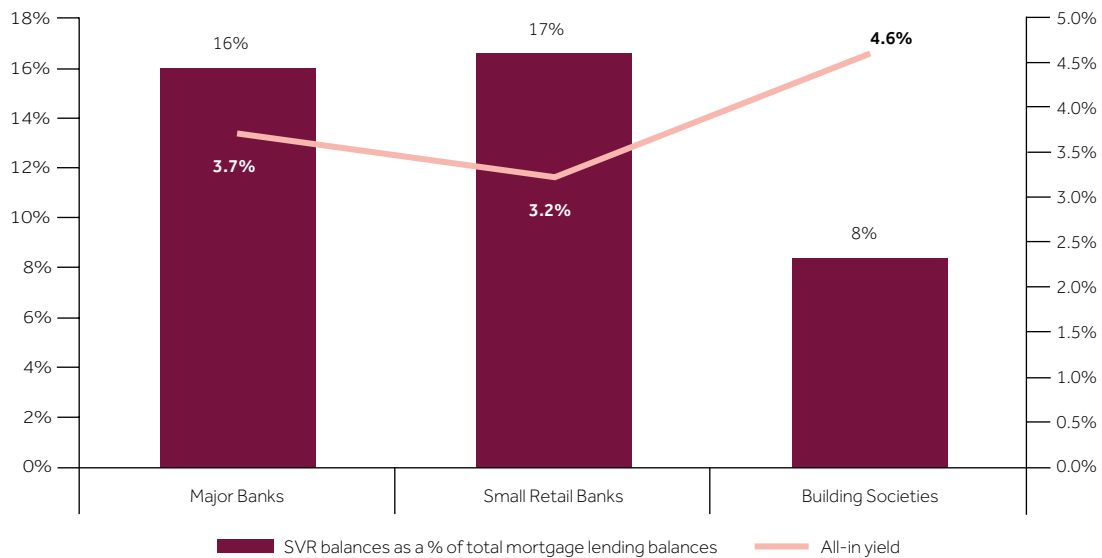
¹⁶ Simple average over 3 years, includes 6 major banks, 6 small retail and 3 building societies.

¹⁷ See CP18/42 Technical Annex: Chapter 8 - Profitability, Section 3.

¹⁸ Strategic Review of Retail Banking Business Models Progress Report, Figure 7.2, pg. 48, 2018, FCA.

3.37 The figure below shows that major banks and small retail banks have a higher proportion of SVR mortgage balances than building societies, with around 16-17% of total mortgage balances on SVR compared to 8% for building societies. However, building societies earned the highest yield on their SVR book at 4.6% compared to major banks at 3.7% and small retail banks at 3.2%.

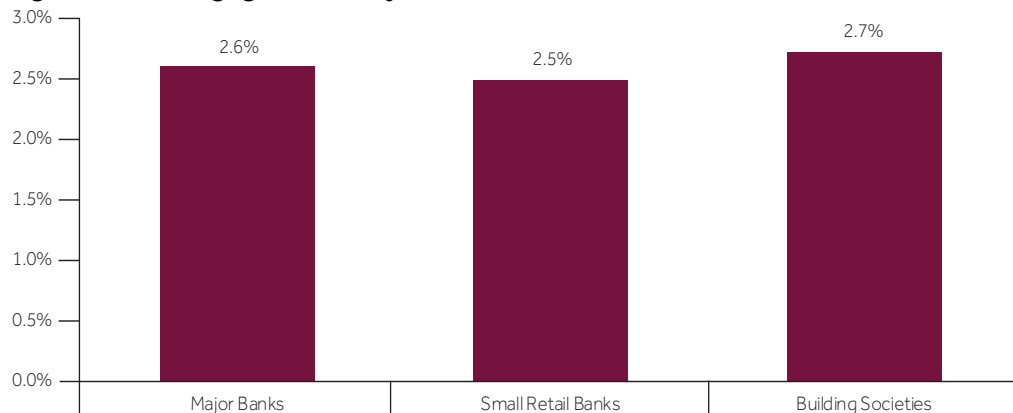
Figure 3.7: SVR Mortgages – Composition and all-in yield (2017)



Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 6 small retail banks, 9 building societies. All-in yield calculated as the sum of gross interest income and fee income divided by average lending balances. Analysis includes both BTL and Owner-Occupied Mortgages.

3.38 We also considered the average all-in yield for the total mortgage book (including mortgages on SVRs, fixed rates and other rate types). The figure below shows that all-in yields for the total mortgage book did not vary significantly between the different firm types, ranging from 2.5% to 2.7%. We conclude that mortgage lending is not a significant driver of the differences in the weighted average all-in yields that we identified in Figure 3.4 at the retail bank level.

Figure 3.8: Mortgages – All-in yield (2017)



Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 6 small retail banks, 9 building societies. All-in yield calculated as the sum of gross interest income and fee income divided by average lending balances. Analysis includes both BTL and Owner-Occupied Mortgages.

3.39 The similarity in the all-in yield on mortgages between different types of firms disguises marked differences in the returns that different banks achieve on mortgage lending once capital is taken into account. We discuss capital requirements for

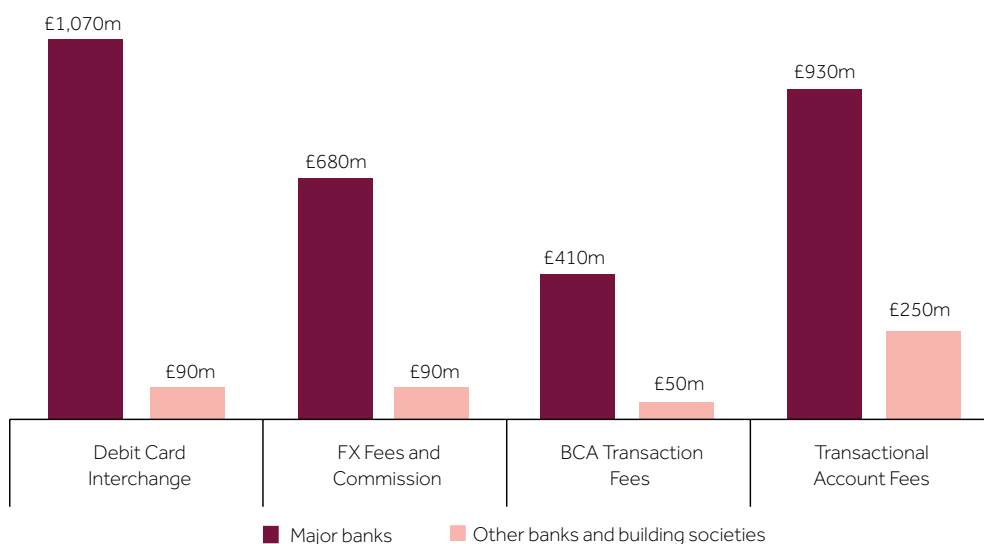


mortgage lending and how these affect return on equity for different types of firms in paragraphs 3.76 to 3.98.

Transactional banking revenues

3.40 As the largest providers of transactional banking, major banks earn substantial revenues 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, transaction charges on business current accounts, and monthly account fees. Figure 3.9 shows the significant revenue pool that these fees and charges generate. Transactional banking also generates some negative revenue, such as the net interchange paid to ATM providers as a result of customers using ATMs, however this is not included in the analysis below.

Figure 3.9: Revenue from transactional banking by type and firm category (2017)

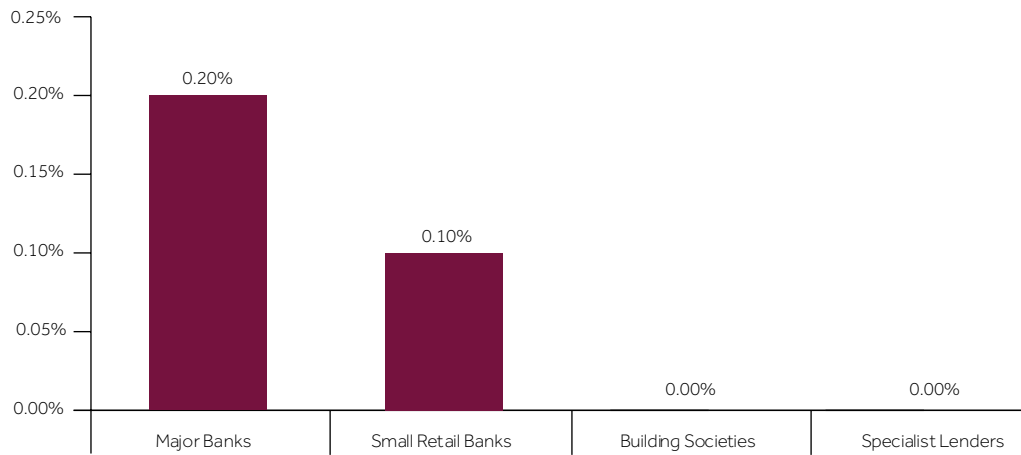


Source – FCA analysis, sample includes 6 major banks and 13 other banks and building societies that earned revenue from transactional banking. Interchange includes revenue from SME and Personal debit card transactions. FX includes fees and commission on foreign payments and transfers. SME transaction fees include charges for manual and electronic transactions through business current accounts. Transactional account fees include monthly charges for personal current accounts (e.g. packaged accounts) and business current accounts. Excludes: ATM interchange, negative revenue, revenue from overdrafts, and direct revenue from ancillary products, such as insurance.

3.41 Major banks earn more from transactional revenues than smaller banks and building societies in absolute terms, and also when scaled as a percentage of lending balances, reflecting the increased scale of their PCA and BCA businesses. The figure below shows direct payments revenues as a percentage of lending balances. Direct payments revenues represented 20 basis points of lending balances for major banks compared to 10 basis points for small retail banks. As expected, building societies and specialist lenders without PCA and BCA businesses do not have this revenue source. PCA banks require relatively little in the way of incremental capital to earn additional payments revenue, because payments are not associated with incremental credit risk.¹⁹ As a result, payments make a modest but valuable contribution to return on capital for PCA providers.

¹⁹ Additional payments revenue could lead to some incremental capital being held in relation to operational risk.

Figure 3.10: Payments revenues as a percentage of lending assets (2017)



Source – FCA analysis, sample includes 6 major banks, 7 small retail banks, 9 building societies, 6 specialist lenders. Includes debit card interchange, FX fees and commission, BCA transaction fees. Excludes transactional account fees, ATM interchange, negative revenue, revenue from overdrafts, and direct revenue from ancillary products, such as insurance.

3.42

Fees on BCAs are significant. Banks typically charge fees per-account and fees per transaction on business current accounts (after the expiry of any initial fee-free period for new business customers). The figure below shows per-account fees on BCAs compared to those on PCAs. On a per-account basis, our analysis shows that fees on an average BCA account were around 10 times higher than those on a PCA.

Figure 3.11: Average revenue earned per customer account (2017)



Source – FCA analysis, sample includes 12 BCA providers, 15 PCA providers. Includes: debit card interchange, ATM interchange, FX fees and commission, packaged account fees, negative revenue, BCA transaction fees, BCA monthly fees. Excludes: revenue from overdrafts.

3.43

Large PCA banks also have a significant share of the BCA market. The market share of the 6 largest providers was 85% in business current accounts.²⁰ Many BCAs are cross-held with a PCA. The CMA's Retail Banking Market Investigation found that around 50% of start-ups took out their BCA with their main current account provider.

20 Retail banking sector: Overview, 2017, FCA.



Cost Drivers

3.44 Having illustrated the differences in yields and cost of funding between business models, we now consider the extent to which there are corresponding differences in operating costs for our business model categories.

