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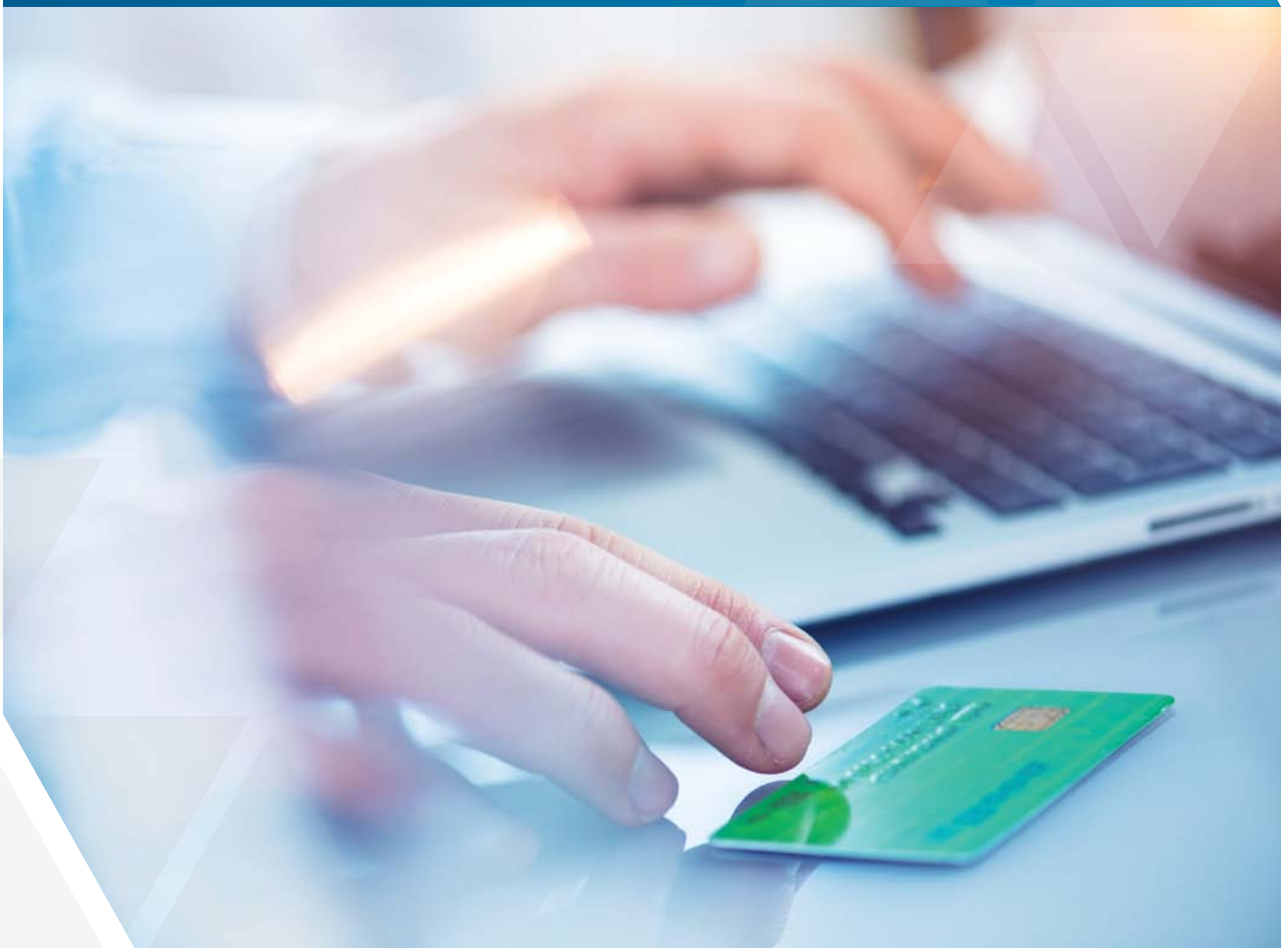
Viewpoint

Insights and opinions from Baringa Partners

UK current account market – the start of the revolution?



UK current account market – the start of the revolution?

The Ancient Greeks said there is nothing permanent except change; nowhere is this more evident than the banking industry. A sector which appeared to be frozen in the mists of time, is now undergoing unprecedented change.

Post crisis, there has been a surge of significant new regulation which appears to be finally abating and returning to a more sustainable level. The Government has aimed to tread a careful path, striking a balance between encouraging new entrants to the market and maintaining the regulation needed to keep customers safe.

