

# Strategic Review of Retail Banking Business Models

Progress report

June 2018

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# 1 Summary

Concentration in retail banking was stable and high for many years and has increased following the financial crisis. Since then, challenger banks have made some progress and alternative business models have begun to emerge. Despite this, the major banks still have over 80% of the PCA market.

We now stand at a crossroads. Technological change, facilitated by Open Banking and the second Payment Services Directive (PSD2), has the potential to drive innovation and competition for the benefit of consumers.

This review looks at the sources of competitive advantage that have helped the major banks to retain their market shares in the recent past, with a view to evaluating the potential for change and the impact of that change on business models. We have not yet fully explored all aspects of this, but our early analysis indicates that a key component of competitive advantage to date has been the combination of personal current accounts (PCAs) and large branch networks, bringing the following benefits:

- a funding cost advantage from large numbers of customers holding balances in PCAs paying no interest, and in savings accounts which pay lower interest rates than other providers
- significant additional income from fees and charges on PCAs, particularly overdraft charges
- the ability to cross-sell lending products to PCA customers
- the ability to cross-sell business current accounts (BCAs) and associated business savings balances, which also pay no/low interest

Major banks generate a positive contribution to profits from the majority of PCA customers. A small proportion seem to generate significantly more contribution than others. This contribution comes from overdraft charges and funding benefits on balances. Banks get more funding benefit from customers with larger balances, but we are concerned that unarranged overdraft charges are more likely to be incurred by vulnerable customers. We have put forward proposals to address consumer harm caused by overdraft charges in our High-cost Credit Review Consultation Paper.

Retail banking may be changing as digital channels become increasingly important and Open Banking and other regulatory changes take effect. This update sets out the work we have done to date and how we plan to develop it in the next phase of our work to explore the impact of future change scenarios on business models and consumers.

## The competitive landscape and background to our review

- 1.1** In April 2017, we launched a programme of discovery work – the Strategic Review of Retail Banking Business Models (the ‘Strategic Review’). In our Purpose and Scope paper published in October 2017 we set out in more detail the issues we wanted to focus on.<sup>1</sup> Specifically we wanted to examine the potential effect of technological

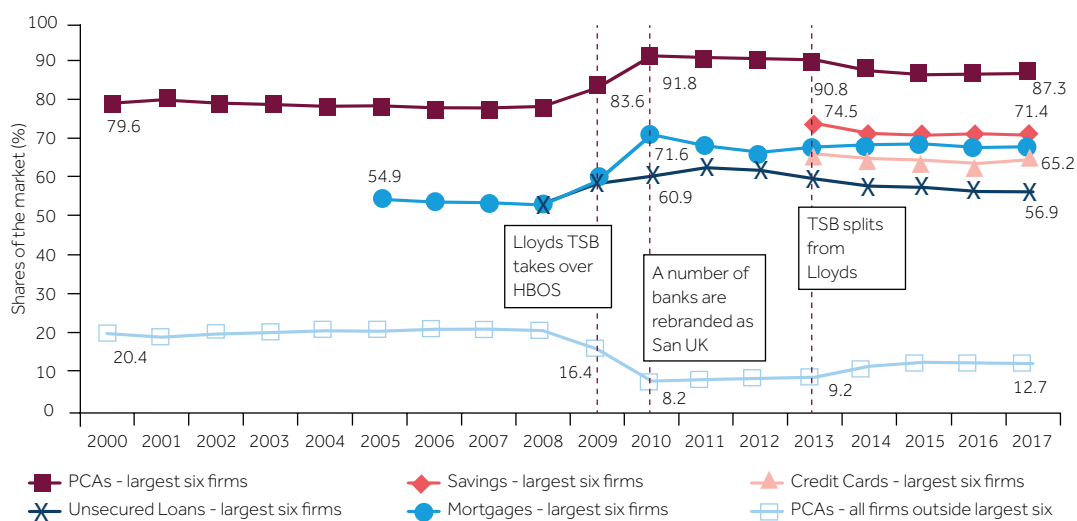
<sup>1</sup> <https://www.fca.org.uk/publication/multi-firm-reviews/strategic-review-retail-banking-business-models-scope.pdf>



change and increased digitalisation combined with new regulatory initiatives such as Open Banking and PSD2. We also said we wanted to look at how free-if-in-credit (FIIC) PCAs are paid for and whether that leads to concerns about the distribution of profits from different types of consumers or different products.

**1.2** The established bank and building society business models have co-existed for a long time, and market shares have been relatively stable between them. Figure 1.1 shows that the market shares of the six largest banks for PCAs have increased to over 80% following consolidation after the 2008 financial crisis. Entry and expansion from new and established challenger banks have occurred but their market shares remain low.

