Strategic Review of Retail Banking Business Models: Purpose and Scope

October 2017

1. Introduction

In April 2017, we launched a programme of discovery work – the Strategic Review of Retail Banking Business Models (the 'Strategic Review'). In brief, the Strategic Review seeks to:

- understand retail banking business models in greater depth
- understand how free-if-in-credit banking is paid for, in particular whether it leads to concerns about the distribution of profits from different types of consumers or different products
- understand the impact of changes such as increased use of digital services and reduced use of branches on banks' business models and the potential consequences for our consumer protection and competition objectives

Since launching the Strategic Review we have met a range of firms and industry bodies and looked at information already available to the FCA. This paper provides further detail on the project's purpose and scope ahead of engaging with firms to gather information. We set out:

- the context for the Strategic Review
- how we use business model analysis in conduct and competition regulation
- the changing face of retail banking
- the potential effects on retail banking business models
- our approach to information gathering and next steps

2. The context for the Strategic Review

Retail banking provides a vital economic function. It has a significant impact on consumers and small and medium enterprises within the UK. This is both directly, through providing transactional banking, savings and lending products, and indirectly, through the impact consumers and small and medium enterprises themselves have on the real economy.

An industry experiencing significant change

The retail banking industry has seen significant economic, technological and regulatory changes 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. We want to ensure our regulatory activities remain effective now and in the future. So we want to both build a deeper understanding of the effect of these changes on different retail banking business models and gain greater clarity on the consequences for firms and consumers. Fundamentally, we need to understand where and how banks earn their revenues and returns, the extent to which this differs between different types of firms and how this may change as business models and strategies evolve. This will put us in a better position to identify potential sources of harm in a timely way, make appropriate interventions where necessary, and better evaluate their impact.

This review is discovery work and we do not have specific regulatory interventions in mind. However, in Section 5 we describe in more detail how recent and future changes could potentially affect firms' business models. But the future is uncertain and our review may suggest alternative scenarios from those we outline.

3. How we use business model analysis in conduct and competition regulation

In this section we explain the importance of business model analysis in our role as a conduct and competition regulator. Firstly, how we use it to identify the potential for harm to consumers now and in the future, and, secondly, its use as an evaluation tool to assess the impact of our interventions. We also explain how the Strategic Review builds upon the existing business model analysis the FCA carries out.

As a diagnostic tool, business model analysis provides an insight into firms' incentives, and what behaviours these incentives may be driving. Business model analysis helps us understand how firms currently make money, as well as the strategic factors they take into account when making decisions, such as which products to offer, their price, which channels to use and which customer segments to serve. We want to build up a clear picture of how the industry creates value.

We can then consider whether this picture suggests the potential for consumer harm, and any risks to the fair treatment of consumers. By understanding the drivers of decision making, we will also be better able to evaluate how firms might respond to known issues and forthcoming changes, and so consider the potential for future harm. This harm might take different forms but could, for example, include fees or products that are opaque and complex for consumers to understand or represent poor value.

The information we can get from business models

Large retail banks operate complex, multifaceted businesses, with many products and services sharing a common cost base. A detailed understanding of how much different products and services contribute to profitability helps us assess how sustainable business models are likely to be as circumstances change, and the potential implications for competition and consumers. It may also, for example, help inform us on whether a large proportion of profits are earned from one type of customer or one type of product. This could raise questions of fairness, as well as provide insight into the potential ability for new types of competitor to emerge. Understanding the synergies and links between products and business areas will also mean we can better evaluate the likelihood of firms expanding or contracting their operations, and consider any access implications for consumers.

Consumers can also be harmed when markets are not functioning effectively because competition is hindered or distorted. Business model analysis helps answer questions such as how much rivalry exists in different parts of the market, and how strong and sustainable this rivalry is. It also tells us about how stable profits are and how likely they are to come under pressure from entry and expansion of competing business models. We can also use the knowledge of how different business models compete with each other when we consider how our regulatory perimeter is drawn.