A number of factors are attracting previously unseen levels of new entrants into the marketplace with many choosing the Personal Current Account (PCA) as the core product around which to build their wider proposition. So far, these 'new' challengers have only launched marketing campaigns with key themes of optimised for mobile and lower costs. They are not yet hindered by legacy infrastructure or issues.

Traditional banks have been riddled with technology challenges in their core banking platforms, and we continue to see outages of core banking systems directly impacting customers. These banks are trying to focus on re-platforming legacy applications, to deliver an online, digital experience, which they at least hope will keep pace with new challengers. We are also starting to see more innovative PCA products finally being launched. Customers are starting to respond to these new products with significant customer acquisition being achieved through fulfilling customers' adjacent needs by bundling products, and through cross-product rewards.

The PCA has come to the forefront of this changing environment, as competition intensifies to hold the customer's primary relationship, the opportunities it presents through the intimacy which customers have with their PCA and the customer insight it makes available.

In this Viewpoint, we focus on:

1. why PCAs are the key product in the UK Retail Banking market
2. how competition in that market is intensifying, and how the overall landscape of the market is changing
3. whether new challengers will indeed make headway and gain market share
4. how changing customer attitudes are affecting this landscape and open data protocols
5. is this really the 'Uber' moment for the current account market? Can Fintech have the same impact on financial services as Uber did on the taxi industry? If so, then what do the key players need to do to be successful?

A number of factors are attracting previously unseen levels of new entrants into the marketplace

PCAs – an attractive proposition

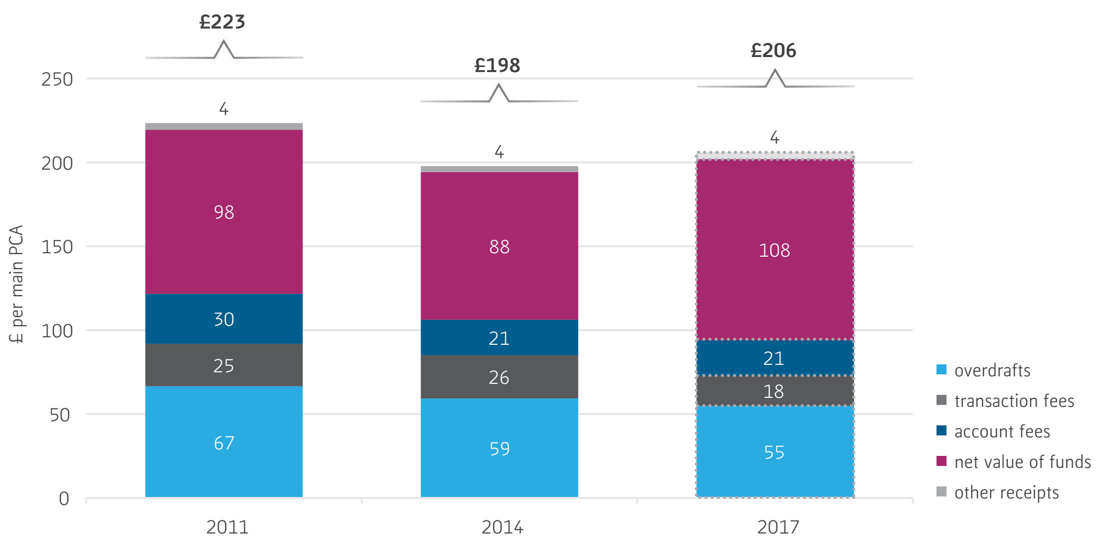
The PCA can still be a highly profitable product, as demonstrated by the number of new entrants utilising this as a core product – according to the Competition and Markets Authority (CMA), average net revenue per account in 2014 was £177 per annum.

The profitability of PCAs has come under some pressure in recent years (see Figure 1 below). Overdraft fees have been decreasing due to regulatory pressure, and banks are improving real-time notifications and text messaging solutions. Banks have also been increasing credit interest payments and other types of rewards on PCAs to attract customers in a low-interest-rate environment. More recently, the interchange income derived from debit cards has also been hit, whilst there has been suggestions from some market participants to mandate paying credit interest.

Nevertheless, PCAs in isolation can remain profitable. Furthermore, a rise in base rate on the horizon promises a boost to overall net interest income.