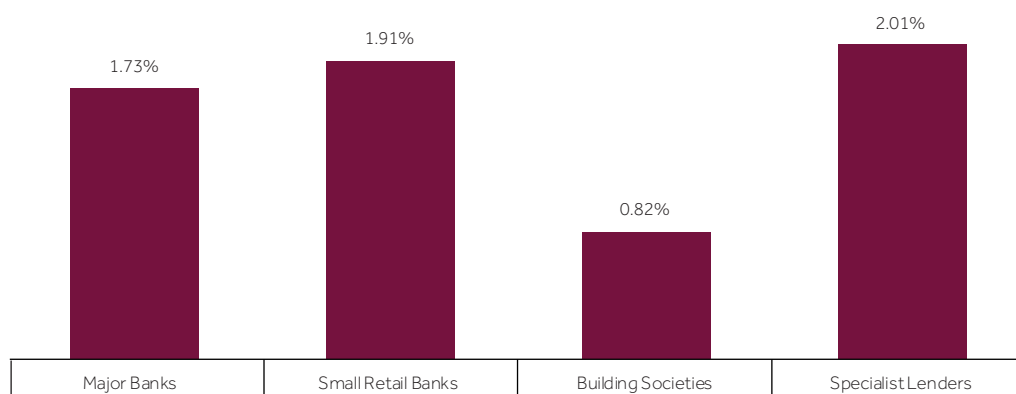
3.45 We examine:

- how the overall cost to asset ratio varies between different types of bank;
- how aspects of the cost base such as branch networks, customer service costs and IT costs differ between different types of bank;
- the relationship between costs associated with the PCA offering and funding cost advantages.

Overall cost asset ratio

3.46 In figure 3.12, we observe, major banks on average have lower costs than small retail banks and specialist lenders as a percentage of lending assets. Building societies have the lowest costs as a percentage of lending assets.

Figure 3.12: Cost as a percentage of lending assets (3 Year Average)

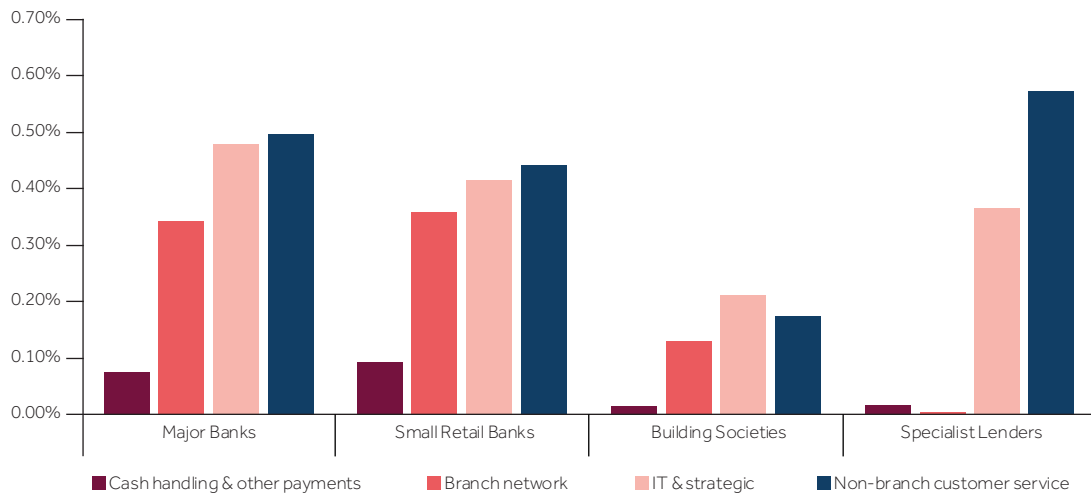


Source – FCA analysis, weighted average for 3 years, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.

Operating Costs are on an underlying basis and do not include costs that are exceptional or one-off in nature as provided by firms. We have employed operating costs to average lending assets as the primary metric for cost analysis as it controls for size and is less sensitive to funding and loan book composition (as is the case with a cost to income metric).

3.47 To understand some of the drivers of differences in costs between business models we asked firms to allocate costs into four areas: Cash Handling and Other Payments; IT and Strategic; Branch Network; and Non-branch Customer Service (including marketing, communications and the costs of customer service other than in-branch). Figure 3.13 shows that major banks and small retail banks have higher costs in payments, branch networks and IT than building societies and specialist lenders. Specialist lenders tend to allocate a high proportion of their cost base to non-branch based customer service and marketing, reflecting the bespoke lending that these firms undertake and the lack of branch networks.

Figure 3.13: Operating Costs as a % of Lending Assets (3 Year Average)



Source – FCA analysis, weighted average for 3 years, sample includes 5 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.
Operating Costs are on an underlying basis and do not include costs that are exceptional or one-off in nature as provided by firms.

3.48 Other costs not included in this figure: central costs such as HR, treasury, finance, risk and legal; non-branch property costs; the costs of fraud; and the FSCS levy. We have not examined these areas in detail.

3.49 In the following sections, we discuss branch costs, the costs of cash and payments, and IT systems costs in further detail. We note the following:

- Branch network costs remain a significant proportion of industry costs. Major banks spend more on a cost-per-branch basis than other types of firms. Total branch costs are falling as banks close branches.
- Costs of cash handling and other payments related costs, including the costs of operating ATM networks, are a relatively small proportion of banks' cost bases.
- IT systems and related IT investment costs are a large percentage of total cost base.

Branch networks

3.50 The traditional banking model has involved extensive branch networks – often in prime retail locations – and large numbers of UK-based customer service advisors in branches and call centres. These models have served banks well in the past, as historically customers have been attracted by branch presence when opening a bank account. Banks have traditionally required customers to visit branches when opening accounts and customers have needed to visit branches to transact. Banks have also been able to use branches to sell lending and other products.

3.51 As discussed in paragraph 2.11 and Annex 1, branch usage is declining. Most banks have reduced the size of their branch networks significantly over the years. Over the period 2012-2017 banks have closed 3,114 branches or around 24% of the network.²¹ The cost of the branch network for the 6 major banks has fallen by around 6% over the 3-year period to 2017. This relatively small cost reduction is consistent with banks

21 Source: FCA analysis of Experian Shop*Point data.

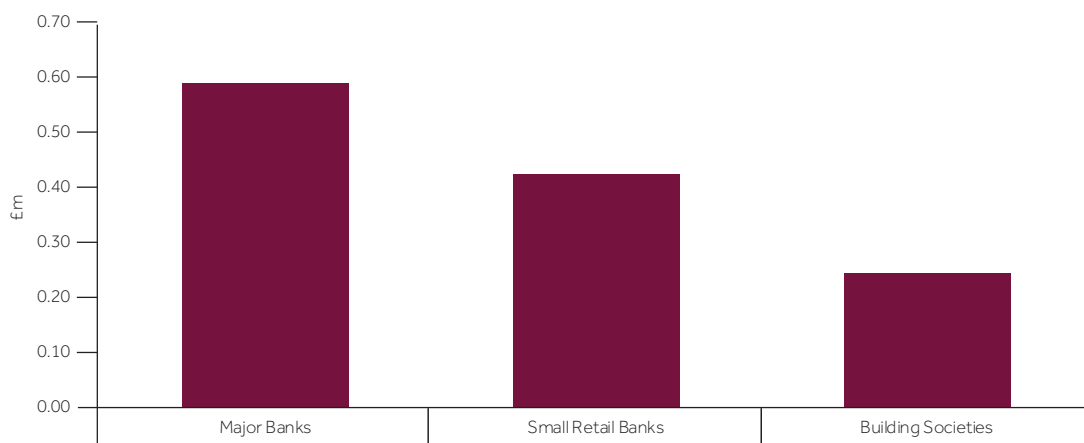


spending money on improving their remaining branches and on one-off rationalisation and closure costs.

3.52 Despite the decline in branch numbers, the firms in our sample²² spent a total of around £4.4bn on their branch networks in 2017. Major banks and small retail banks spent an average of 21% of their total cost base on operating their branch networks, and building societies spent an average of 16%.²³ Most specialist lenders and digital banks do not incur branch costs at all.

3.53 On a per-branch basis, annual operating costs appear to vary widely between firms. The figure below shows average costs per branch for 2017 for different firm types. Building societies had the lowest costs per-branch at around £240,000. Major banks and small retail banks had significantly higher average costs per-branch at £590,000 and £420,000 respectively.

Figure 3.14: Average Cost per Branch (2017)



Source – FCA analysis, weighted average for 3 years, sample includes 6 major banks, 7 small retail banks, 9 building societies.

3.54 Major banks and small retail banks higher costs per-branch are consistent with established high street banks having more branches in costlier locations and having larger, more prestigious sites than building societies. Building societies may be more likely to have cheaper 'shop front' style branches in cheaper locations, consistent with their significantly lower costs per branch.

3.55 As banks continue to shrink their branch networks, there is scope for branch costs to fall further. There is a limit to this, given many customers of traditional banks continue to value branches as a channel. Traditional banks are likely to face higher costs in this area for the foreseeable future, compared to digital-only business models that do not incur branch costs.

Cash, ATMs and other payment costs

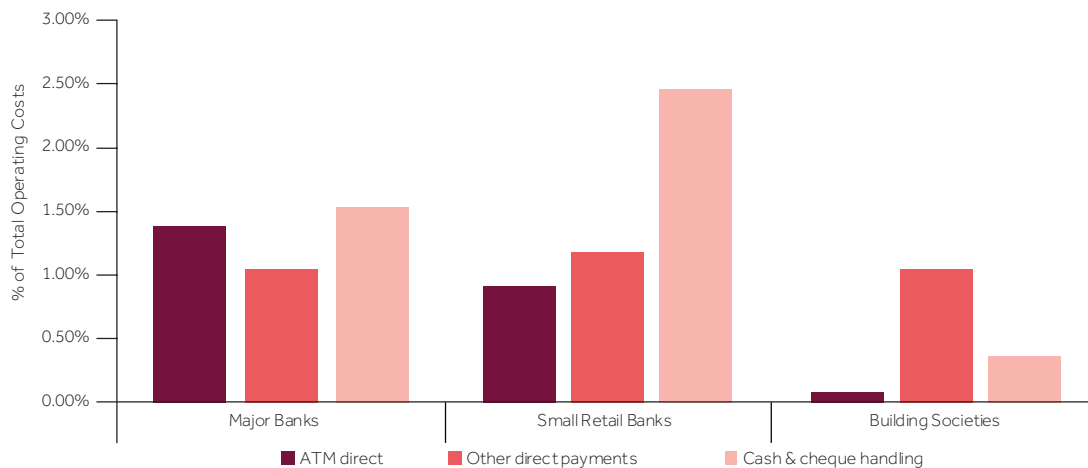
3.56 We asked banks to provide us with information about the direct costs of cash handling, including the costs of cash, ATMs, and payments handling. Based on this information, these costs represent around 4% of the overall cost base for major and small retail banks. They do not include indirect or allocated costs such as the costs of branch staff involved in handling cash.

22 Sample includes 6 major banks, 9 Building Societies, 7 small retail and 8 Specialist Lenders. There is a significant dispersion in costs between banks which could be due to differences in cost allocation. We report weighted averages. Branch costs include staff and rental costs.

23 Ibid.

3.57 Cash, ATM and payments costs unsurprisingly fall more heavily on banks with PCAs and BCAs. The figure below shows a breakdown of these costs as a percentage of total operating costs. Figure 3.15 shows a breakdown of these costs by category and a comparison by firm type.