**Figure 1.1: Concentration levels in retail banking in GB measured using market shares of the largest six firms since 2000**



Source: FCA analysis of GfK data<sup>2</sup>

**1.3** The retail banking sector has been the subject of a series of reviews over the last 18 years. These include:

- Cruickshank report into Retail Banking (2000)
- Competition Commission investigation into SME banking (2002)
- Office of Fair Trading investigation into overdraft charges (2007)
- Competition Commission investigation into Payment Protection Insurance (2009)
- Independent Commission on Banking report (2011)
- Parliamentary Commission on Banking Services report (2013)

<sup>2</sup> Concentration levels are measured using market shares based on number of accounts (main mortgage for the mortgages market). For each provider, we have averaged GfK rolling data to compute yearly market shares (3 months rolling data for the PCA market, 6 months rolling data for all other markets). We have then summed up the market shares of the six largest providers in each market. Source: GfK Financial Research Survey, 6 months rolling data Jan 2000 – Dec 2017 (3 months rolling data for PCA market). Savings data exclude Premium Bonds.



- CMA and FCA market study on banking services to small and medium sized enterprises (2014)
- Competition and Markets Authority market investigation into retail banking (2016)

**1.4** We have aimed to build on this existing work, but have taken a different approach to previous reviews. We are considering retail banking as a system, rather than focussing on separate product areas, business lines, or individual firms. We are looking at not just the largest banks but the full range of business models, including those of small retail banks, building societies, and specialist lenders. We are looking at the full suite of activities from deposit taking to lending, and how each activity contributes to return on equity. This approach will give us a holistic picture of how profits are generated; the relative competitive advantages and disadvantages of different business models and of barriers to entry and expansion. It will allow us to understand the effects of increased competition, regulatory and other changes across both sides of the balance sheet and across different types of firms. We will use this to explore the impact of different potential scenarios for the evolution of the industry landscape on business models and consumers.

**1.5** We do not envisage taking policy action as a direct result of this work. Instead it will inform our ongoing policy work in retail banking and related areas, including:

- We are considering interventions on overdrafts as part of our High-cost Credit Review (HCCR).<sup>3</sup> The impact of our proposed interventions will be considered separately in a subsequent HCCR publication, and will draw on information from this review to provide a broader perspective.
- Our Mortgage Market Study is looking at potential remedies to make it easier for consumers to find the right mortgage and to switch more freely to new deals.<sup>4</sup>
- We are exploring whether competition in the cash savings market could be improved, particularly to ensure the fair treatment of longstanding customers, who tend to receive lower interest rates than those who opened their accounts more recently.<sup>5</sup>

**1.6** It is possible that in future we will decide to launch policy work on other aspects of the retail banking market where we have concerns.

**1.7** To inform much of our analysis so far we referred to readily available financial and strategic information from firms, presented in different formats and levels of detail. From this, we compiled a basic dataset for 2016, making a number of assumptions and judgements in the process. For the work on the distribution of contribution to PCA profitability between different types of consumers, we analysed a detailed transaction-level dataset from 2015 and 2016. We set below our initial analysis, noting these data limitations.

**1.8** This paper provides an update rather than a final view. The remainder of this section summarises our initial analysis, sets out areas for further engagement, and describes our proposed scenario analysis.

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3 FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018).

4 <https://www.fca.org.uk/publication/market-studies/ms16-2-2-interim-report.pdf>

5 FCA Business Plan 2018/19 p.29



## Initial analysis

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**1.9** Our analysis suggests that major banks generally have lower funding costs than other banks. This reflects their extensive PCA and branch networks, which in combination and over time have resulted in a larger proportion of relatively price-insensitive customers. Whilst that may change in future as digital channels become increasingly important and Open Banking and other regulatory changes take effect, the PCA offering and branch network have to date brought four main benefits:

- funding cost advantage
- significant additional non-interest income
- benefits of cross-selling lending products to PCA customers
- benefits of cross-selling BCAs and associated business savings balances

**1.10** We recognise that the operation of PCAs and branch networks comes with a significant cost. We have not yet fully explored the interplay of these additional costs with the benefits described in more detail below.

**1.11** We summarise our initial analysis in each of these areas below, followed by a summary of our initial analysis on the distribution of profits from PCA customers.

### Funding cost advantage

**1.12** Since the 2008 financial crisis, bank funding has shifted towards retail deposits and away from wholesale funding. Retail funding now comprises on average 87% of total funding across the market as a whole. Smaller banks and building societies are more reliant on wholesale funding, including on Bank of England schemes such as Funding for Lending and Term Funding Schemes, than major banks. In the future, ring-fencing and the withdrawal of the Bank of England schemes are likely to lead to changes in the funding mix of firms.