But the real value of the PCA is in its role as a gateway product and the customer data it makes available. PCA transactional information not only provides insight into products customers hold with other banks but also to their behaviours and propensity to certain types of marketing and offers. Understanding how a customer behaves enables a PCA provider to provide a tailored proposition that meets their needs and draws the most value from the relationship – right time, right place, right offer. Providing the right product and service to customers at key moments of truth, whether they're buying first home or planning for retirement is essential.

Figure 1. Analysis of PCA Value (£ per main PCA per year)



Source: CMA Retail Banking Market Investigation Provisional Findings Report, October 2015. 2017 forecast based on Baringa analysis.

An increasingly competitive market

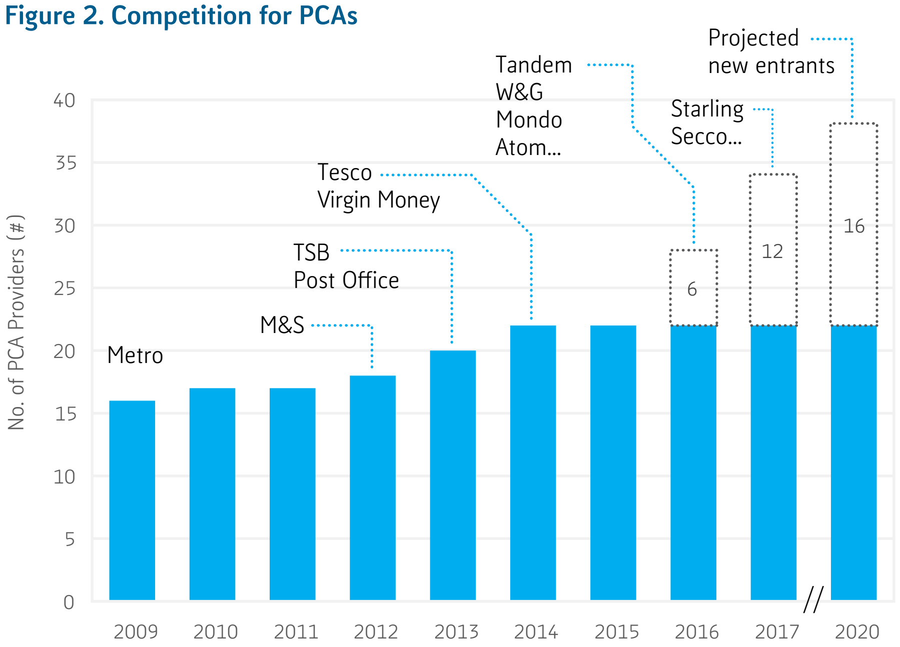
New banking entrants

Since the regulatory changes in 2013, we have seen a flurry of new entrants into the UK banking market with 12 new licenses approved across the retail market. In addition to the overseas investors we are seeing enter the UK banking market (Sabadell buying TSB, BBVA backing Atom), nearly 20 other institutions are in active pre-application discussions with the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

This influx of new entrants can be attributed to a combination of market conditions that has made launching a new bank increasingly simple and profitable:

- the changes introduced by the FCA, including a faster licensing procedure and relaxation of rules has made it easier and simpler to secure a banking licence in the first place
- high RoE on offer has attracted an influx of external funding from investment funds and private equity firms backing the majority of new entrants
- the maturing of Software-as-a-Service (SaaS) technology platforms now allows start-ups to avoid much of the enormous up-front capital investment that would be involved if they were to build or buy their own systems
- business models built on a 'digital-only' basis that forgo an expensive branch presence in the high street and explicitly target specific customer segments such as new-to-country, high net worth individuals or digital natives, has become a viable model.

Figure 2. Competition for PCAs



*Projections based on volume of banking licence applications.
Source: Baringa Market Analysis, December 2015

Figure 3

2015	Market share	# of PCAs	2020	Market share	# of PCAs
Big 5	80%	54m	New entrants	5%	3.2m
Other	20%	13m			

Represents annual switch volume of c. 650k over five years. Current annual switch rate is c. 950k.

Source: Baringa Market Analysis, December 2015

Backed by institutional investors, the business model of many of the entrants will be predicated on rapid growth over a 5 to 10 year period followed by exit either through an Initial Public Offering (IPO), take-over or management buy-out. It is, therefore, conceivable that some of the new entrants fail to reach critical mass in a highly competitive market where new customer acquisition is hindered by deep seated customer inertia. **In order to acquire a five per cent share of the market over the next five years would require challengers to pick up around 70 per cent of existing switching volumes.**

Further disruption of the value chain

The competitive landscape in the market is also changing due to on-going pressure from the technology industry. Investment in Fintech is growing faster in the UK than it is anywhere else in the world.