Figure 3.15: Breakdown of Cash, ATM and Other Payment Costs (3 Year Average)



Source – FCA analysis, weighted average for 3 years, sample includes 5 major banks, 7 small retail banks, 8 building societies. We also note that ATM interchange is often a negative revenue for firms, this has not been included in the figure above but would equate to values between 0-2% of total costs.

IT systems

3.58 Legacy IT systems are often cited as being a burden on large banks.²⁴ We asked firms to tell us their IT running costs and the costs of implementing strategic initiatives to change IT systems. Overall, we found that these costs made up between 18-26% of total operating expenses.

3.59 When considered as a percentage of lending assets, IT running costs are higher for major banks and small retail banks with PCA networks than for building societies and specialist lenders. These costs were around 0.4%-0.5% of lending balances for major and small retail banks. Building societies had the lowest cost to asset ratio at 0.2%.

Figure 3.16: IT Costs and Strategic Initiatives as % of Lending Assets (3 Year Average)

| | Building Societies | Major Banks | Small Retail Banks | Specialist Lenders |
|---|--------------------|-------------|--------------------|--------------------|
| IT Cost and Strategic Initiatives as % Lending Assets | 0.2% | 0.5% | 0.4% | 0.4% |

Source – FCA analysis, weighted average for 3 years, sample includes 5 major banks, 8 small retail banks, 7 building societies, 9 specialist lenders.

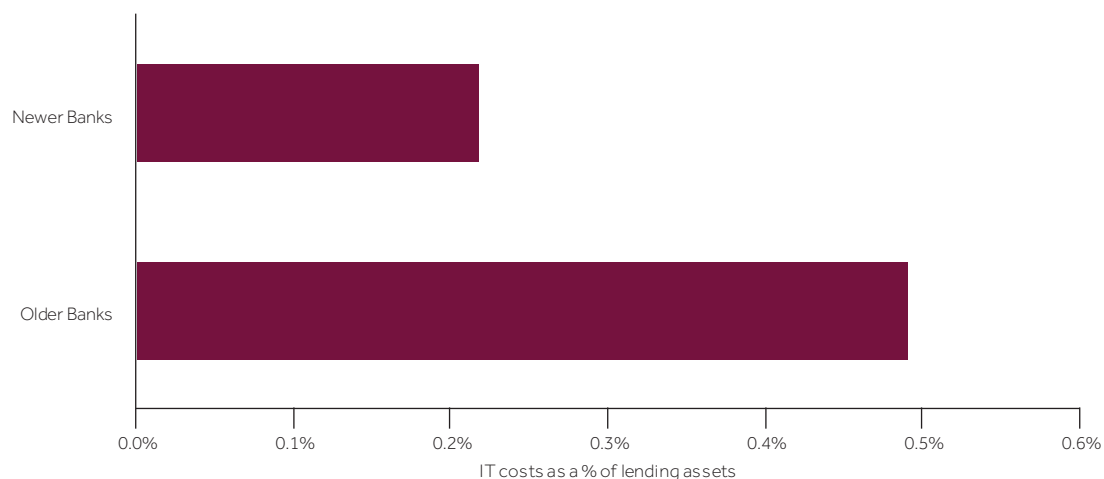
3.60 To get a sense of the scale of IT costs that might be regarded as 'one-off' restructuring or reconfiguration costs compared to business-as-usual costs, we asked banks to split out the costs of strategic change initiatives from general IT spend. From the data supplied, we find that the costs of strategic change are significant for major banks. Over the last 3 years, 4 major banks have incurred at least £680m on strategic change areas such as reconfiguring and rationalising IT systems; improving cyber resilience; and development of digital propositions including those involved with PSD2 and Open Banking.

24 See for example: The Telegraph, 'Banks face continued IT woes as legacy infrastructure holds them down' (2018).



3.61 We also investigated the link between IT costs and the age of the bank. figure 3.17 compares IT costs for a sample of banks segmented by date of incorporation. The older cohort of firms were incorporated before 1993 (i.e. more than 25 years ago) and the newer firms after this date and now in a mature or steady state business model. Newer banks have lower IT costs as a proportion of lending assets at 0.2% compared to older banks at 0.5%.

Figure 3.17: IT and Strategic Initiatives Operating Expenditure (3 Year Average)



Source – FCA analysis, weighted average for 3 years, sample includes 10 Older banks and 6 Newer banks.

3.62 Our analysis supports the view that legacy bank IT systems can be burdensome and costly to change. New digital banks don't have these legacy structures, or the associated costs.

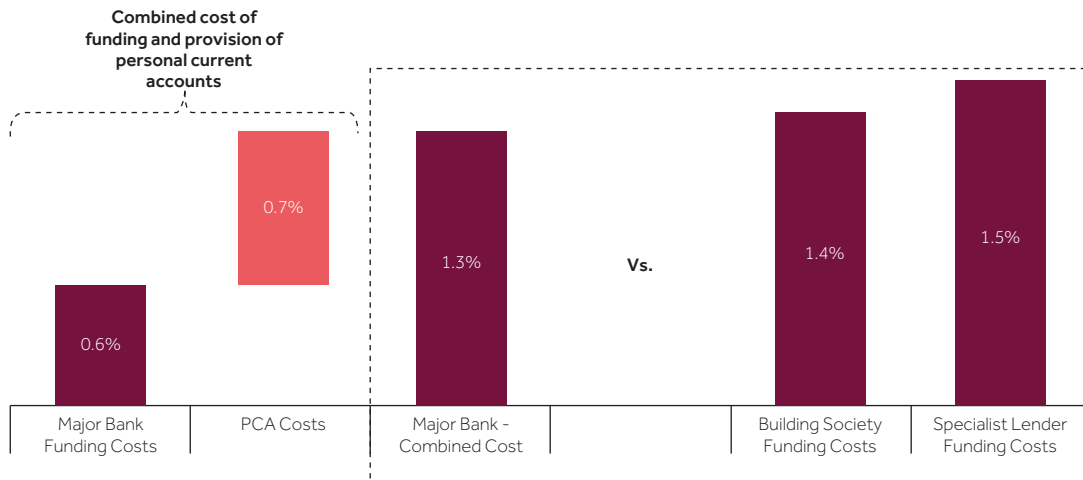
Funding costs and transactional banking relationship

3.63 In our Progress Report, we said that we wanted to determine to what extent the costs of providing transactional banking offset the funding cost advantage achieved by current account providers. Large PCA providers obtain much, but not all, of their funding from PCA balances and associated instant access savings accounts that are opened alongside a PCA. There is thus some logic to looking at the combined cost of funding, including the costs of operating the PCA as a 'funding channel'.

3.64 Data from 4 major banks indicates that the cost of providing PCAs is approximately 35% of total operating costs, or 0.7% of average lending assets. In allocating costs to the provision of PCAs, banks have had to assess the extent to which the cost of the branch network, payments, customer service, IT and operations are attributable to providing current accounts. Banks told us that there was a degree of judgement in this exercise. Nevertheless, we found that for the four banks that provided an allocation of operating costs, the results were relatively consistent, ranging from around 25 to 40%.

3.65 We observe in figure 3.18 that when the allocation of PCA operating costs is added to total funding costs, major banks' combined funding costs are between 10-20bps lower than those of building societies and specialist lenders.

Figure 3.18: Combined funding cost and PCA costs as % lending assets (2017)

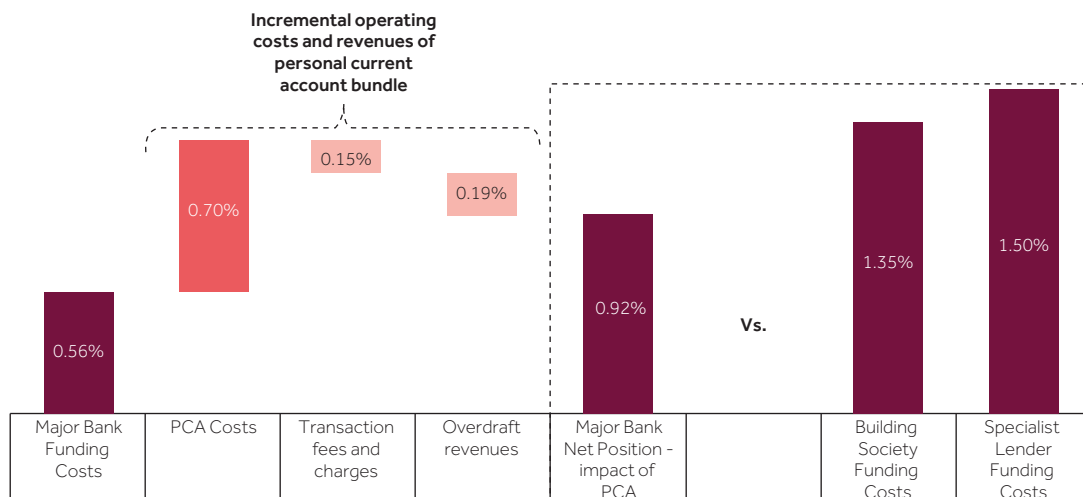


Source – FCA analysis, weighted average for 2017, sample includes 4 major banks. Costs expressed as a percentage of average lending assets. Major banks funding costs at 0.6% differ from Figure 3.20, due to a smaller sample size and different time period.

3.66 The above comparison suggests that major PCA providers obtain a funding cost advantage from providing PCAs even after taking into account the operating costs of running the transactional banking business.

3.67 To consider a more complete picture of PCA economics (Figure 3.19) we also added in the revenues that major banks earn from transactional fees and charges and overdrafts (net of any impairment costs). This increases the net advantage of running the transactional banking business to between 40-60 bps. We acknowledge we have not included all costs associated with running the PCA such as the costs of any additional capital employed, but would not expect these to significantly alter the picture.

Figure 3.19: An illustration of the net impact of personal current accounts (2017)



Source – FCA analysis, weighted average for 2017, sample includes 4 major banks. Costs expressed as a percentage of average lending assets. Major banks funding costs at 0.6% differ from Figure 3.20, due to a smaller sample size and different time period.



Return on capital

3.68 In this section we consider the underlying profitability of different retail banking business models, looking at return on assets and return on equity. We consider underlying returns here as the returns from ongoing retail banking activities, excluding business lines in wind-down, as well as exceptional costs and revenues such as fines and gains from asset sales. The analysis is intended to demonstrate some of the key factors driving differences in returns across business models. It may not reflect a complete picture of the returns each retail bank or building society earns in practice, because some costs and benefits that could be attributable to retail banking activities may have been excluded from the numbers by some larger banking groups.²⁵ The analysis illustrates returns at a point in the economic cycle in which interest rates are low and credit impairment is low – long-term returns may differ.

Return on assets (ROA)

3.69 Major banks have a higher underlying return on retail lending assets than small retail banks and building societies. The table below shows 3-year average return on assets for different firm types. Major banks' average return on assets was 1.1% over the period, compared to 0.3% and 0.5% for small retail banks and building societies, respectively. This is primarily a result of higher lending yields – a greater proportion of unsecured lending and higher yields on that lending – and significantly lower funding costs. Specialist lenders have a different lending mix to other business models, and earn a relatively high return on assets at 2.3% despite having high funding and operating costs in comparison to other business models.