Business model analysis is also helpful as an evaluation tool. Regulation has a fundamental influence on the way the market operates. Examples include regulatory capital and liquidity requirements dictating capital structures and funding sources, responsible lending requirements that limit who firms can sell to and the products that they sell, and conduct requirements that dictate how firms should engage with customers. By understanding how such measures affect business models, profitability, and economic incentives, we can better assess their effectiveness and value. We need to conduct any assessment of the impacts of our policies on a market-wide basis to ensure that we pay proper attention to different types of market participants. This includes smaller innovative firms as well as larger firms with established business models.

How we currently carry out business model analysis

We already undertake some business model analysis as part of our ongoing programme of firm supervision. This includes reviews principally focusing on a single firm at a time (in support of Firm Evaluations). This approach allows us to understand specific factors in a firm – its particular business model, the unique tensions and pressures it faces and the specific actions it is likely to take. While this provides some insight into industry-wide issues, it does not allow for a full view of industry trends. Factors that are insignificant for individual firms may be more of a problem when considered across the industry as a whole and seen over time. The industry may easily manage rapid change from a single firm, but the same change repeated across many competitors could cause significant disruption and unnecessary harm to consumers and markets.

4. The changing face of retail banking

Competition in retail banking has been a longstanding concern. Traditional business models have included full service large retail banks offering mortgages, lending, savings and current accounts, building societies focusing on mortgages and savings, and credit unions. These business models have been relatively static. A few large firms have held high and stable market shares for many years with little or no new entry or innovation from new types of business models.

We have launched the Strategic Review at a time when many changes in retail banking are coming together. In recent years, in response to macroeconomic, technological and regulatory changes, challenger banks have emerged. Some offer a wide range of services from a limited branch network, while others offer focused services with no branches. In this section, we discuss the current environment, including the types of business models that have emerged, and discuss the nature and extent of some of the changes affecting the market. In section 5, we explore some of the implications of these changes.

Regulatory changes have encouraged competition

In recent years a number of regulatory interventions designed to facilitate competition in the retail banking and payments sector have been introduced. Some of these interventions have already started to have impact, for example the New Bank Start-Up Unit, and the Interchange Fee Regulation. Other work is at an earlier stage, including European initiatives such as the second Payment Services Directive (PSD2), UK regulatory initiatives such as Open Banking and work to improve competition in cash savings and credit cards.

As well as these interventions, some firms have had to incur significant fines and redress payments following a series of investigations into misconduct, including PPI mis-selling, LIBOR and foreign currency manipulation. Other regulatory initiatives have threatened specific revenue streams within retail banking. These include reduced interchange fees, price caps on payday loans and a focus on overdraft fees. These changes have also influenced business models.

After the global financial crisis, regulators introduced new rules to protect the stability of the financial system, including on the levels of capital and liquidity banks needed to hold to safely manage cyclical and unexpected economic shocks. This has affected profitability of business models and has influenced product mix. It has played a part in the emergence of new models such as peer-to-peer lending platforms offering an alternative to traditional bank sources of funding and lending.

These regulatory changes have happened against a backdrop of several years of relatively favourable macro-economic conditions since the financial crisis. 'Lower for longer' interest rates mean that the cost of funding within retail banking has been at a historic and sustained low for some time. This has been supported by relatively stable funding markets, a benign credit risk environment and schemes supported by the Bank of England including the Funding for Lending and Term Funding Schemes. While bank lending contracted after the financial crisis, in recent years banks have increased lending volumes.

The impact of technology

Technology is also having a profound effect on consumer behaviour and the costs of providing services. Consumers and small businesses are changing the way they interact with their banking providers, reflecting the way technology has made this easier in other markets. Emerging trends include the move from banking transactions being made in branches to online and mobile devices, increased use of brokers and intermediaries and greater use of price comparison websites for savings and lending. The development of 'bank in a box' (i.e. off-the-shelf banking software) and contactless, mobile payment and other technological developments offer opportunities for new and innovative financial service providers with different cost-structures – including online-only banks – to enter the market. FinTechs and other providers are also offering new services that compete with the traditional retail banking business model. In payments, e-money accounts and money management tools are incorporating services which allow customers to see an aggregated view of their accounts at different banks.