In 2014, London's Fintech start-ups attracted £343 million, triple the amount invested in the previous year. The first half of 2015 alone saw UK Fintech companies raise £306 million. According to one source, the value of this sector in London alone now puts it on par with San Francisco, the city widely considered as the global headquarters of technology.

The model for most Fintech firms appears to be aimed at picking off small high value slices of the end-to-end value chain rather than competing with the banks head on. This is raising the question as to whether banks can successfully compete with more nimble and agile start-ups, or if they instead will need to embrace a more 'open' ecosystem model to stay in the race. Many are recognising that their best chance of success is to collaborate and partner with a variety of non-bank companies to achieve the best result for their customers.

Examples of challenger bank models on the horizon:

Tandem

UK launch: Customer Banking licence approved November 2015, launch expected in the second half of 2016.

Business model: Tandem is still to reveal its full strategy but there is clear intent that the bank will offer the full range of Retail banking products, including current accounts and mortgages. The intended focus for the digital-only bank is to enable customers to manage their money, leveraging big data to create tailored offers that meet the needs of its customer base. Mobile will be the primary distribution channel, supported by a call centre to manage larger transactions. Not having the constraint of legacy issues and expensive infrastructure, Tandem believe they can offer better value to customers.

Funding / backing: Approximately £100m in capital from a group of institutional investors.

Mondo

UK launch: Beta-test version of app released October 2015.

Business model: Mondo is already in the process of rolling out a prototype app and prepaid MasterCard to 500 people as a test-and-learn exercise with customers to get feedback on functionality and the experience. Mondo's CEO Tom Blomfield has been vocal about building a bank transparently and delivering an experience that aligns with what customers have come to expect from big tech firms like Google and Facebook. Built for customers who are comfortable banking on mobile the app will potentially feature a myriad of attractive features: automatically applying for refunds if you forget to tap out on London Underground, blocking your debit card with just one tap and real-time notifications showing your daily spend or if you are nearing your overdraft.

Funding / backing: London Venture Capital firm Passion Capital.

Fidor

UK launch: September 2015.

Business model: Fidor offers a unique banking experience built around its online community, established with the objective of renewing confidence in the banking system enabling customers to be actively involved in the bank's decisions. Currently the bank offers a limited Smart Current Account, which is the centre piece of the customer relationship from which savings bonds can also be accessed. Future plans also include offering peer-to-peer lending, crowd funding platforms and multi-currency investments. Fidor's 'interest for likes' feature incentivises customers to get likes for products on Facebook by improving interest rates on in-credit balances.

Funding / backing: European private equity house JZI Group.

▶ Changing customer attitudes?

In the current account market there remain huge levels of customer apathy. In 2015, just over 1 million current account customers switched, down from 1.15million in 2014. (Source Bacs.). Whilst adverts on the TV and radio have been resurrected, we still have to ask the question whether customers really care about a product which essentially they view as free. There have been winners and losers in the switching space, but ironically customers are generally switching away from 'free if in credit' to propositions where they earn rewards for an annual fee.

Customer trust in banking has seen improvement over the past few years, but remains relatively low overall in comparison to a number of other industries. The level of customer complaints also remains high. According to details released by the FCA in September 2015, the number of people complaining about their current accounts in the first half of the year was up by a third against the previous year, with just over 500,000 such complaints between January and June.

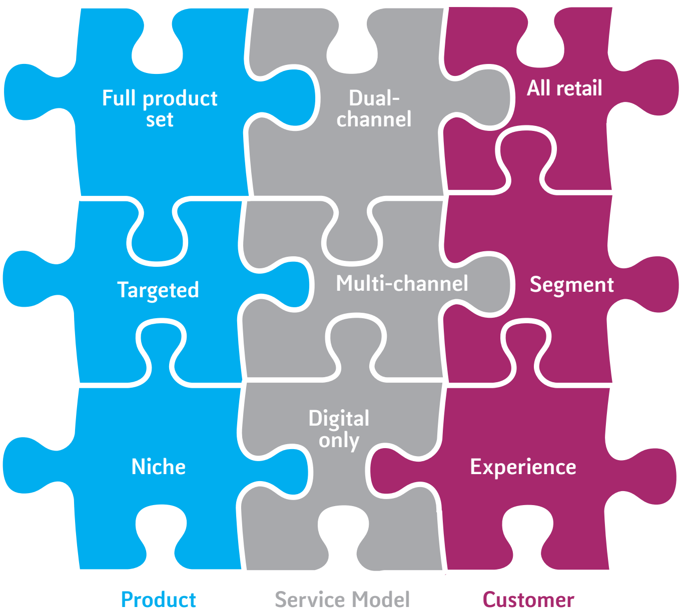
At the same time, customer expectations around service and overall experience continue to rise, driven by the levels of service and experience they encounter in other industries. The wider customer base is becoming increasingly comfortable banking online and the next ten years will see approximately eight million youngsters – who have grown up surgically attached to their mobile devices – getting to the age where they need to select a bank account provider. This will open the door further to new entrants, based on a digital-only model to challenge the incumbents for market share.