Figure 3.20: Underlying return on retail lending assets (3 Year Average)

| | Major Banks | Small Retail Banks | Building Societies | Specialist Lenders |
|---|-------------|--------------------|--------------------|--------------------|
| Underlying return on average retail lending assets | | | | |
| Lending yield | 3.7% | 3.3% | 3.1% | 6.3% |
| Cost of funds | -0.8% | -1.0% | -1.6% | -1.7% |
| Additional fee income | 0.3% | 0.2% | 0.0% | 0.0% |
| All-in margin | 3.2% | 2.4% | 1.5% | 4.6% |
| Loan loss ratio | -0.2% | -0.2% | 0.0% | -0.3% |
| Underlying Costs | -1.7% | -1.9% | -0.8% | -2.0% |
| Other income / Expenditure | -0.2% | -0.1% | -0.1% | 0.0% |
| Underlying return on lending assets | 1.1% | 0.3% | 0.5% | 2.3% |

Source – FCA analysis, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.

Figures in the table may not sum to the all-in margin 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 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.

²⁵ For example, some costs associated with wholesale funding and liquidity management, some shared Group operating costs, and some costs associated with holding capital to meet leverage requirements may have been excluded by certain firms.

Underlying return on equity (ROE)

3.70 To understand the profitability of different business models we now consider the amount of equity capital each requires. We have estimated the RWA density of different business models using firms' data on credit and operational risk weighted assets associated with their retail banking business. We have assumed a ratio of equity to risk-weighted-assets (RWAs) based on observed industry data.²⁶ 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. This is discussed in more detail later in this section.

3.71 Major banks and specialist lenders make a higher underlying return on risk-weighted assets and return on equity than small retail banks and building societies. As can be seen from the table, major banks' and specialist lenders' underlying ROE was 26-28% compared to 6% and 11% for small retail banks and building societies respectively.

3.72 The difference in ROE between major banks and small retail banks is perhaps of most interest since these business models are broadly comparable. ROE for building societies is difficult to compare with other firms because building societies make distributions to members through higher savings rates (and hence make lower NIMs) whereas a bank must remunerate shareholders through dividends and capital appreciation funded out of ROE.

Figure 3.21: Estimated underlying return on equity (3 Year Average)

| | Major Banks | Small Retail Banks | Building Societies | Specialist Lenders |
|---|-------------|--------------------|--------------------|--------------------|
| Underlying return on equity | | | | |
| Estimated total RWA density | 26% | 33% | 29% | 58% |
| Underlying pre-tax return on risk-weighted assets (RoRWA) | 4.4% | 0.8% | 1.9% | 3.9% |
| Underlying pre-tax return on equity (ROE) assuming equity is a minimum of 15% of RWAs and each firm meets minimum leverage requirements | 28% | 6% | 11% | 26% |

Notes:

Estimated total RWA density is calculated as total RWAs/total lending assets. Includes assumptions about the size of RWAs relating to operational risk.

3.73 The higher underlying ROE for major banks relative to small retail banks is achieved by earning higher yields (usually associated with higher risk lending) whilst maintaining a lower RWA density. The lower RWA density also magnifies the impact of lower funding costs on returns.

3.74 Building societies have the lowest all-in margin of any category, reflecting their focus on mortgages and higher funding costs (which may be partly a result of paying higher savings rates as a 'member dividend'). They are nonetheless able to earn double digit underlying returns on equity due to a low cost to asset ratio and relatively low RWA density, compared to small retail banks.

26 Banking Sector Regulatory Capital, 2018 – Q2, Bank of England.



3.75 Specialist lenders achieve similar underlying return on equity to major banks but through a very different model, which relies on a high yield lending. In this model, high funding costs, and operating costs are overcome by high yields on lending.

Impact of Capital Requirements

3.76 The levels of equity capital that banks are required to hold influence their return on equity. Since for the same level of profit, a lower level of equity results in a higher return on equity. In general equity funding also is much more expensive for banks than retail or wholesale debt funding.

3.77 The PRA sets out a framework for bank capital requirements. As set out in a letter to the TSC from the PRA,²⁷ capital requirements are subject to several factors: i) risk based capital requirements and the approach to calculating risk weighted assets, ii) minimum leverage ratio, iii) the diversity and risk profile of a firm's lending assets and, iv) additional capital buffers under the Pillar 2 framework and CRDIV/CRR.

3.78 We consider the impact of these various factors below, narrowing our analysis to those areas that materially drive differences in capital levels. We would like to highlight that as with the preceding sections, Nationwide has been included with Major Banks.

i) Impact of different approaches to credit risk weightings

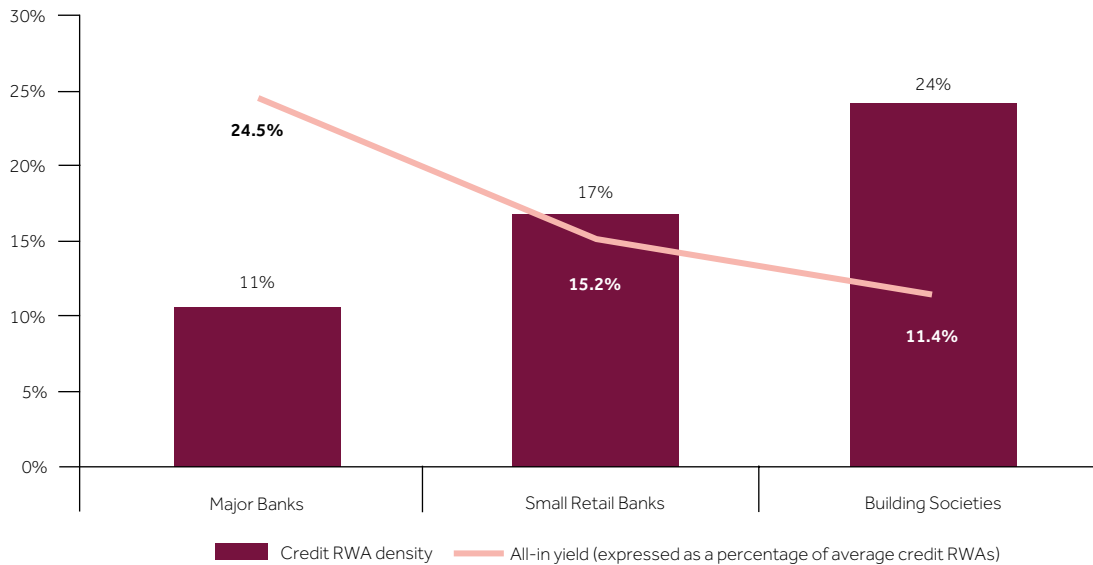
3.79 Larger banks predominately use their own internal models under the Internal Ratings Based approach (IRB) to determine credit RWAs, with smaller institutions generally applying prescribed risk weightings under the Standardised Approach (SA). We note that within the firm cohorts there is a mixture of IRB and SA firms and for IRB firms not all asset classes employ IRB to determine RWAs. As observed in figure 3.22 these differences in approach influence the lower risk weightings for major banks in mortgages.²⁸

3.80 Lower risk weights increase major banks' returns on mortgages compared to small retail banks and building societies. While mortgage yields are comparable across business models (see paragraph 3.38), when compared to credit risk weightings, mortgage lending yields are significantly higher for major banks. Figure 3.22 shows that mortgage lending yields as a percentage of risk weighted assets were 24.5% for major banks, compared to 15.2% and 11.4% for small retail banks and building societies, respectively in 2017.

27 The Bank of England: Letter to Rt Hon Andrew Tyrie MP Chairman, 2016.

28 Differences in the risk profile of the lending activity also influence credit risk weightings.

Figure 3.22: Mortgages – Credit RWA density and all-in yield (2017)



Source – FCA analysis, weighted average for 2017, sample includes 6 major banks, 6 small retail, 9 building societies. Credit RWA density calculated as average Credit RWAs divided by average lending balances. Based on mortgage credit RWAs as provide by firms. 6 Major Banks, 2 Building Societies and 3 Small Retail Banks within the sample employ IRB in 2017. All-in yield calculated as the sum of gross interest income and fee income divided by average Credit RWAs. Nationwide has been included in Major Banks. Analysis includes both BTL and Owner-Occupied Mortgages.

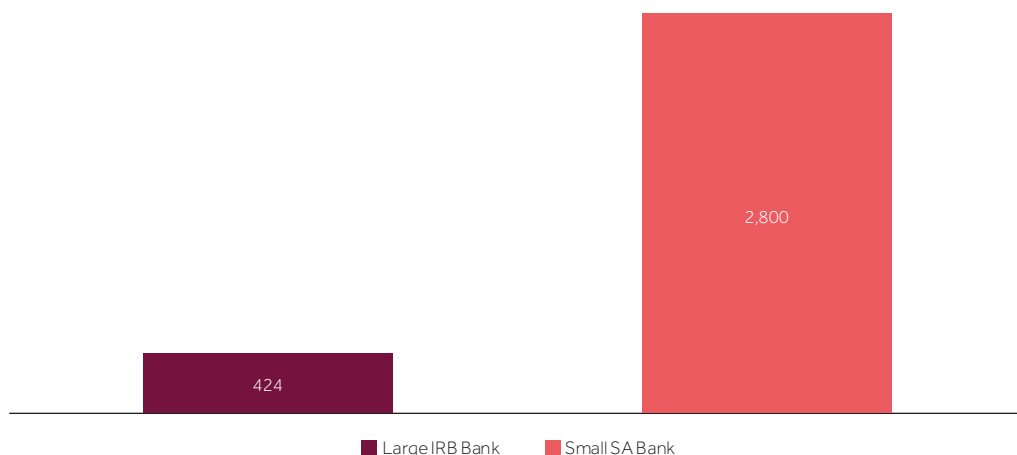
3.81 The Bank of England and the CMA have noted that the advantage IRB firms have in risk weightings is particularly acute in low LTV residential mortgages.^{29,30} The standard approach fixes the risk weighting at 35% for residential mortgages below 80% LTV.³¹ However, risk weightings for IRB firms positively correlate with LTV (i.e. lower LTVs equate to lower risk weights).

3.82 The advantage IRB firms have is at its greatest in low LTV bandings. As an example, for a mortgage with an LTV below 50%, IRB modelled risk weights are between 4.5% and 6.1%.³² Below in figure 3.23 we demonstrate the impact of these lower risk weights on the amount of capital required for a £100,000 residential mortgage (assuming leverage is not a constraining factor, covered separately below). This shows that a SA firm would have to hold close to 7 times the amount of capital for the same loan (based on the pillar 1 requirements for capital). Common buffers that are required of all deposit takers (Capital Conservation Buffer and Counter Cyclical Buffer) would further exacerbate this difference because they are based on a % of risk weighted assets.

29 Refining the PRA's Pillar 2A capital framework, 2017, Bank of England.
30 Retail banking market investigation final report, Appendix 9.3, 2016, CMA.
31 Refining the PRA's Pillar 2A capital framework, 2017, Bank of England.
32 Ibid.



Figure 3.23: Estimated Pillar 1 capital required for a £100,000 loan, LTV below 50% (£)



LTV below 50%.
Based on Pillar 1 requirements only.
IRB Risk Weights based on Bank of England analysis.
IRB credit risk weighting based on mean of 5.3%, SA credit risk weighting of 35%.

3.83 Controlling for the approach to determining credit risk weightings alone, we see it likely takes primacy in explaining the differences in mortgage credit risk weightings between firms (above factors such as average LTV).