**1.13** Major banks with established PCA businesses and extensive branch networks have retail funding costs that are close to half those of other banks. This stems from:

- a high proportion of funding from PCA balances and related instant access savings accounts paying no or very little interest
- interest rates on interest-bearing savings balances that are between 30% and 50% lower than other banks, based on on-sale rates

**1.14** This has created a barrier to entry and expansion. Potential challengers struggle to replicate these funding cost advantages because they find it difficult to attract the customers of incumbent banks who are unresponsive to competing offers, and are unlikely to switch provider. These customers are more likely to keep their money in low or zero interest-bearing accounts. Challengers are more likely to attract price-sensitive customers who are prepared to switch provider to take advantage of promotions. This type of customer regularly looks at 'best buy tables' and price comparison websites. This means challengers need to offer retail savings deposits with significantly higher interest rates than incumbent banks to attract and retain more price-sensitive customers.

**1.15** This funding cost advantage is significant despite the current low interest environment, but it might be even higher if interest rates rose. This would depend on how consumers move balances in reaction to interest rates: the proportion of savings in non-interest bearing accounts has risen in the low interest rate environment from around 5% in 2007 to over 20% by 2016. If interest rates were higher, the proportion of savings in non-interest bearing accounts would likely fall.

#### **PCAs generate significant additional income**

**1.16** Around 40% of the value that major banks obtain from PCAs is derived from the use of PCA balances as a funding source. In addition they obtain significant revenues from other sources, including:

- Overdraft related fees and charges. Overdraft revenue, including interest and other fees and charges, contributes over 30% of PCA income. Major banks appear to earn high margins on overdrafts in comparison to other credit products.
- Other fees and charges including interchange fees on debit card transactions, packaged account fees, and foreign exchange fees. We estimate these fees and charges collectively contribute around 30% of PCA income.

#### **Benefits of cross-selling other products to PCA customers**

**1.17** Many people go to their PCA provider when taking out lending products. For PCA customers holding other financial products, there is a relatively high probability that these will be held with their PCA provider:

- 52% of PCA customers with credit cards have one with their PCA provider
- 48% of PCA customers with personal loans have one with their PCA provider
- 32% of PCA customers with mortgages have one with their PCA provider

**1.18** Mortgages are the largest contributor to major banks' lending balances and gross income. Major banks derive a higher proportion (30%) of mortgage net interest income from customers on 'back book' SVR mortgage rates in comparison to the proportion of balances on these rates (14%).

#### **Benefits of cross-selling BCAs and associated business savings balances**

**1.19** The supply of core SME Banking products, including business term loans, BCAs and overdrafts, is concentrated among the major banks. The CMA found that the four largest providers in GB accounted for 82% of BCAs in 2015. Similarly, the four largest UK providers accounted for around 80% of general-purpose business loans (including commercial mortgages) in 2014.<sup>6</sup> Specialist lenders have increased SME lending volumes in the last few years but it is not clear to what extent this has affected the market shares of the largest providers in core retail business banking markets.

**1.20** Our analysis has focused on SMEs within the retail banking divisions of the major banks. These tend to be smaller businesses with annual turnover of less than £6.5 million. Our analysis indicates that these businesses are an important source of low cost funding for retail banks with established branch networks. They deposit on average around four times as much as they borrow, and banks pay low interest rates on SME deposits.

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6 See paragraph 7.26 of the CMA Retail Banking Market Investigation Final Report and Appendix 7.1.



- 1.21** In addition to the funding benefit from SME deposits, banks also earn significant fees from BCAs because SMEs commonly pay transaction charges and monthly account fees as standard. Our own analysis and that of the CMA suggests that fees, including overdraft charges, comprise around 55% of the total revenue that banks earn from BCAs.<sup>7</sup>
- 1.22** Around 50% of BCAs are opened with the owner's PCA provider. SMEs are highly likely to choose their main BCA provider for related products such as overdrafts, loans, credit cards, commercial mortgages, and related financial services.<sup>8</sup>

### **Distribution of PCA contribution between different consumer types**

- 1.23** Banks generate a positive contribution from the majority of PCA customers, including from overdraft charges and from the funding benefit they derive from balances.
- 1.24** A small proportion of customers pay significantly more than others. Around 10% generate between one-third and a half of the contribution from PCAs. A small proportion generate small losses, with most of these losses comprising bad debt costs on overdrafts. We will be refining our understanding of costs to serve different types of consumers as a next step in our analysis.
- 1.25** Banks derive greater funding benefit from customers with larger PCA balances. PCA customers with cross-holdings (i.e. those who hold other retail banking products with the same bank) tend to have higher PCA balances than those who only hold a PCA. Banks may therefore be earning even more contribution from some customers with high PCA balances than our distributional analysis shows, since we have not included the contribution from their cross-holdings.
- 1.26** The majority of unarranged overdraft charges are concentrated on less than 2% of PCA consumers. We have concerns that unarranged overdraft charges are more likely to be incurred by vulnerable consumers. This is an area of focus for our High-cost Credit Review.<sup>9</sup>
- 1.27** Our analysis is based on data for 2015 and 2016. Changes due to the interest rate environment, the advance of technology and regulatory initiatives such as Open Banking and PSD2 could affect how consumers pay for their PCAs and how much they pay.