Whilst these expectations are increasing, a number of the traditional high street banks have been struggling to get some of the customer basics right with payments outages and online services being unavailable. Customers looking to switch are, therefore, increasingly considering factors such as channel availability in addition to other factors such as product features, overdraft charges and robustness of balance sheet.

High street banks have been investing significantly in pushing up their customer service levels, enhancing their current account propositions and developing their online and mobile banking services. But a likely outcome is still a market characterised by providers with vastly divergent business models that seek to differentiate themselves based on product offering, service model, and, or target customer segment.

Indeed, the greatest threat posed to the more established players no longer comes from the impact of regulation but from the competitive environment it has created and the potential to lose their most profitable customers to new entrants while continuing to be burdened with the costs of physical branches and ageing technology.

Figure 4. Divergence in business models



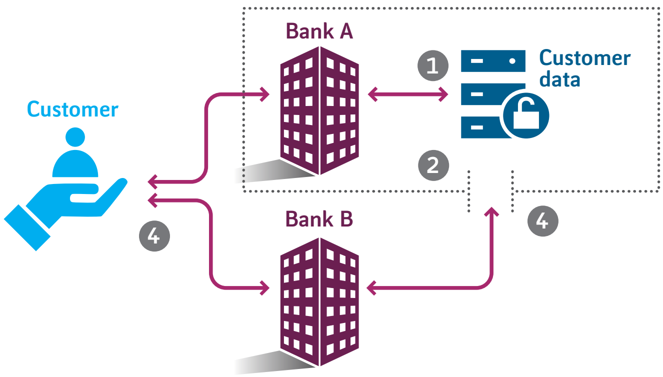
Towards a world of consumer empowerment through open data

The primary current account relationship is highly valued by retail banks as it makes available a wealth of data and insight about the customer, which it can then use to better serve, personalise and market products and services to these customers.

This has been noted by the regulator, and they are leveraging this data to empower customers to make choices about their current account provider. Through the miData project and price comparison websites, customers are able to download their transaction history, and then upload to a comparison site in order to ascertain whether they could be better off with another provider – CMA research suggests that the average customer could be £70 per year better off if they switched.

This customer data model will come under further change in late 2017, post the planned implementation date for Open Application Programming Interface (API) standards that are expected to be introduced as part of the second Payment Services Directive (PSD2). This change has the potential to revolutionise the customer-to-bank relationship, and also opens up the door further for new non-bank market entrants, giving them easier access to transactional customer data held by their main banks.

Figure 5. The Open-API model



1. Bank A stores customer data in a way allowing specific items of data to be accessed in isolation of other information.
2. Bank A implements an 'Open API'. or doorway, allowing external bodies to access customer data subject to the right permissions and credentials.
3. Customer grants permission to Bank B to access a specific segment of his or her data.
4. Bank B is able to retrieve, modify and transact on the customer's data held by Bank A.

A future banking model might include increased price transparency, greater competition and lower hurdles for switchers. We would expect the market to be more price sensitive and a have a much more selective customer base. Such a market would be more like the insurance industry, with customers more likely to shop around for the best deal on various products, switching from one provider to the next whenever a better price became available.

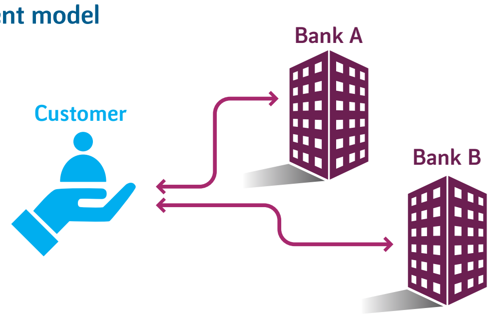
With the features and pricing of the underlying product separated from this decision, customers will ultimately choose a provider that offers them the most useful and usable solution for managing their money. It is likely that two distinct models will appear in the market:

- as before, it opens up the possibility of customers choosing a single bank with which to hold their 'primary day-to-day relationship', accessing and managing their other product holdings (held with other banks) through this single provider
- this 'primary day-to-day relationship' no longer needs to be held by a bank at all. Any third party will be able to compete to own this relationship.