3.84 Focusing solely on this advantage in determining risk weighted assets, we see IRB firms have an incentive to focus their lending in low LTV mortgages where their capital advantage is greatest. Conversely, it means SA firms might be inclined to compete in the higher LTV bandings (or other higher risk consumer credit products), where their required risk weightings are closer to those of IRB firms. For example, the comparative advantage is lower in LTVs between 80% and 90%, IRB weightings vary from 19.1% to 25.8% compared to SA weightings of 36%.³³

3.85 A number of firms, including some of those in our data samples, have moved from the SA to IRB during the period of this review. However newer firms find that meeting the requirements for IRB permissions is particularly challenging due to their size, limited historical data and resource constraints. As discussed further below, the PRA is taking steps to address these issues.

ii) Minimum leverage ratio requirement

3.86 Under leverage ratio requirements,³⁴ 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. Smaller firms' disclosure requirements create a market and regulatory expectation that they also hold capital in excess of the prescribed minimum. 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.

3.87 We see this with Building Societies that employ IRB modelling, where the average 2017 CET1 ratio at 34%³⁵ is much higher than the sector average of 15%. These firms are

³³ Refining the PRA's Pillar 2A capital framework, 2017, Bank of England.

³⁴ Ibid.

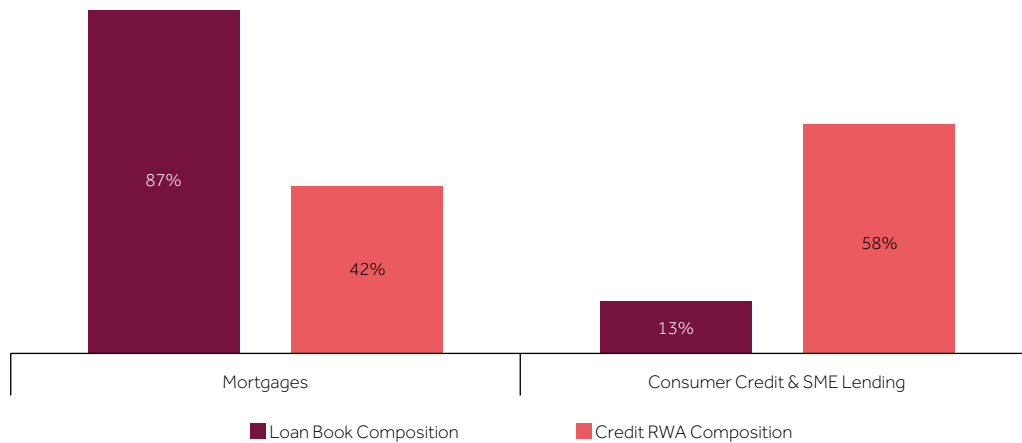
³⁵ Based on a balance weighted average of 2 building societies for 2017.

likely to hold equity well in excess of minimum Pillar 1 and 2 capital ratio requirements but need to do so in order to meet the constraints put on them by minimum leverage requirements. Other factors will affect the level of CET1 held by Building Societies including their more limited access to capital markets.

iii) Benefit of loan book diversity in overcoming leverage constraints

3.88 To avoid having to hold more capital than is necessary against low risk lending, major banks diversify to include lending with higher risk weights (including consumer credit and SME lending) in their lending portfolios. The figure below shows the relative proportion of major banks' loan books and credit RWAs made up by mortgages and consumer credit, demonstrating this point. Consumer credit and SME lending makes up 13% of major banks' loan books on average but comprises 58% of credit RWAs.

Figure 3.24: Major Banks – Make up of Loan Book and Credit Risk Weightings (3 Year)



Source – FCA analysis, 3 year weighted average, sample includes 6 major banks.
Mortgages includes each firms' portfolio of residential and BTL mortgages, inclusive of all LTV bands.

3.89 This helps to explain why the blended risk weighting of major banks when viewed across their total lending portfolio at 26% is much higher than that of mortgages alone. The blended rate is still over 7pps lower than that of small retail banks (33%) and 3pps lower than building societies (29%).

3.90 As a result of the preceding factors, we see that Major Banks 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. Building Societies are constrained by having to hold the majority of their lending assets as mortgages. Newer banks in particular are likely to find adding new business lines, which require different expertise and consume material amounts of capital, challenging, when placed on top of the considerable efforts needed to gain IRB permissions in the first place.

3.91 Optimising capital to meet leverage requirements is a delicate balance and has an impact on banks' willingness to compete. For example, if mortgage portfolios were to grow faster relative to other lending types, the diversity benefit they currently receive from consumer credit and SME lending in overcoming leverage constraints would quickly erode.



iv) Additional requirements

- 3.92** There are other factors that to some extent erode the capital advantage major banks and other IRB firms have in mortgages. First, major banks hold higher levels of operational RWAs related to higher levels of non-lending and transactional income. Under TSA methodology for the calculation of operational risk, payments-related income streams attract an up-lift in RWA requirements relative to other retail bank income streams.
- 3.93** Second, larger firms are often captured by the buffer for Globally Systemic Important Banks (G-SIB, phased in until 2019) and the Systemic Risk Buffer (SRB, applicable from 2019).
- 3.94** Third, PRA buffer applies to all retail banking institutions but for systemically important firms the PRA holds them to a higher standard given the potential impact of their failure on the wider economy.³⁶
- 3.95** We note that additional buffers calculated as a percentage of RWAs may increase large banks' incentive to specialise in low risk lending. Lowering the firms risk weighted assets through changes in the makeup of the loan book can to some extent soften the impact of higher capital ratio requirements (where those requirements are measured in relation to risk weighted assets).
- 3.96** Some buffers also carry additional leverage ratio requirements, that are scaled with the corresponding RWA requirement, so that a firm with a 1% G-SIB buffer will have to hold an additional leverage ratio buffer of 0.35%. This acts as an additional constraint.
- 3.97** The minimum requirement for own funds and eligible liabilities (MREL), being phased in by the Bank of England from January 2019, could also impact the amount of regulatory capital held by firms. In particular, if some firms are unable to issue MREL eligible liabilities, or there is a lack of investor demand for such instruments, those firms may face pressure to meet MREL through retained earnings.
- 3.98** We have focused in this section on the additional requirements of larger banks as required by capital adequacy regulation however smaller institutions face pressure to hold higher levels of capital than necessarily prescribed by Pillar 2/CRDIV. There are several reasons for this including the need to demonstrate solvency to potential and existing shareholders, in order to access wholesale funding at reasonable rates and to mitigate capital access issues that might present themselves during a period of economic downturn.

Conclusions on impact of capital requirements

3.99 In summary, we find that:

- IRB banks and building societies are able to hold significantly lower RWAs in low risk mortgages than other banks;
- This advantage is not fully offset by leverage constraints as large banks benefit from diversifying their loan books;
- Many larger banks have to hold more capital relative to RWAs due to additional buffers, but because they hold lower levels of RWAs, large IRB banks still have a

³⁶ See correspondence between Mark Carney and Rt Hon Andrew Tyrie MP, 5 April 2016.

capital advantage. This is an important driver of the higher return on equity that they achieve relative to smaller banks and building societies.

3.100 The Bank of England and the CMA have noted the advantage IRB firms have in risk weightings in low LTV residential mortgages.³⁷ The Bank is undertaking the following initiatives to reduce the distortive effect this has on competition in retail banking:

- Refinement of Pillar 2A (the PRA has proposed adjusting Pillar 2A to address differences in risk weighting approaches (see SS31/15) for SA firms).
- Supporting smaller firms through the IRB approval process.³⁸
- In conjunction with BCBS, the finalisation of Basel 3 which includes output floors on IRB modelled risk weightings at the firm level. These output floors will require IRB risk weightings to equate to (at a minimum) 72.5% of the equivalent risk weight under the Standardised Approach.
- In addition, mortgage risk weightings under the Standardised Approach are to scale in line with increases in LTVs.³⁹ This should improve incentives for smaller firms to compete in lower LTV mortgages as the capital they hold will be more commensurate with the underlying credit risk.

Comparing return on equity between major banks and small retail banks

3.101 In this section we consider the reasons for the difference in return on equity between major banks and small retail banks. IRB banks achieve capital advantages by combining a diverse and relatively high yielding loan book with low credit risk weights for mortgages. This can be seen when comparing the underlying return on equity of major banks and small retail banks. Major banks can achieve a higher yield at the same time as holding less capital, contributing to a significantly higher ROE than small retail banks and building societies.

3.102 In Figure 3.25, reading left-to-right, we first show the impact on ROE of increasing the lending yield of small retail banks to match that of major banks, whilst maintaining the same leverage. The same approach is then applied to funding costs, fee income, operating costs, and other components of return on assets. Finally, we show the impact of applying higher leverage to this model. The impact on ROE of increasing leverage is magnified by the choice to first increase yield and lower funding costs, etc. Had we first shown an increase in leverage, whilst holding other factors constant, the increase in ROE would have been lower, whilst the impact of increasing yield would have been higher. This highlights the fact that a higher yield or lower funding costs are worth more (in terms of ROE) to a more highly levered business model.

3.103 In practice, a bank is unlikely to be able to increase its lending yield without impacting other factors. Typically, higher yields are associated with higher risk lending, and therefore higher capital requirements and lower leverage. As such, Figure 3.25 represents the combined impact of several significant business model differences (including lending mix, RWA modelling), rather than a series of isolated steps that could be achieved in practice.

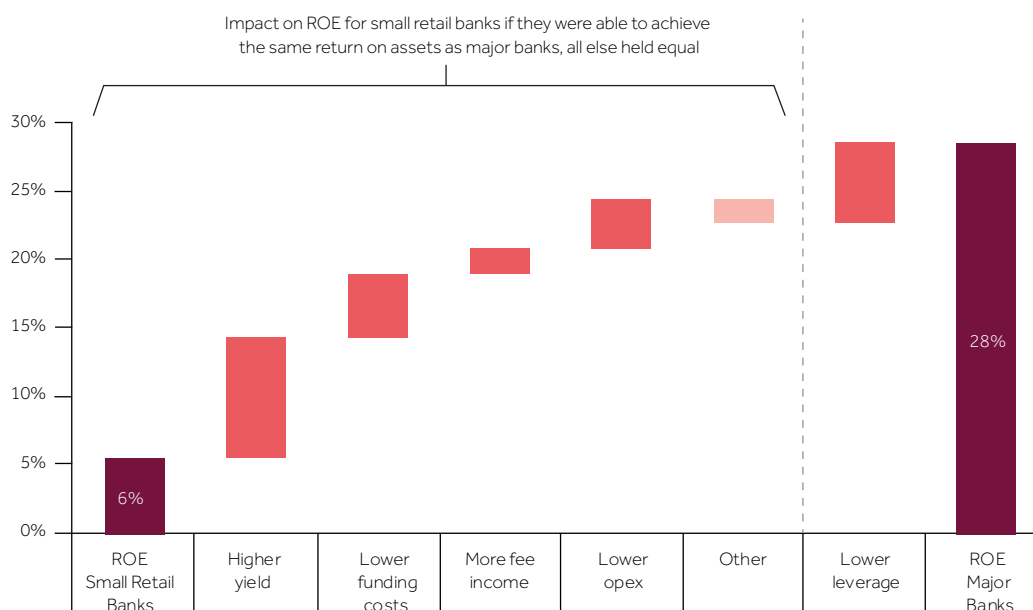
37 Refining the PRA's Pillar 2A capital framework, 2017, Bank of England; Retail banking market investigation Final report, Appendices 7.1 to 10.2, 2016, CMA.

38 PRA Competition Report, 2017, Bank of England.

39 High-level Summary of Basel III Reforms, 2017, Basel Committee on Banking Supervision.



Figure 3.25: Differences in underlying return on equity between small retail banks and major banks (3 Year Average)



Source – FCA analysis, sample includes 6 major banks, 7 small retail banks, 9 building societies, 7 specialist lenders.
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.