### **Areas for further engagement**

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- 1.28** We have not yet explored all relevant factors. Some of our work is continuing, for example, developing a fuller picture of the drivers of return on equity and understanding the impact of branch closures on different consumer types. There are a number of areas where we need further engagement with banks and building societies to further our analysis. Two significant areas that we will focus on in the next stage of our review are the nature of the customer base and costs of retail banking.

<sup>7</sup> CMA Retail Banking Market Investigation Final Report and Appendix A7.2-3 Table 1.

<sup>8</sup> The CMA found that more than 90% of SMEs went to their main bank for overdrafts, business loans, credit cards; over two thirds went to their main bank for invoice discounting and factoring, and more than three quarters for commercial mortgages. Over half of SMEs only considered one provider when seeking lending.

<sup>9</sup> FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018), section 4.





### The nature of the customer base

- 1.29** We will increase our understanding of the nature and behaviour of customers of different categories of firms, so we can better predict how they will be impacted by forthcoming changes. For example, which customers are more or less likely to switch product or provider in response to Open Banking and what impact this would have on business models.
- 1.30** We are interested in the types of customers who have switched product or provider in the recent past, and how they compare with longer tenure customers. In particular, we want to understand the contribution earned from these different groups to give us a picture of relative importance to firms' business models.
- 1.31** We also want to look at the impact of cross-holdings and understand to what extent firms earn higher contribution on lending products when lending to PCA customers than otherwise. These consumers may be less price-sensitive and PCA providers have substantial information on their financial position which they can use to make better informed, and therefore potentially more profitable, lending decisions.
- 1.32** We will engage with firms to find effective and proportionate ways to explore these questions.

### The costs of retail banking

- 1.33** We will increase our understanding of how the costs of servicing equivalent customers differ by category of firm so we can better predict how business models may change in the future under different scenarios. For example, in scenarios where competition intensifies, what is the scope for larger firms to respond by reducing costs, and how might this affect consumers? In scenarios involving reduced PCA income, what is the likelihood of new charges being introduced for PCAs or services being scaled back?
- 1.34** We will compile data on operating costs, volumes, and data on dimensions of service quality from a range of retail banks, in a consistent format across several different cost categories, and use it to explore the reasons for differences in costs between business models. In addition to operational costs, we want to develop our understanding of the cost of capital, including the capital base and the required rate of return.
- 1.35** The costs of retail banking have not been examined in depth in previous studies so we will require banks to provide us with data for this exercise. We will engage with firms to explore how this can be done in a proportionate way.

### Future scenarios in retail banking

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- 1.36** We will look at how technological change and increased digitalisation combined with new initiatives including Open Banking, PSD2, GDPR, the CMA's remedies and the competition remedies that we are consulting on as part of our High-cost Credit Review<sup>10</sup> will impact business models in future, using a series of scenarios. In our Purpose and Scope paper we said we would consider:

- competition between different business models<sup>11</sup>

<sup>10</sup> FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018)

<sup>11</sup> Purpose and Scope paper, section 5.5 (Competitive advantages and disadvantages of alternative business models).