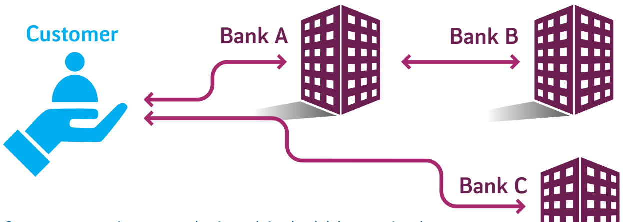
Figure 6. Future alternative models

The current relationship model is characterised by a 'primary' relationship that customers typically hold directly with their bank. Many customers hold products from multiple providers and have to engage and interact with each separately to manage their holdings. Introduction of Open APIs and technological development could result in this model being significantly distrupted. The ability to manage all banking products through single relationship is considered very attractive by many customers.

Current model

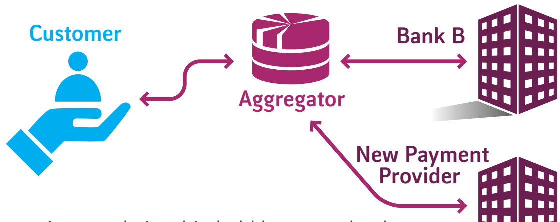


Potential future model A



Customer primary relationship held by a single bank that acts as a 'gateway' to secondary banks.

Potential future model B



Customer primary relationship held by a non-bank entity that aggregates banking products held.

We are already seeing some tentative steps in this direction with innovative banking product 'aggregators' such as OnTrees, Your Wealth and Money Dashboard pushing into the market. Uptake has been slow but the technology is maturing and the implementation of Open API will act as a significant accelerant. One potential outcome could be a wide fragmentation of the marketplace with a variety of pricing models emerging (eg free versus premium paid-for services) as well as niche providers entering the market (eg high-end luxury providers) catering for smaller segments of the customer base.

Figure 7. Spotlight on aggregators – Snapshot of three providers of banking aggregation services:

ONTREES

UK launch:
2012 (acquired by MSM 2014).

Head Office: UK.

Business model: Tandem customers get a free personal finance app, which aggregates transactional data from their various banking products (based on Yodlee). Ontrees, in return, receives the customer's permission to access and sell insights drawn from their personal financial data to third parties. Moneysupermarket's acquisition offers an additional opportunity to cross sell financial products through the price comparison website on a commission per sale basis.

Number of customers: Unknown.

MINT

UK launch:
2006 (acquired by Intuit 2009).

Head Office: California, US.

Business model: Similar business model to Ontrees, serving the US and Canadian markets. Mint originally provided account aggregation through a deal with Yodlee, but has since moved to using intuit for connecting to customer bank accounts.

Number of customers: Over 10m users in the US and Canada (Wiki 2013).

YODLEE

UK launch:
1999.

Head Office: California, US.

Business model: The company offers scalable personal financial management solutions for banks and companies, which allows them to work with customers' existing financial data. Yodlee connects to banks' websites using user credentials to extract information either via direct feed or screen scraping to gather recent transactions and price information. Yodlee groups transactions into common categories and learns over time as more and more users re-categorise transactions.

Number of customers: Unknown.

Conclusions

Will there be significant change in the retail banking market, especially for PCAs?

The signs are there that the PCA market is entering a phase of significant growth. High street banks are actively 'buying' accounts through up-front inducements – many in cash. Huge amounts of new investment are also entering the market. New players see an opportunity to turn a profit by acquiring specific segments of profitable customers, while keeping their costs far below those of incumbents. An interest rate rise over the next year would further stoke the flames of competition, and the Competition and Markets Authority (CMA) review into the UK Retail Banking market will likely lead to further steps to make switching easier.

There are significant differences now, compared to what came before. We are seeing changes in both the market and customer behaviour which could result in banking's own 'Uber' moment - re-invigorating the industry, creating new business demand at a lower cost and improved customer experience. Banks, therefore, need to consider carefully the following:

Where you sit in the value chain
All players need to consider which part of the value chain they want to play in, and how hard they wish to compete for the primary customer relationship versus focus on the product manufacturing side. With competition centred around the day-to-day interactions with the customer, banks will need to consider whether they really can compete in the experience and satisfaction stakes with the likes of Uber, Amazon, Google or John Lewis.