New regulatory approaches, including simpler authorisation processes, together with favourable macro-economic conditions and greater consumer use of technology-based banking, have helped a record number of new entrants to the market. This has put pressure on firms' margins as they compete for profitable lending opportunities. Established firms are having to re-examine their business models and focus on investing in technological services, rather than the traditional branch-based model. At the same time, they are having to address the ongoing challenges of maintaining and updating large and disparate legacy IT infrastructure.

The pace of change will continue. The UK's decision to leave the European Union has created macro-economic uncertainty within the financial sector and wider UK economy. The unknown outcomes of Brexit, combined with the potential for future interest rate rises and inflationary pressures all directly affect retail banks' assessments of future financial risks. In particular, a weak economic environment and its impact on consumers' ability to service debt could materially affect business models.

Increasing competition in the future

Competition is likely to accelerate in the future as the changes brought by the CMA's Open Banking Remedy and PSD2 take full effect. These will allow new and innovative ways of using the information in customers' accounts, and potentially prompt new platforms through which consumers can access goods and services. The ongoing trend towards digital banking may mean that, once Open Banking becomes a reality, the ownership of the customer relationship may shift away from full service, universal banks to these platforms. Consumers may become less likely to rely on a single firm for their banking needs and could move money to another provider in response to competing offers. This could affect the economics of current revenue streams and funding and lending sources. The levels of technological investment that firms might need to compete in the future could put pressure on their returns, for example, where new ways of providing retail banking services have a lower per unit cost than current models.

5. The potential effects on retail banking business models

We want to understand how firms have reacted to the changes described in Section 4, the ways they are likely to respond to future pressures, how this will affect the development of retail banking business models and the potential implications for consumers. We are not prejudging this and do not have any specific intervention in mind. However, with a number of imperatives for change, we think now is a good time to understand how business models have already adjusted and how they may evolve in future. We need to understand the differences and similarities in business models, the different drivers of profitability and the interdependencies within the business models (particularly in relation to personal current accounts (PCAs)).

To underpin this understanding, we have identified a series of hypotheses about how business models might be affected by these changes. Our analysis will explore these in more depth. They cover the following:

- the role and economics of PCAs and cross-selling
- the competitive advantage of large 'back books'
- credit expansion and sub-prime lending
- effect of technological change, greater intermediation and the future of branches in retail banking
- competition advantages and disadvantages of alternative business models
- distributional issues for PCAs

While these will be our initial areas of focus, we may find additional areas of interest as we develop our work. We will explore these further in the second phase of the project.

5.1. The role and economics of PCAs and cross-selling

Retail banks have multiple product lines which they may sell together as a package, or sell to both new and existing customers. Examples include foreign exchange services offered alongside transactional banking services, packaged bank accounts that include insurance products and mortgage customers being offered home insurance.

PCAs have historically been viewed as an 'anchor product'; a valuable source of customer loyalty and retention that provides a 'gateway' to selling other products and services. Some customers clearly value the convenience of being able to access their personal banking services through one provider. Recent and future developments through increased digitalisation and Open Banking could mean that the PCA's importance as an anchor product, and the ability to bundle or cross-sell products, may gradually erode over time.

The role of the PCA business and associated savings as a stable and relatively low cost source of funding for banks has increased in recent years and reliance on wholesale funding has reduced following the financial crisis. If, in future, the propensity of consumers to move PCA balances from their main bank increases, this may affect larger banks' ability to use them to fund longer term lending and so fulfil their traditional 'maturity transformation' role of converting short-term deposits into longer-term lending. Both these factors change the economics of PCAs and could mean banks have to change their retail banking business models.

The mix between fees and net interest margin may also be changing across PCAs and other retail banking products. As fees become more transparent, banks may need to rely more on net interest margins. Alternatively, they may introduce new fee types.