A note on digital banks

- 3.104** A small number of digital-only banks participated in this review and provided us with data and information about their businesses. We have not generally reported these data in our figures and tables because the very early stage of these businesses means that it is difficult to interpret the financials or compare them with more established business models. To the extent possible, we make some general observations about these business models below.
- 3.105** Our analysis shows that digital only banks have significantly lower average deposit balances than more established banks. This reflects that customers of these banks often retain their main bank account with their existing provider and use the new account as a subsidiary account for making payments, thus getting the benefit of the functionality but without having to make a full switch.
- 3.106** These banks are currently in a high growth phase and are spending heavily on customer acquisition and investment in systems and infrastructure development. These costs are expensed but could be viewed as a long-term investment. If restated on this basis, this would reduce any reported losses significantly.
- 3.107** On a cost per account basis the underlying costs of these banks currently look broadly similar to those of larger banks, although they are falling rapidly as account numbers grow. If digital banks can continue to grow their customer bases without incurring significant additional investment they could reduce their cost per account to a level that is well below that of larger banks. This could be possible because they have modern scalable IT systems, do not have significant branch networks and call centres, and currently have a limited number of services with fewer features.



3.108 If digital banks can keep their costs down whilst also increasing customer numbers and growing balances, this could help them to counter some of the advantages that larger banks have in terms of funding costs, scale and capital.

3.109 In the following section we discuss the prospects for new business models, including digital banks and non-bank providers, to grow in the future by capturing customer relationships and encouraging customers to switch services. Providing enhanced and innovative customer experiences based on data analytics is likely to be key to this, and digital banks seemingly have an advantage here. Whether this advantage is sustainable or whether larger banks catch up in time could be key to their long-term success.



4 Fintech revolution? Or incumbent evolution?

- 4.1** In this section we consider scenarios for the future of the retail banking industry, drawing on our business model analysis and conversations with industry and consumer stakeholders at our September 2018 Conference on the Future of Retail Banking.
- 4.2** We explore the potential for different types of scenarios to arise in retail banking, including:
- Banks as Utilities: scenarios in which 'disintermediation' of retail banking occurs so that traditional deposit takers and lenders start to lose direct relationships with customers.
 - The Big Switch: scenarios in which increased switching of deposit taking and lending products results in established banks losing market share to other firms.
 - Platform providers: scenarios involving large platform providers entering the retail banking market with business models that involve disintermediation and/or a full retail banking proposition.
 - Gradual evolution: scenarios in which the market remains largely unchanged, switching remains at low levels and new business models fail to gain significant traction.
 - Waterbed: scenarios involving banks losing transactional revenues or deposit and lending volumes but raising charges to a smaller group of less engaged customers.
- 4.3** Gradual Evolution and Waterbed scenarios are considered under the heading 'The Evolution of Traditional banks' because they depend on the response of incumbent banks to new entrants. We consider the Waterbed scenario in the context of FIIC banking.
- 4.4** We conclude this section with some thoughts on the implications of changing business models for the FCA.
- 4.5** We have focused on the foreseeable future 0-5 years out rather than longer term. This means we have focussed on current/near-term technology and have placed limited attention to nascent technologies.
- 4.6** The key message from our dialogue with stakeholders was 'This time it is different'. As set out in the introduction, regulatory developments, combined with consumer take up of digital technology, technological developments such as cloud computing, and the amount of investment going into fintech, provide unprecedented possibilities for change. It is too early to predict how the market will evolve, as Open Banking is at a very early stage of implementation. Whether traditional banks will adapt and survive, or succumb to more innovative business models is yet to be seen.

Banks as Utilities

4.7 Open Banking and other regulatory initiatives around payments create possibilities for new business models. In this section, we consider the prospects for these new business models to capture elements of the customer relationship, so that instead of dealing directly with his/her bank, the customer interfaces partly or wholly with a third party. This could result in some services such as payments being provided separately from other banking services. In the extreme, we could see vertical separation of the value chain so that incumbent banks become capital intensive 'utility infrastructure providers' of core savings and lending products (mortgages, loans, savings etc) with other firms taking over the distribution and customer facing aspects.

4.8 The following sub-sections consider the potential for new business models of this nature. We first consider three related areas where existing business models may not be delivering good value or may not be fully meeting customer demand: card-based payments, money management services, and foreign exchange services. This informs us about the scope for new models to appeal to customers.

Lower prices on card-based payments

4.9 The scope for new payments models to attract consumers based on price is limited, because banks typically don't charge directly for making payments (other than in some circumstances – for example large value CHAPS payments or payments in foreign currency discussed separately below). Banks offer 'bundled' PCAs that include functionality to make and receive day to day payments at no additional charge, including through the provision of a debit card. Customers often don't see any charges on their account, unless they go overdrawn. Equally, credit cards are typically offered free to those consumers who use the card purely to transact, with charges incurred only for taking extended credit.

4.10 In contrast, merchants pay fees for accepting individual payments, in particular, they pay fees to a 'merchant acquirer' when they accept card based payments (including debit card and credit card payments). The merchant acquirer retains a share of this fee and a share – 'the interchange' fee – is passed to the card-issuing bank (the consumers' bank).

4.11 Under PSD2, there is scope for Payment Initiation Services Providers (PISPs) to offer a lower cost payment solution to merchants. This is because PISPs can circumvent the traditional card networks and can initiate direct bank-to-bank payments using the Faster Payments system, thus avoiding interchange fees and charges. Merchants could therefore have an incentive to encourage consumers to switch away from using cards, for example by offering discounts or through smoother check out processes (e.g. no need to remember card numbers or authentication codes).

4.12 New payment providers have more scope to directly encourage SMEs to use cheaper alternative payment methods because SMEs are typically charged transaction fees by their bank. So in the case of SME payments, both the payer and the recipient of the payment could save money by switching away from traditional card-based payments to cheaper alternative bank-to-bank payment solutions.

4.13 BCAs could be an attractive target for new payments business models because of the high transaction fees that banks currently charge and the relatively high number of payments made. This means that SMEs could potentially gain relatively significant sums from switching to alternative, cheaper payments solutions.



Enhanced money management services

- 4.14** It's possible that new entrants could offer value-added services to consumers, for example using payments data to enhance visibility and insight into spending (such as spending 'dashboards' or savings 'pots') and helping consumers with budgeting and money management. Many of the newer competitors in PCAs differentiate themselves by combining insights and money management tips from payments data with current account provision.
- 4.15** Traditional banks have done well at providing basic payments functionality and infrastructure, but arguably have done less well at helping consumers to manage their spending.
- 4.16** Our Financial Lives Survey found that 42% of UK Adults are not confident in managing their finances. In addition, approximately half indicate that their financial situation is cause for concern for them and feel that they are not be able to make a difference themselves. Just over one in ten of the population have no savings.
- 4.17** The Money Advice Service found that around 50% of consumers were focused on their current needs and wants, at the expense of the future.⁴⁰ 51% consumers struggled to keep up with bills and credit commitments, indicating the need for tools to aid them in keeping track of their finances and managing day-to-day money.⁴¹
- 4.18** Participants at our September 2018 conference noted that fintechs could be well positioned to harness payments data to design innovative money management solutions that would appeal to customers looking to improve their financial position or make it easier to manage their money.
- A number of business models have arisen which combine payments and savings (or investments) together.
 - New business models are also offering value added services to SMEs based on integration of payments data with accounting or tax software to provide more efficient and automated management reporting and completion of tax returns.

Cheaper foreign exchange payments

- 4.19** Traditional banks and forex bureaux have made money on supplying consumers and SMEs with foreign exchange related services including international bank to bank transfers, and buying and selling foreign currency in cash form as well as facilitating overseas card-based payments. Charges can include transaction fees as well as a margin or spread on the exchange rate, taking a cut of approximately 3-6%⁴² of the total transaction value. Such charges brought in a total revenue for major banks of £682 million in 2017. These charges are not always transparent to consumers and we have previously written to firms to address misleading marketing in the foreign exchange market.
- 4.20** New business models are entering the market for foreign currency payments, providing more transparent pricing and helping consumers and SMEs to reduce the costs of foreign currency transactions. Often these business models offer 'interbank' or 'wholesale' exchange rates via digital apps.

40 Financial Capability in the UK, 2015, The Money Advice Service.

41 Ibid.

42 Travel Money and Card Use Abroad, 2011, OFT.

The Big Switch

- 4.21** In this section we consider the possibility of new business models to encourage consumers to switch main banking relationship or switch individual savings or lending products.
- 4.22** Switching is not an end in its own right. Competition works well for consumers when there is enough of a threat of switching to deter providers from raising prices or lowering quality to existing customers. For that threat to exist consumers must be able to switch easily and some must do so.
- 4.23** Industry participants and consumer representatives at our September 2018 conference told us that the ability of new services to raise awareness of better deals is important, but to drive real competition the prospect of switching accounts needs to become more appealing for consumers. There was agreement that switching rates are low because of various factors including low awareness of the benefits from switching and a perception that switching will be difficult and time consuming, particularly in PCAs and BCAs. Many participants expressed a view that the ability of new services to make switching more appealing was critical to whether PSD2/Open Banking leads to more competition in PCAs and BCAs.
- PCAs, overdrafts and savings balances**
- 4.24** FIIIC PCAs depend on banks generating funding benefit from balances, as well as earning fees on overdrafts, interchange revenues, and other fees and charges. Our analysis of account-level data shows that the majority of FIIIC accounts make a positive contribution to bank profits from a combination of these sources of value. A small subset of consumers – around 10% – are responsible for 60% of the value that banks derive from PCAs.⁴³ This subset of consumers mostly either hold high balances in their current accounts or are heavy overdraft users.
- 4.25** PCA consumers with high balances also tend to hold higher savings with their bank, so could make considerable gains by switching their PCA and savings balances to accounts paying more interest. In addition, our analysis indicates that PCA customers are paying high fees and charges for using overdrafts, particularly unarranged overdrafts.
- 4.26** To what extent will these two groups of customers, or other groups of customers, be persuaded to move to better value services in the future? We've analysed the characteristics of switchers and found that they tend to be younger and more digitally active, have lower balances, use overdrafts less, and are less likely to hold other credit products with their PCA provider (see Annex 3 for details). If these trends continue to hold in the future, customers with the most to gain: PCA customers with higher balances – who tend to be older – and heavy overdraft users, may not be the first to move.
- 4.27** New business models could encourage more shopping around. New apps to help consumers manage their money could raise awareness of the potential gains from doing so. For example, an app could access a customers' current account data to analyse average balances, and calculate how much money the consumer could save by moving to a different account or by transferring an overdraft balance to a credit card.

⁴³ Calculated as the total value from funding benefit, overdraft charges, and other fees and charges, net of direct costs. See Annex 2 for details.



Personalised services of these type could encourage more consumers to switch main bank account or to shop around for particular aspects.

4.28 'Marketplace' type business models have the potential to reduce search and switching costs by offering customers the ability to open, view, and move money between accounts with a variety of partner banks, with the convenience of one single login and one single identity check. Such apps could make it easier to switch accounts between providers and/or to access better deals with the same provider than is currently the case.