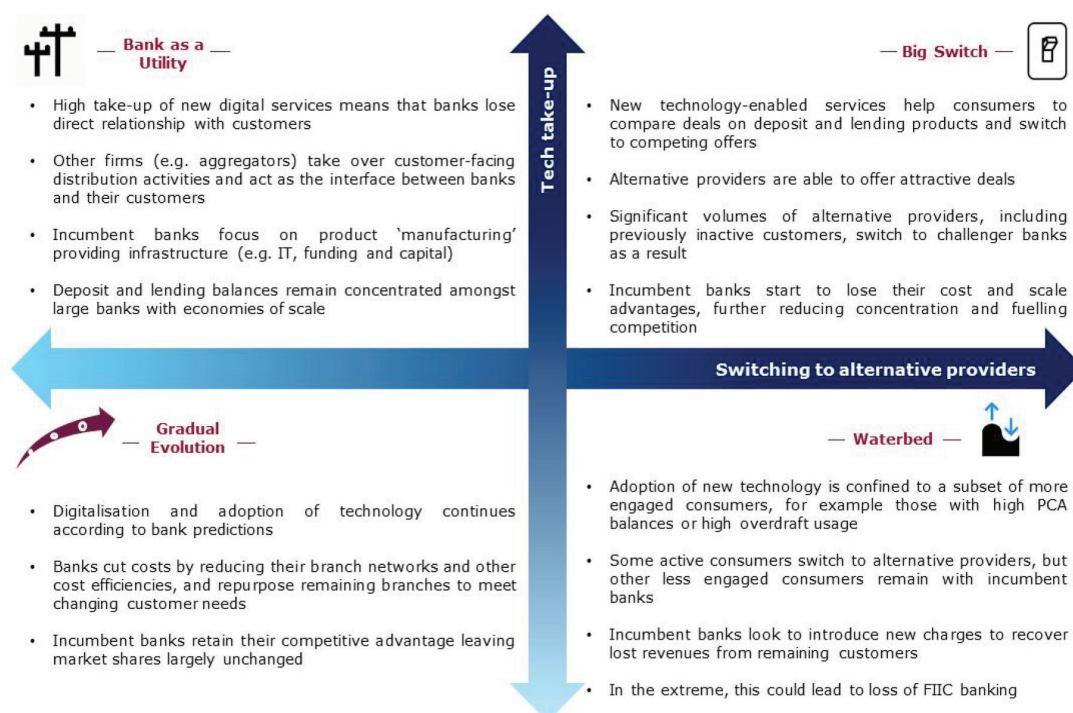


- the retention of customers on 'back book' deals<sup>12</sup>
- the economics of the PCA and the ability of firms to cross-sell<sup>13</sup>
- the branch closure programme<sup>14</sup> and
- how future interest rate rises<sup>15</sup> affect profitability, particularly where firms had taken on riskier forms of lending or had lent more to already indebted people.

**1.37** How the retail banking landscape evolves in the future and over what time period depends on demand and supply side factors as well as on macroeconomic and other exogenous factors. Change could be slow and muted, or rapid and dramatic, depending on the strength of these factors and the speed with which they take effect. There are many possible future scenarios. In the graphic below we illustrate four alternative scenarios that could arise in the future depending on:

- The extent to which consumers embrace digitalisation, technological innovation and the sharing of their banking and other personal data with third parties. With a high rate of 'tech take-up' consumers would place less reliance on branches and shop around more easily to get the best offers for payment services, savings and borrowing.
- The extent to which consumers move payments, deposit balances, and/or lending activity away from incumbents and towards alternative providers, resulting in a reduction in market concentration.

**Figure 1.2: Illustration of potential future scenarios**



12 Purpose and Scope paper, section 5.2 (The competitive advantage of large 'back books').

13 Purpose and Scope paper, section 5.1 (The role and economics of PCAs and cross-selling) and section 5.6 (Distributional issues for PCAs).

14 Purpose and Scope paper, section 5.4 (Effect of technological change, greater intermediation and the future of branches in retail banking).

15 Purpose and Scope paper, section 5.3 (Credit expansion and sub-prime lending).

**1.38** Other factors not captured in the graphic, such as the macro-economic environment and the nature of the products and services offered by firms, will also dictate the direction in which the market evolves and the pace of change.

**1.39** We do not intend to predict whether any one of these scenarios will take precedent. Our focus is on understanding the implications, in the event aspects of these scenarios emerge. Some of the questions we want to evaluate are:

- how will these scenarios affect existing business models and what new business models might emerge?
- what are the potential benefits and harms for consumers, and which types of consumers will be most affected?

#### **'Gradual evolution' scenarios**

**1.40** Until recently around 80% of PCAs and BCAs were opened through a branch and branches were an important part of incumbent banks' PCA service offerings and cross-selling strategies.<sup>16</sup> But customer behaviour is changing rapidly with the increased usage of app and web-based tools to perform transactions and the increase in electronic payments, meaning branch usage is declining. Banks are steadily reducing the size of their branch networks in an effort to cut costs, and are repurposing branches to meet changing customer needs.

**1.41** We want to explore what this branch closure programme means for bank business models and consumers. How will it affect the cost base of incumbent banks compared to the digital challengers? How will it impact the ability of vulnerable customers to access banking services? And how will it affect SMEs needing to access branch services to deposit cash?

**1.42** In scenarios where switching and technology take-up are muted, and incumbent banks successfully cut costs and retain customers by reducing and repurposing branch networks and investing in digital services, the status quo may remain.

#### **'Banks as utility' scenarios**

**1.43** Competition in payments may gradually result in non-banks handling more payments instead of PCA and credit card providers. This could reduce interchange revenues. But what are the wider implications of more competition in payments? As well as the loss of interchange revenue, banks could start to lose control over payments data and the advantages this gives in terms of marketing and risk assessment.

**1.44** Aggregators and account information providers may drive disintermediation too, if consumers turn to marketplace-style platforms to manage their banking relationships.