We are also interested in the economics of business current accounts, which are different to PCAs because they typically levy transaction charges. But they are still seen as an important product on which to base a banking relationship, from which a wide variety of other services can be sold. These services include foreign exchange, asset finance, commercial mortgages, insurance, and deposit accounts. If relationship banking and customer loyalty is eroded by Open Banking and increased digitisation, the economics and business models of small and medium enterprises (SME) banking may also change.

5.2. The competitive advantage of large 'back books'

In many financial markets, different groups of consumers engage to different degrees. A significant proportion of consumers actively look for the best deals and switch providers. This puts pressure on firms to design and offer competitive products.

However, many consumers stay with the same provider and product for many years. Firms do not have incentives to lower, and may even be able to increase, the price these long-standing customers pay. As a result, these consumers do not benefit from new, more competitive products.

For example, our Cash Savings Market Study found that providers had significant liabilities in the form of balances in savings accounts opened many years before (the 'back book'). These accounts paid lower interest rates than those opened more recently. Mortgages show the same pattern, with customers reverting onto standard variable rates from fixed rates and so paying higher interest rates than customers who choose another fixed rate deal with the same or another provider. This dynamic makes it harder for challengers to grow market share, as they cannot offset attractive rates for new customers (the 'front book') against returns from the back book.

As a result, large banks' back books provide significant competitive advantage and profitability. However, remedies to increase price transparency, increased digitisation and Open Banking may make back book savings customers more likely to search and switch to new deals. Similarly, in mortgages, the trend towards brokers advising consumers on the choice of mortgage and mortgage provider ('origination'), combined with the impact technology might have on switching, may result in a gradual reduction in banks' competitive advantage from this area.

We want to understand how future developments that might erode the number of back book customers may affect the economics of retail banking business models and what changes they may make as a result.

5.3. Credit expansion and sub-prime lending

The benign credit risk environment and competition has created challenges for incumbent firms looking for attractive lending opportunities that provide both strong margins and volumes. We want to know whether these pressures have made firms relax their credit risk appetites, leading them to take on riskier forms of lending or lend more to consumers who are already in debt.

We now know, for example, that unsecured consumer credit has reached pre-financial crisis levels; one in six people with debt on credit cards, personal lending and car loans are currently in financial distress[1].

In the future, for example, if interest rate rises mean that consumers struggle to repay these debts, there are clear implications for banks' profitability. We want to understand the extent to which large banks have taken on significant 'sub-prime' or non-standard credit risks and the implications of future interest rate rises on profitability.

5.4. Effect of technological change, greater intermediation and the future of branches in retail banking

We already know that intermediation and advice is playing a greater role in the mortgages market. This, along with consumer transition to online and mobile-based transaction banking is a well-established trend that is reflected in widespread branch closure programmes across the sector.

In the future, intermediation in this and other sectors could fundamentally affect retail banking business models if, for example, consumers start to move their current account or savings balances more often and new competitors emerge.

Banks' moves to reduce costs and improve efficiency may be a response to greater competition and developments in technology, and is welcome if it delivers better value and improved service for customers. However, as the number of bank branches declines, it could become difficult for some consumers to access services.

So we want to understand how banks are investing in technology, and what the future role of branches will be in retail banking. In particular, we want to understand how banks see the importance of branches in, for example, customer acquisition and marketing, fulfilling account opening processes, and transactional banking services. We also want to understand any potential impact of branch closures on vulnerable

[1] Occasional Paper No. 28: Preventing financial distress by predicting unaffordable consumer credit agreements: An applied framework.

consumers. As set out in our Mission, consumers in vulnerable circumstances are more susceptible to harm and generally less able to advance their own interests. Given this, we will prioritise such consumers to secure an appropriate degree of consumer protection.[2]

5.5. Competitive advantages and disadvantages of alternative business models

We know that a variety of firms with new and innovative business models have increased their market share in the relatively benign market conditions since the financial crisis. The low cost of funding has supported growth in lending to consumers and SMEs. Taking advantage of developments in technology and consumer behaviour, firms have developed new and innovative ways to serve customers, and have found niche areas to specialise in. They have overcome considerable challenges, for example, different regulatory capital requirements, diseconomies of scale and scope higher costs of funding, and high costs of acquiring customers. At the same time, they have benefited from new technology which has lowered customer servicing costs and do not have the costs of legacy branch and IT networks. We want to understand more about how the cost structures of the different participants in retail banking could change and how this could affect competition.