4.29 In the current implementation of Open Banking the functionality of data sharing is only available on PCAs and BCAs (although the OBIE plans to create Open Banking standards for all payment account types covered by PSD2 including credit cards, e-wallets, and prepaid cards).⁴⁴ There are also limitations on the potential for automated switching due to the requirement for customers to directly authorise transactions, rather than providing an open agreement to actions that can be triggered by the third party on customers' behalf, subject to conditions. This means that, under current rules, although a system could identify a better account, the customer cannot grant permission for the funds to be moved without giving an explicit instruction for each move.

4.30 It could become easier for overdraft users to switch PCA. Understanding eligibility for overdrafts can be difficult for consumers looking to switch their PCA provider. Heavy users of overdrafts stand to gain the most from switching, but may find it harder to do so. Over time a consumer may have become accustomed to having an overdraft facility with his/her PCA provider but can find it difficult to know if a new provider will offer an equivalent facility. We are introducing rules to require firms to provide on-line or in-app tools that help consumers assess their eligibility for overdrafts when comparing accounts.⁴⁵ These new rules will complement Open Banking, and should make it easier for overdraft customers to switch PCA in future.

4.31 In addition to the unbundling of payments discussed in the section on Banks as Utilities, there is scope for 'unbundling' of overdrafts from the PCA as new payments providers could offer alternative and cheaper sources of credit (subject to having a Consumer Credit Licence) which could be pre-applied for and accessed easily when needed.

Consumer credit

4.32 Many consumers gravitate from low introductory rates (on fixed rate mortgages, and balance transfer deals on credit cards) onto higher rates over time. Many PCA customers take out lending products with their PCA provider, and may not be getting the best deals on these products, as indicated by the higher yields on credit cards shown in figure 3.6.

4.33 'Intermediary' relationships are a common feature of the mortgages market. This model relies on consumers providing a significant amount of information to mortgage brokers to enable them to assess suitability to apply for different mortgage products. Mortgages are high value items so that consumers are more likely to see the benefit in investing time to supply information to the broker to help them shop around on the consumers' behalf.

44 UK's Open Banking Project Expanded, 2017, OBIE.

45 See High-cost Credit Review: Overdrafts (CP18/42).

- 4.34** Other consumer finance markets such as personal loans and credit cards are less heavily intermediated and more consumers turn to their existing PCA provider, or go directly to a new provider (perhaps having used a price comparison website to identify an attractive rate), to obtain these products without going through a broker. A difficulty in shopping around for consumer credit is credit eligibility: the customer does not know if they will be eligible for a product or not before they apply for it, and the items are not sufficiently high value to warrant the cost of using a broker. The existing PCA provider is an attractive option in these circumstances, as it has pre-existing knowledge of the customers' financial situation (being able to access PCA data) and the customers ID, thus streamlining the decision-making process compared to going to another firm that would have to refer to a credit reference agency.
- 4.35** With Open Banking and PSD2, third party intermediaries could perform the credit risk assessment using the customers' PCA data. The consumer would need to give the third-party permission to access their PCA data. In this way, the information advantage that the customers' own bank had in the past could be overcome – and it could become easier to shop around for the best deal on lending products, with the ability to factor in eligibility based on credit risk assessment. This could lead to reduced prices for consumers.

Sub-prime lending and over-indebtedness

- 4.36** Many consumers experiencing problems with debt are effectively shut out of mainstream finance. Mainstream lenders typically focus on mass-prime lending segments leaving niche segments underserved, resulting in many consumers – around 3 million – using payday lenders and other forms of high cost credit including rent-to-own lending. We have announced measures to protect these consumers, some of whom are the most vulnerable in society (see CP18/35: Rent-to-own and alternatives to high-cost credit for further information).
- 4.37** In addition, many consumers rely on basic bank accounts, which do not usually have any facility to borrow money via overdrafts.
- 4.38** New business models operating low cost digital platforms may be able to meet the needs of some of these customers more effectively than mainstream banks, for example by utilising technology to lower the costs of service provision and enable the provision of small loans more cost effectively, and use customer data analytics to more effectively assess credit risk.
- 4.39** Helping consumers to get out of debt, through app based tools to help with budgeting and money management, could also assist with rebuilding credit scores and help people back into mainstream finance.

Platform Providers

- 4.40** We asked participants at our September 2018 conference about the prospects for large-scale entry into payments or core deposit taking and lending services in the UK by an established technology platform.



- 4.41** The consensus was that platform providers were most likely to focus on engaging with new business models in financial services to the extent that they supported or developed the functionality of their core platform offering, rather than extending into an entirely new industry. As such, the entry of a large platform provider into core lending and deposit taking was viewed as unlikely, although not impossible.
- 4.42** New payments business models bypassing costly card-based payments options could be attractive to retailers of all sizes including large platform retailers such as Amazon. Social media platforms are also likely to be looking at these options, to enhance the functionality of their services to facilitate payments between individuals.
- 4.43** New lending models that could help more SMEs and micro businesses to trade or advertise on platforms such as Google or Amazon would potentially be a good fit. However, they are likely to continue to rely on banks' expertise in credit assessment, risk management, and financial intermediation to provide the underlying lending.

The evolution of traditional banks

- 4.44** In this section, we consider the ability of traditional retail banks to adapt their own business models to compete with potential competition from challenger business models described above. We first consider the ability of traditional banks to meet fintech challengers head-on by developing their own solutions to – utilise the opportunities created by Open Banking and PSD2. We then consider the potential for banks to reduce availability of FIIIC banking in the future, in response to competitive pressures. Finally, we look at the issue of branch closures, as a way to cut costs.

The battle for customer relationships

- 4.45** Participants at our September 2018 conference noted that the ability to effectively harness the power of technology and of consumer data will be key to the success of new business models seeking to capitalise on PSD2/Open Banking.
- 4.46** Major banks are investing in fintech companies and in developing their own technology, for example 'aggregator' or platform services through which their customers can view multiple accounts including those held with other financial institutions. Traditional banks have large data lakes; but have historically found it difficult to use them, and it hasn't been a core part of their business models. Competition from fintechs may sharpen their incentives to get better at using data; but given a shortage of data science skills and IT constraints it is not clear to what extent they will be able to match the newer digital challengers.
- 4.47** IT constraints should not be underestimated, in the view of many participants. Traditional banking models tended to be structured around product line 'silos' which focus individually on selling products and growing lending balances. Legacy IT systems make this difficult to change if they are disparate and difficult to join up or query, involving different databases with no linking variables. This means that traditional banks have struggled to develop a customer view that enables them to look holistically at the data they hold on customers and develop propositions on the back of this, for example to help customers manage their financial wellbeing at different stages in their lives.
- 4.48** Participants tended towards the view that business models based on using payments data to provide better value or enhanced services to consumers are one of the more

probable scenarios of those discussed. New business models mean that transactional services can be offered separately from the PCA, avoiding the need to switch banks, which is unattractive for many consumers. Further these models may not require a full banking license with the associated costs and capital investment requirements. Unless traditional banks can match the functionality offered by these new services, it's possible that digital challengers will win the battle for customer relationships.

4.49 At the same time, data may not always be used to the customers' advantage. If banks become better at using data to identify those customers who may be less price sensitive or less likely to switch, they could selectively raise prices to these consumers. In situations where competition in deposits and lending starts to squeeze margins, it's possible that major banks have more scope to react to competition by matching competitors' rates. This could further entrench current practice whereby loyal customers get rates that are less favourable than newer customers.

4.50 There is thus an important question about the extent to which big data will be used to further banks' interests or to further consumers' interests. This is question we plan to explore further with industry and other stakeholders.

Will banks move away from FIIC?

4.51 A key question for us in this study is what does the future hold for the FIIC model?

4.52 The strategic importance of the current account base both in terms of bringing low cost funds (funding benefit), overdraft fees and charges, interchange fees and other charges and the ability to cross-sell other products suggests that banks are likely to have incentives to retain the FIIC model as an option for those customers who want it.

4.53 Banks obtain significant value from most FIIC accounts. Our analysis of account-level data shows that most FIIC accounts make a positive contribution to bank profits. Consumers who make a higher PCA contribution (particularly through funding benefit) also hold higher savings with their bank, so their funding benefit to the bank may be even greater.

4.54 However, the FIIC model involves a degree of 'cross-subsidy', in the sense that the costs of transactions are covered by other sources of value: for example, the value of customer balances or overdraft charges. This works because the PCA is sold as a bundle of services. As described above, with new business models we could start to see increased unbundling of PCAs so that payments services, lending services, and deposit-taking services are separated. If this happens, we could start to see existing pricing models unwind so that more cost-reflective charging for individual elements is introduced.

4.55 We set out in our High-cost credit review that any reduction in overdraft charges due to our interventions is unlikely to result in a widespread reduction in FIIC provision. However, new business models could result in consumers using overdrafts less, or consumers moving positive balances out of PCAs and into interest bearing accounts. The prospect of significant balances being moved out of PCAs remains unlikely in a low interest environment but may become more relevant if interest rates rise. If this happens, there is a possibility of FIIC accounts becoming less widely available. New business models might also reduce the benefit that banks currently get from cross-selling other products to current account customers. If the profitability of FIIC accounts declines considerably, banks might start to introduce transaction charges or monthly account fees.



4.56 Our account-level analysis indicates that transaction charges, were they to be introduced more widely, could affect customers who visit branches and withdraw cash from ATMs more frequently. FIIC banking offers might be withdrawn first for these types of consumers. However, to the extent that FIIC banking currently produces a distributional outcome that results in many consumers receiving low or no interest on PCA deposits; high overdraft charges for many consumers; and some overdraft charges falling heavily on vulnerable consumers, it is not clear that a more cost-reflective pricing structure would produce worse outcomes for consumers overall.

Cost cutting measures including further branch closures

4.57 In response to changing customer preferences, including increased use of digital channels and payments methods and reduced cash usage, banks are closing branches and spending less on cash handling infrastructure. In the section below we discuss the scope for cost reduction in branches; ATMs; and cash and cheque handling more generally. This is relevant to the ability of traditional banks to cut costs in response to competition from new, potentially lower cost, business models.

(i) Branch closures

4.58 Consumers and small businesses commonly use branches for day-to-day banking transactions such as paying-in cash and cheques and withdrawing cash. Branches continue to be an important channel, for example in providing access to cash, cash-handling services, and other transactional banking services, opening new accounts and providing information and advice to customers.

4.59 Banking branches are important for small businesses (SMEs) as well as for consumers, for example for paying-in and withdrawing cash. Research from Charterhouse⁴⁶ shows that while most SMEs use on-line banking as their main banking channel, branches are the primary channel for a significant number of SMEs. Around 20% of SMEs with turnover below £2m used branches as their primary banking channel.

4.60 However, as consumers are transitioning away from branches to digital banking, and cash usage is falling, many banks are closing branches. Branch interactions fell by 42% between 2011 and 2016.⁴⁷ Banks are achieving cost savings from closing branches: our analysis of major UK retail banks showed that branch network costs for the 6 major banks fell by around 6% during the 3-year period to 2017. This suggests it is a strategy that is likely to continue in the future and we expect further branch closures as banks seek to respond to changing technology and customer behaviour.

4.61 As many banks shrink their branch networks they are tending to focus on retaining branches in key locations with higher future business potential. Examples include city centres and other main centres of population and commercial activity.

4.62 Some banks are aiming to offer a range of different branch types, tailored to local needs, such as:

- Service only branches: focused on processing simple transactions quickly, with several self-service machines and limited or no counter services. Such branches may need fewer staff than traditional ones.

46 SME Banking and Finance Report, Base: 10,089 SMEs, 2017, Charterhouse Research. Please note: Charterhouse Business Banking Survey year-ending Q3 2016.