Focus on customer centric product proposition
Given the likely divergence of business models between full-service 'bricks and mortar' banks and digital only providers, it is critical that banks focus on offering the right propositions. The underlying products and supporting digital tools and service model will need to meet the often divergent needs of customers. Propositions need to be simple to understand, have transparent pricing, and allow customers to choose how they want to manage their money.

Position to retain customer relationship
The PCA is still recognised as customers' primary banking relationship and the key to owning a wider relationship. The first step for incumbent banks is to use what is already on their doorstep. They must make use of the data they hold on their existing customers to look for opportunities to serve them better and offer keener pricing to retain the most valuable customers.

The next step is to position themselves as the 'one-stop-shop' for all of a customer's banking needs or their preferred access point for financial services. This will involve exploiting the Open API regulation to be introduced in the next two years and considering how they can learn from existing aggregators already on the market.

Who to partner with - don't try to go it alone

As traditional lines between industries become increasingly blurred and Fintech and big tech firms make inroads into retail financial services, it is critical that banks invest in relationships with a wide ecosystem of companies rather than trying to go it alone. The pace of technological innovation means it is increasingly difficult and costly for banks to try to compete independently in this space and working with partners will allow them to bring the best propositions to their customers.

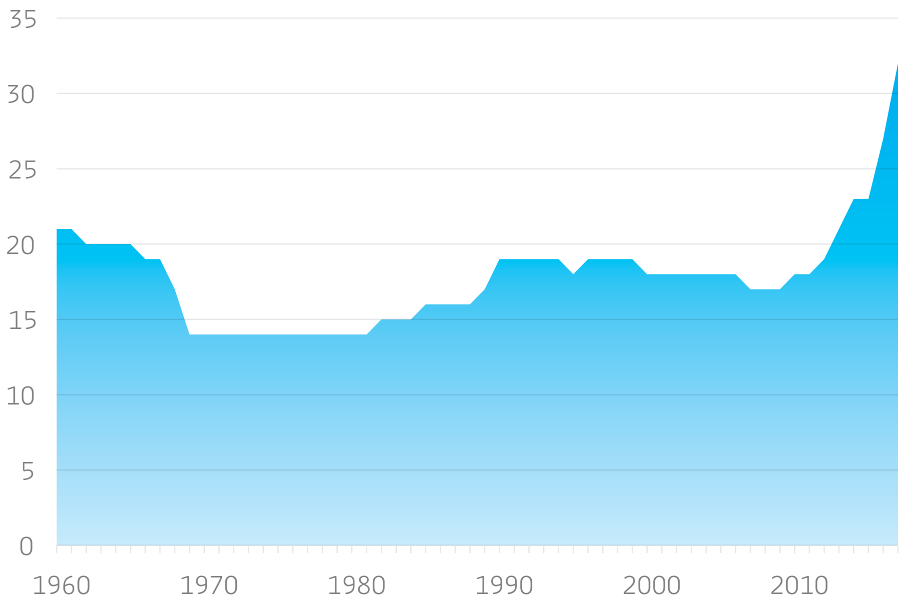
Traditional retail banks should also think hard about how they might work with new challenger bank entrants to make the most of each other's strengths. Conversely, a partnership with a high street bank would give a digital-only start up access to its physical assets such as the branch and ATM network.

Can I just buy market share?

Backed by institutional investors, the business model of many of the entrants will be predicated on rapid growth over a 5 to 10 year period followed by exit either through IPO, take-over or management buy-out. Acquisition of one of the newer challenger banks by a traditional high street institution could offer them an avenue to acquire customers inorganically – with concentration of high-value customer segments - or to acquire new brands through which to sell their broader product proposition.

Figure 8. Long cycle of consolidation is turning

Number of PCA providers in UK market (brands)



*Excludes private banks. UK excluding Northern Ireland.