**1.45** We want to explore scenarios in which banks lose ownership of customer relationships and as a consequence cross-selling and customer retention is reduced.

**1.46** In extreme versions of these scenarios, incumbent banks could become capital-intensive utility infrastructure providers and other firms could take over the sales and distribution of products to consumers.

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16 From 2012-2017 on average 75% PCAs were opened in a branch and 82% of start-ups opened their BCA in their local branch, based on FCA analysis of firms' submissions and a Charterhouse survey of SME start-ups (see CMA Retail Banking Market Investigation Final Report, paragraph 2.23).



### **'Waterbed' scenarios**

- 1.47** In these scenarios, take-up of Open Banking is confined to a subset of consumers. Incumbents lose some market share but recover a proportion of the lost revenues from their remaining customers. Alternatively, or in addition, banks could accelerate cost cutting programmes in an attempt to stabilise profits.
- 1.48** Our initial distribution analysis suggests that a small minority of PCA customers – including those with large balances and heavy overdraft users – make a significant contribution to banks' profits. If as a result of Open Banking some of these profitable customers change their behaviour, might banks react by introducing new charges for PCA services or change the pricing of other retail banking products, thus creating a 'waterbed' effect? For example, might the sector move away from FICC banking?
- 1.49** As set out in our HCCR Overdrafts Consultation Paper,<sup>17</sup> we are considering intervening on overdraft charges. The impact of our proposed interventions including the scope for 'waterbed' effects and market entry will be considered separately in a subsequent HCCR publication, using information from this review and other sources.

### **'Big switch' scenarios**

- 1.50** In these scenarios, take-up of Open Banking is more widespread and more significant volumes of consumers actively engage with technological innovations and use them to search and switch to alternative providers, including challenger propositions.
- 1.51** In extreme versions of these scenarios, incumbent banks could start to lose their cost and scale advantages and significant numbers of their profitable back book customers. This would fuel competition and potentially reduce concentration even further.

## **Next steps**

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- 1.52** We will continue to develop our work to explore these important questions. We look forward to engaging further with market participants to hear their views on the emerging analysis set out in this update as well as on the priority areas for future work and proposed scenarios.
- 1.53** We welcome submissions in response to this update, including evidence or views on any of the emerging thinking contained in the update or views on the areas of focus for the next part of the review or the scenarios we are considering. We will be engaging directly with banks to discuss these points, but are also keen to hear from other stakeholders. Please send written submissions to Nikki Hall at [StrategicReviewofRetailBanking@fca.org.uk](mailto:StrategicReviewofRetailBanking@fca.org.uk) by Friday 7th September 2018. If you would like to discuss alternative ways to provide input, please contact us using the same email address.

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<sup>17</sup> FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018), section 4.



## 2 Introduction

In April 2017, we launched a programme of discovery work – the Strategic Review of Retail Banking Business Models (the 'Strategic Review'). In our Purpose & Scope paper we set out the issues we wanted to focus on. Specifically we wanted to examine the potential effect of technological change and increased digitalisation combined with new regulatory initiatives such as Open Banking and PSD2. We wanted to understand how free-if-in-credit (FIIC) PCAs are paid for and the distribution of profits from different types of consumers or different products.

We collected information from 45 firms, including major banks, small retail banks, building societies, specialist lenders. We also included a number of small building societies and new digital banks.

Our review considers retail banking as a system, rather than focussing on separate product areas or business lines, or on individual firms. We have looked at the full suite of activities from deposit taking to lending, seeking to understand how each activity contributes to return on equity and how this differs by business model.

This document provides an update on the progress we have made on the review.

### How we have approached the review

#### Coverage of firms

- 2.1** This review covers retail banking services to personal and small business customers. It focuses on the products and services that are used on a regular basis by large numbers of consumers and small businesses. This includes current accounts, savings products, mortgages, personal loans, credit cards, and business finance.
- 2.2** Retail banking is concentrated amongst a few very large firms with a long tail of much smaller institutions. We regulate around 650 UK and EEA banks, building societies, and credit unions which supply retail banking services to personal and small business customers. Around 500 of these firms are small credit unions.<sup>18</sup>
- 2.3** Within the remaining 150 or so retail banking firms we distinguish the following categories:
- Major banks, offering a full suite of personal and business banking products, with lending dominated by mortgages. Large PCA and BCA customer bases and extensive branch networks. We include Nationwide and Santander UK in this category.
  - Small retail banks, also offering a full suite of personal and business banking products but on a much smaller scale and having relatively limited PCA/BCA customer bases and branch networks. Supermarket banks have been included in this category.