47 Help at Hand report, 2017, BBA.

- Advisory branches: focused on meeting customers' more complex financial needs and building relationships with them.
- Community branches: focused on both advisory and daily banking services.

- 4.63** Branch coverage has fallen in every region of the UK, with some regions experiencing more closures than others. Despite this, coverage across different regions was similar in 2017, ranging from 13.3 branches per 100k inhabitants in the East Midlands, to 18.6 in Wales. See Annex 1 for our detailed analysis of the impact of branch closures.
- 4.64** People are having to travel further to their nearest branch because of branch closures. Our analysis indicates that in rural areas, 9.1% of banking customers were affected by branch closures, and 6.8% were affected in urban areas. We looked at changes in the average distance that consumers had to travel to get to their nearest branch between 2015 and 2016. We found that when a branch closed in a rural area this increased by 3.7 miles. In urban areas, the distance increased by 1.9 miles. We expect these trends to continue as firms close more branches in the future.
- 4.65** From our 2017 Financial Lives Survey, we found that greater proportions of older consumers (65 years and over) and those on lower incomes (less than £15k per year) use branches at least once a month.⁴⁸ They may therefore be more inconvenienced if their local branch closes as they are less likely than other consumers to be using alternatives, such as mobile banking.⁴⁹
- 4.66** In summary, on average, rural customers are likely to experience longer journey times to reach their nearest bank branch in future. Older and low-income consumers tend to use branches more often than other consumers. Our Financial Lives Survey finds that these consumers are also less likely to use alternatives such as mobile banking, and therefore may be most inconvenienced by branch closures.
- 4.67** When closing local branches, it is important that banking firms consider the needs of consumers and communicate clearly with them to ensure they can continue to access banking services. The Access to Banking Standard, supervised by the Lending Standards Board (LSB), sets out the actions which firms have agreed to take, including conducting impact assessments considering the impact of closures on local customers. The LSB notes, in its Access to Banking Standard Summary Report that overall compliance with the Standard is good but improvements are needed in firms' branch closure impact assessments.
- 4.68** Following branch closures, we found evidence of more customers logging in to mobile banking apps, indicating that branch closures may be increasing the transition to digital banking.
- 4.69** Alongside banking firms, other operators such as the Post Office, the LINK ATM network and some convenience stores, provide banking services to customers in their local area. Advances in digital banking are also helping to replace services traditionally available at local branches. For example, some banks now enable customers to pay-in cheques via their mobile banking apps.

48 Financial Lives Survey, 2017, FCA. Question RB 133a: "Still thinking about your main day-to-day account, over the last 12 months, have you used a particular branch regularly (i.e. at least once a month)?"

49 Financial Lives Survey, 2017, FCA. Question RB 32B/Csum: "In which of the following ways have you conducted particular activities, such as paying bills in the last 12 months?" The question is asked of UK adults with a main day-to-day account. Unweighted base: 2,565. Weighted base: 10,982.



4.70 The Post Office's Banking Framework Agreement, launched in January 2017, enables 99% of personal banking customers and 95% of small business customers to carry out some everyday banking activities at one of the Post Office's 11,500 branches. Customers of many high street banks (including all the major ones) can check their balances, pay-in cash and cheques and withdraw cash at local post offices.

(ii) ATM closures

4.71 ATMs enable consumers to check their balances and withdraw cash. They also offer other services, such as mobile phone top-ups and the ability to pay credit card bills. At the end of 2017, there were just under 70,000 ATMs in the UK, of which around 54,000 were free-to-use (FTU). The number of FTU ATMs grew by around 50% in the last decade, but numbers have now begun to fall.

4.72 LINK announced in January 2018 that it was cutting interchange fees paid to ATM operators and was strengthening its financial inclusion programme to protect FTU ATMs 1km or more from the next nearest one, through higher fees. This was part of LINK's wider initiative aimed at re-balancing the distribution of FTU ATMs between urban and rural areas. The Payment Systems Regulator is LINK's economic regulator and, in October 2018, put in place a Specific Direction designed to make sure LINK does all it can to fulfil its public commitment to FTU ATMs 1km or more from the next nearest one.

4.73 The cost of running the UK free-to-use ATM network has been estimated at around £1 billion per year, according to LINK. Pay to use ATMs cover their own costs.⁵⁰

(iii) Cash and cheque handling

4.74 More generally, banks incur costs associated with handling cash in branches and elsewhere that are not captured in our own estimates of branch costs or ATM costs. These costs include the costs of bank staff involved with counting cash at the branch counter, security costs involved in transporting cash to and from branches, and other costs.

Implications of change

4.75 Many of the scenarios discussed in this chapter could result in positive outcomes for consumers, including lower prices and more customer-orientated propositions. However, some scenarios could result in less favourable outcomes for some consumer groups.

4.76 Part of the motivation for conducting this review has been to identify – in the context of industry change – where we can do more to facilitate better outcomes for consumers or to anticipate harm. As set out in our Purpose and Scope document, we want to ensure that our regulatory activities remain effective now and in the future.

4.77 In line with our Approach to Supervision, we will conduct a programme of analysis to understand the value chain in new payments business models. We are also looking at the different levels of consumer protection offered by some of these payment models in comparison to traditional card-based payments methods.

50 Access to Cash Review, Call for Evidence, 2018.

4.78 We recognise that we may not always be best placed to act alone to facilitate better consumer outcomes or to deal with potential harms. As set out in our Approach to Consumers,⁵¹ we are one part of a network of agencies seeking to promote the interests of consumers. Some of the themes we have identified in this review highlight the need for us to continue to work collaboratively with Government, other regulators, charities, consumer bodies and industry to achieve the best outcomes.

4.79 These issues can be grouped into three overarching themes: access to financial services; the use and sharing of customer data; and system resilience and financial crime. We discuss each of these in turn below.

Access issues

4.80 Access issues, including access to branches, cash, FIIC banking, and to financial services more generally are as follows:

- Incumbent banks are cutting costs in response to changes in customer behaviour, including closing branches. Whilst branches will remain a key part of banks' business models for the foreseeable future, branch networks will continue to shrink. Consumers who rely on their local branch will feel the effect the most. We think that both online and app-based banking and the provision of branch services by the Post Office can help to address this, but may not fully do so for all consumers.
- Consumers and small businesses who rely on cash may also be affected by branch and ATM closures. Cash transactions are declining rapidly and are set to fall further, as contactless payments and other card based payments increase. Some retailers and transport providers no longer take cash. As usage declines, the cost of the infrastructure and systems in place to handle cash may start to look disproportionate. If banks start to remove this infrastructure unilaterally, access to cash might become problematic for some consumers and small businesses. In Sweden and the Netherlands, for example, ATMs are being consolidated and run as a single entity. The Access to Cash Review has been commissioned to examine the appropriate response to the rapid decline in cash usage.⁵²
- FIIC PCAs may become less widely available in the future: for example, if new business models encourage consumers to move balances out of PCAs and erode their value as a source of low cost, stable funding. This might lead to the introduction of transaction charges or monthly fees for PCAs. It's possible that this could lead to more consumers being unable to afford a bank account.
- Lack of access to technology or ability to use it, particularly smartphones, could become a new driver of financial exclusion. App based banking services have the capacity to make access to banking easier for many people who currently find it difficult to access services (mobility or hearing impaired, those who find it difficult to access banking in working hours), but as branches and call centres are replaced by apps and virtual assistants, the digitally excluded could increasingly find themselves shut out of financial services too. Digital skills and inclusion are part of the governments UK Digital Strategy.⁵³

4.81 As set out in our document on Approach to Consumers⁵⁴ it is often not obvious who should take responsibility for access issues. In a market based economy consumers

51 Our Future Approach to Consumers, 2017, FCA.

52 Access to Cash Review, Call for Evidence, 2018.

53 UK Digital Strategy, 2017. HM Government.

54 Our Future Approach to Consumers, 2017, FCA.



do not have an automatic right to receive products and services. Similarly, firms do not have an obligation to provide them unless the law creates specific universal service obligations, such as basic bank accounts for those who would not otherwise be eligible for a bank account.⁵⁵

4.82 We do not have a specific responsibility to ensure access for all consumers, but will seek to develop practical strategies to tackle access problems, working with firms and stakeholders to do so. However, any decision to place additional economic obligations on firms would be a matter for Government.

4.83 We are currently exploring the merits of introducing a duty of care on firms which, if adopted, could have an important impact on this area.⁵⁶ In addition, the Treasury Select Committee has recently launched a new inquiry into consumers' access to financial services, focussing on the interaction between vulnerable consumers and financial services firms.⁵⁷

Use of data

4.84 Use and sharing of consumer data is the second overarching theme because a key determinant of future competition will be whether data is used in the interests of consumers or whether firms use it to extract more value from consumers:

- Trust between users and providers of services is necessary for financial markets to function well, and is critical if we are to see more competition in retail banking. We aim to promote trust in several ways – by setting minimum standards, by monitoring and enforcing to incentivise compliance and deter poor behaviours and by authorising firms and individuals.⁵⁸
- Trust and confidence may be undermined if data are misused by firms in ways that are not in consumers' interests. It may be necessary for co-ordinated action to agree standards and acceptable uses of consumer data in financial services contexts, similar to the approach in general insurance.⁵⁹ Firms will also need to communicate clearly with consumers to help them understand what their data will be used for.
- The opportunities and challenges arising from the use and sharing of consumer data remains a key area of focus for us. We have published information on our website to help consumers understand the changes, their rights and how they can protect themselves, for example by checking whether an AISP or PISP is registered with us.⁶⁰ It is also vital that incumbent firms do not impeded legitimate data sharing opportunities that are brought about by PSD2 and Open Banking. As new business models emerge and seek to use data in ways that can benefit consumers it is important that the barriers to competition do not increase and that consumers can make informed choices to use them if they wish.

Resilience and financial crime

4.85 Systems resilience and security are a key part of upholding trust and confidence in financial markets. PSD2/Open Banking introduces the possibility of more consumer

55 Under the Payments Accounts Regulations 2015 the 9 largest personal current account providers must offer basic bank accounts. <https://www.gov.uk/government/collections/basic-bank-accounts>

56 A duty of care and potential alternative approaches: DP18/5, July 2018, FCA.

57 Consumers' Access to Financial Services inquiry, October 2018, Treasury Committee.

58 <https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf>

59 FCA Feedback statement on the use of data in retail general insurance <https://www.fca.org.uk/news/press-releases/fca-publishes-feedback-statement-big-data-call-input>

60 <https://www.fca.org.uk/consumers/account-information-and-payment-initiation-services>



data moving from banks to third parties, and technical innovations add system complexity. While people accept that data sharing is necessary to obtain some products and services, they nonetheless have concerns about data sharing, and confidence could be further weakened if significant data breaches occur in future. We have published a joint discussion paper with the PRA on an approach to improve the financial resilience of firms and financial market infrastructures.

- 4.86** A single digital ID could be possible in the future. Current Know Your Customer (KYC) processes require each financial service provider to evaluate the identity of each customer using information requested from the customer for this purpose. This system results in inefficiencies and delays with cost implications for providers and consumers. With new technologies, such as DLT and blockchain, it could be possible for consumers to own and maintain a single digital ID, making the KYC process more efficient, effective, and secure.
- 4.87** As financial services become more fragmented, collaboration and sharing of intelligence on financial crime and fraud becomes more important. Disaggregation of transactions across multiple providers means individual institutions can only see part of the picture, making traditional methods of transaction monitoring less effective. Data sharing and collaboration between institutions is likely to become an important part of detecting crime in the future.