We also want to understand how bank capital requirements affect the business models of different banks. For example, the implications both of the leverage ratio on banks with high volumes of low-risk mortgage lending and the need for some banks to hold significantly more capital for certain types of assets than their competitors.

We know that some challenger banks are currently focusing on expanding their loan books and achieving scale. They do not have substantial numbers of long-standing customers to rely on and have few of the traditional competitive advantages of larger retail banks. So we are interested in what elements of their business models, such as efficiency, low cost or customer convenience, are critical to the success of their current strategies. We want to understand how far changes in the larger banks' business models and charging structures could affect the revenue streams of these new business models.

5.6. Distributional issues for PCAs

In the UK most consumers hold a free-if-in-credit (FIIC) PCA, and do not pay regular fees for using the account's core transaction services.[3] The prevalence of the FIIC model has caused public debate about whether it creates distributional issues, where some consumers pay more (or less) than others depending on their mix of products

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[2] Our Mission 2017: How we regulate financial services, p. 24.

[3] The CMA defines FIIC accounts as 'standard' accounts under which customers do not pay regular fees for using the account's core transaction services, but also do not receive interest on their credit balances (interest forgone) and, like other accounts, pay directly for other services, such as fees and interest for overdraft usage (unarranged and arranged). See para 37 of the CMA's final report on the retail banking market investigation.

and/or how they use them. This is particularly relevant in PCAs, where some groups of consumers are more likely to use overdrafts.

Given our Mission[4], we are interested in whether vulnerable PCA consumers are particularly profitable for banks. This could indicate distributional issues, for example if vulnerable consumers pay (significantly) more than others. It may also indicate potential consumer protection issues, for example, if vulnerable consumers use products that are unsuitable for their needs, such as using unarranged overdrafts as a regular loan.

We are also interested in the profitability of PCA consumers who hold other core retail banking products (i.e. saving accounts, personal loans, mortgages and credit cards), and insurance products.

As set out in 5.1, PCAs are a 'gateway' product, making either little profits or even losses, with banks relying on encouraging consumers to buy other core retail banking and insurance products to their overall profits. One hypothesis is that some existing consumers who have stayed with the same bank for a long time are particularly profitable for banks, particularly if they hold other products with the same bank. To assess this, we will look at patterns of PCA contribution, the cost to banks of servicing them and product holdings for individual PCA consumers.

This more detailed review of PCA accounts will complement our broader 'across the balance sheet' review which will look to understand the role of the PCA business in providing funding for the asset side of the balance sheet.

6. Our approach to information gathering and next steps

We recognise firms' concerns about the burden of collecting information, so we intend to approach the first phase of our work in at least two sub-phases, with the first focused on getting 'readily available' firm management information. This covers both qualitative aspects of the underlying business and product lines within the firm, such as strategic plans, pricing policies and risk appetite statements, and quantitative financial and non-financial information, such as management accounts, customer segmentations and new business volumes.

We will use this information to establish a base line understanding of the business models within retail banking. This phase will also allow us to identify areas, themes and issues we may want to investigate further, and for which we might require more detailed and prescriptive information.

We will also continue to make as much use as possible of data already available to us, including information gathered by the CMA and PRA, or gathered for other purposes, such as the Mortgage Market Study and the High Cost Credit Review.

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[4] See footnote 2.

The second phase will seek to answer, areas of specific focus identified in section 5 and any additional areas identified through discovery in phase one in a more data-driven and evidence based way.

We still expect to publish an update on our work in Q2 2018.