18 Source: FCA analysis.

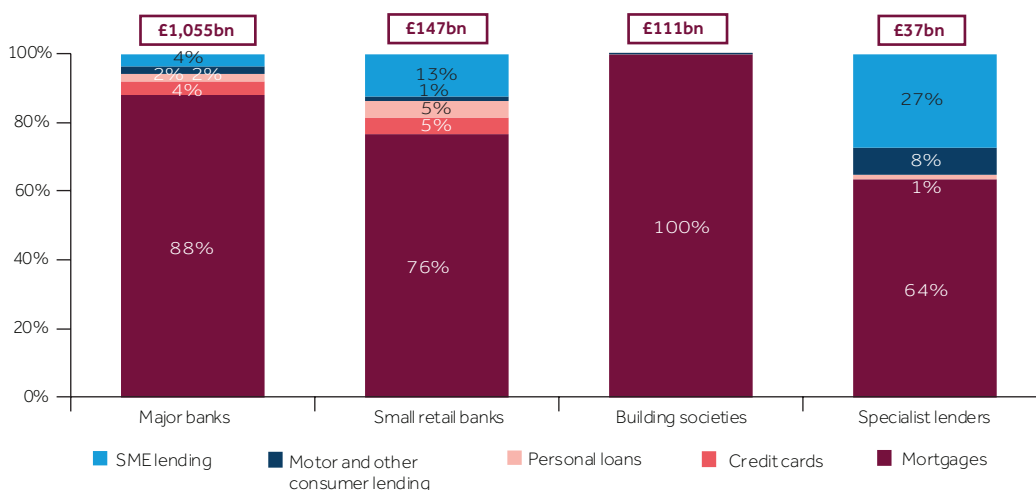


- Building societies, concentrating largely on mortgage lending and generally not offering PCAs or BCAs. Branch networks tend to be focused on local geographic areas.
- Specialist lenders, with a larger proportion of business lending and specialist mortgage lending and not offering PCAs or BCAs. Most do not have branch networks.
- Consumer finance specialists focussing on credit card lending and without branch networks.
- Digital banks, offering a limited suite of personal banking products using the internet as the key distribution channel. Many of these banks are in a formative stage.

**2.4** We have identified these categories to make it easier to compare and explore differences between them. Within each category there is much variety, including differences in the product offering, size and nature of the customer base, the composition of balances, and the distribution strategy and extent of the branch network. Where relevant we have used different categorisations, for example firms with and without PCAs, or with and without branch networks.

**2.5** One of the distinctions between categories is the range of lending activities. Figure 2.1 shows size and composition of total lending balances for the four main categories for 2016.<sup>19</sup> This indicates the importance of mortgages to all categories, with building societies almost exclusively concentrated on mortgage lending. SME lending is more important for specialist lenders. It makes up 27% of their lending mix, compared to 13% for small retail banks and 4% for major banks.

**Figure 2.1: Composition of total lending balances**



Source: FCA analysis; figures rounded to the nearest 1%

19 Lending balances are simple annual averages of opening and closing balances. Based on 33 firms who provided relevant information in response to our information request, including 6 major banks, 9 small retail banks and consumer finance providers, 10 building societies and 8 specialist lenders.



### Our approach to data collection

- 2.6** Our review covers a wide range of firms in the retail banking market and a representative sample of smaller firms from each category. This helps us understand the economics of newer challenger banks and of new digital business models. A full list of the 45 firms who participated in the initial phase of the review is set out in Annex 1.
- 2.7** We asked participating firms to send us 'readily available' firm management information. This covered qualitative aspects of the underlying business and product lines within the firm. Included in this was information on strategic plans, pricing policies and risk appetite statements. It also covered quantitative financial and non-financial information, such as management accounts, customer segmentations and new business volumes.
- 2.8** For the distributional analysis covered in Chapter 5, we used transaction-level data for 2015 and 2016,<sup>20</sup> covering over 1 million consumers randomly sampled from the six largest UK banks.<sup>21</sup>
- 2.9** For smaller firms we asked only for management accounting information and high level strategy documents.
- 2.10** We supplemented the data already available to us, including information gathered by the CMA and PRA, and that gathered for other purposes, such as the Mortgage Market Study and the High-cost Credit Review.
- 2.11** This led to comparability challenges because firms submitted varying quantities and quality of information. Different firms take different approaches to their management accounting information and in many cases do not split information out by individual product lines. Most firms did not submit data for more than two years and some for only one year.
- 2.12** We have therefore made some judgements and assumptions to make valid comparisons. We have concentrated on 2016 only to create a basic set of data. We used this to examine the main drivers of revenues, costs, capital and profits for different types of firms. This allowed us to establish a baseline understanding of the business models within retail banking, which we present in this update. From this we have identified areas, themes and issues we want to investigate further.
- 2.13** We engaged Oxera Consulting LLP to assist us in formulating our approach to this review.