How Baringa can help

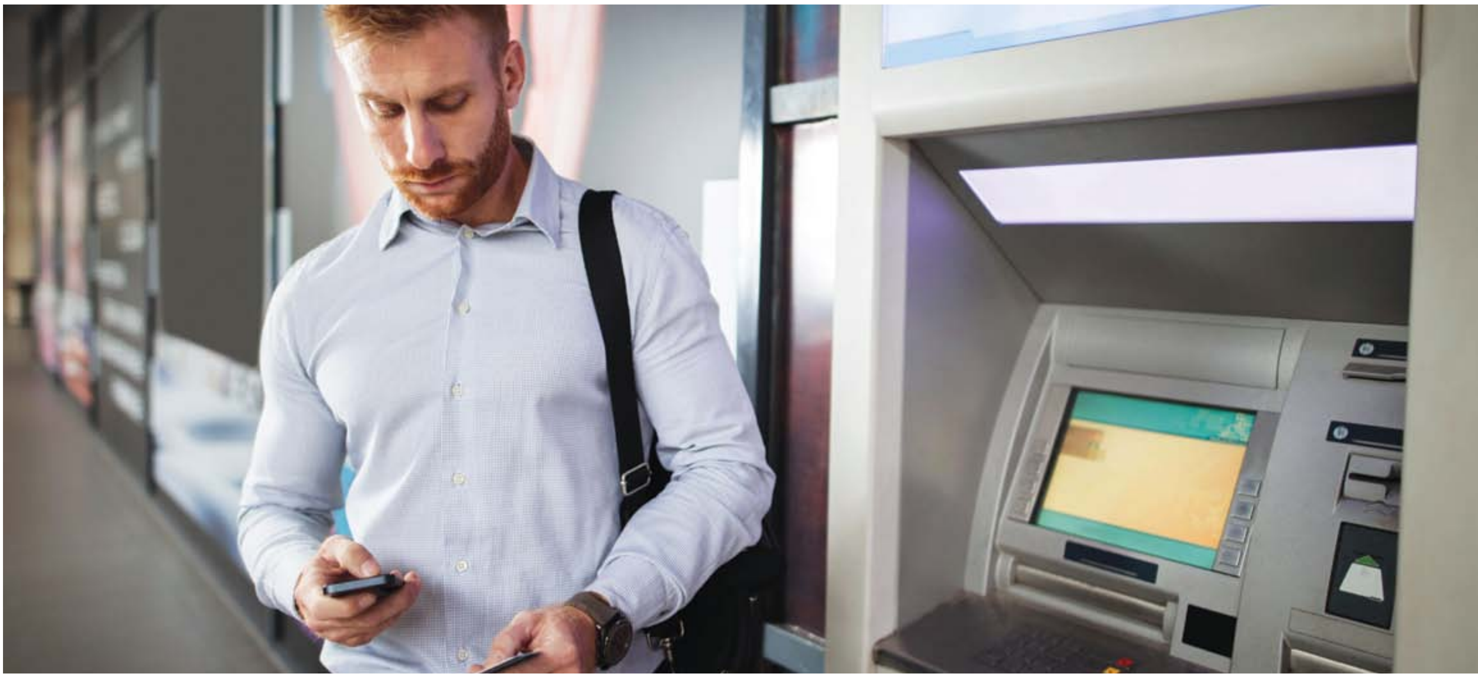
Baringa prides itself on the quality of its Banking practice. Our Banking team has worked with the leading banking providers and high street lenders in the UK and abroad, helping them to innovate in a constantly shifting landscape.

We work in partnership with our clients to assess their challenges and look for viable and pragmatic solutions, shaping and delivering complex programmes delivering real, tangible results.

Baringa's broad spectrum of services includes:

- designing and implementing new operating models for both the more traditional, and new challenger banks
- support clients to evaluate the viability of new revenue streams, new market entry strategies and the implications these have on their P&Ls
- driving cost efficiencies through deep insight into areas such as customer journey management customer contact optimisation
- developing and running transformation programmes to enter new markets, deliver new platforms, and launch new products
- assessing appropriate technology platforms to support strategic decisions and market entry strategies
- optimising and leaning end-to-end customer processes, not only to reduce cost, but significantly improve customer experience, and
- integrating businesses post acquisition.

Please do contact us with any questions or if you are interested in knowing more about the expected developments in the UK current account or broader banking market.



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About Baringa Partners

Baringa Partners LLP is an award-winning management consultancy specialising in: energy; financial services; telecoms and media, in the UK and continental Europe. It partners with blue chip companies when they are developing and delivering key elements of their business strategy. Baringa works with organisations either to implement new or optimise existing business capabilities relating to their people, processes and technology.

Baringa is recognised both in the UK and internationally for its unique culture, which has been acknowledged by a number of awards and accolades and continues to reaffirm Baringa's status as a leading people-centred organisation.

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