### What is covered in this update

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- 2.14** In banking, Return on Equity (ROE) is a commonly used measure of the profitability as it takes into account all costs including the costs of debt financing.<sup>22</sup> It provides a

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20 We build on the dataset first collected for the Prompts and Alerts policy work carried out in 2017.

21 Barclays, LBG, HSBC, Nationwide, RBS and SanUK.

22 The raising of debt finance is integral to the operation of a retail banking business, hence is best regarded as an operating cost rather than a financing cost.



measure of operating profitability as a percentage of the equity base, compared to the appropriate cost of equity.<sup>23</sup>

**2.15** Equation 1 shows how ROE is a function of return on assets and the proportion of assets funded via equity (i.e. the gearing ratio).

$$\text{Equation 1: } ROE = \frac{PBT}{\text{assets}} \times \frac{\text{assets}}{\text{equity}}$$

Where

Equation 2: shows the components of return on assets:

$$\frac{PBT}{\text{assets}} = \frac{\text{net interest income}}{\text{assets}} + \frac{\text{other income}}{\text{assets}} - \frac{\text{operating costs}}{\text{assets}} - \frac{\text{impairment}}{\text{assets}}$$

And Equation 3 shows that the gearing ratio (assets/equity) in banking can be related to the riskiness of the asset as measured by RWAs

$$\text{Equation 3: Gearing Ratio } \frac{\text{Assets}}{\text{equity}} = \frac{\text{assets}}{RWA} \times \frac{RWA}{\text{equity}}$$

**2.16** We have sought to analyse each component of ROE focussing on the drivers of returns and differences between business models.

**2.17** We have concentrated on operating income and costs. Where possible we excluded one-off or non-recurring income or cost items unrelated to business as usual. We are interested in 'underlying profits'. For example, we would exclude costs for settling fines or redress or exceptional non-operating items (e.g. profits or losses on disposals of assets or businesses).

**2.18** We have not completed our ROE analysis at this stage because we do not have sufficient time series data or cost data. This update presents the analysis that we have completed.

- Chapter 3 analyses the differences in funding costs between business models and the part PCAs and SMEs play in funding cost advantages.
- Chapter 4 describes the additional revenue streams that come with the PCA and BCA including a focus on overdrafts and transaction driven income and the role of the PCA and BCA as a distribution channel for other retail banking products.
- Chapter 5 covers distributional analysis within PCAs.
- Chapter 6 looks at the role of branches.
- Chapter 7 considers mortgages.

<sup>23</sup> Pre-tax return on equity would be compared to the appropriate risk adjusted pre-tax cost of capital, to ensure a like for like comparison.



## 3 Funding costs in retail banking

### Banks with PCAs and branch networks have lower funding costs

Retail funding has become an increasingly important source of funding for banks and now comprises 87% of total funding.

Major banks with established PCA businesses and extensive branch networks have retail funding costs that are on average close to half of those of other banks. This stems from:

- Large PCA balances and related instant access savings accounts that pay little or no interest. The proportion of savings in non-interest bearing accounts has risen in the low interest rate environment from 5% in 2007 to over 20% by 2016.
- Interest rates on on-sale interest-bearing savings balances that are between 30% and 50% lower than other banks.
- SME customers depositing significantly more than they borrow and earning little or no interest on their deposits.

PCAs provide long term stable funding to banks because many customers do not move their balances. The more stable the PCA customer base, the more valuable the funds compared to the cost of obtaining long term funding in the wholesale market.

In the next phase of our work we will explore the costs associated with PCAs, BCAs and branch networks to provide a fuller view of the net costs of funding from these sources.

### Retail funding has become an increasingly important source of funding for banks

- 3.1** Debt funding costs are a key operating cost for banks and an important component of net interest margin. Equation 4 breaks the net interest margin down into the yield, or interest income as a percentage of lending assets, minus the funding costs as a percentage of lending assets. The NIM is a function of the extent to which the bank prices its lending above the cost of its funds.

$$\text{Equation 4: Net interest margin} = \text{yield} - \frac{\text{funding costs}}{\text{lending assets}}$$

- 3.2** Banks have access to retail and wholesale funding.
- 3.3** Retail funding comprises customer deposits, predominantly in the form of PCAs, savings accounts and SME deposits. Savings accounts can be instant access or fixed term savings products. Instant access savings accounts typically pay lower interest rates than fixed term savings. SME deposits can include BCA and savings balances, including instant access and fixed term.



**3.4** Wholesale funding includes inter-bank lending such as collateralised short term lending, e.g. repos or securitisations; unsecured borrowing, e.g. bonds or commercial paper; and funding from the Bank of England, including the Funding for Lending and Term Funding schemes.<sup>24</sup> For major banks with corporate banking operations, intra-group funding is also a possibility. In this study we have treated any intra-group funding as wholesale debt.<sup>25</sup>

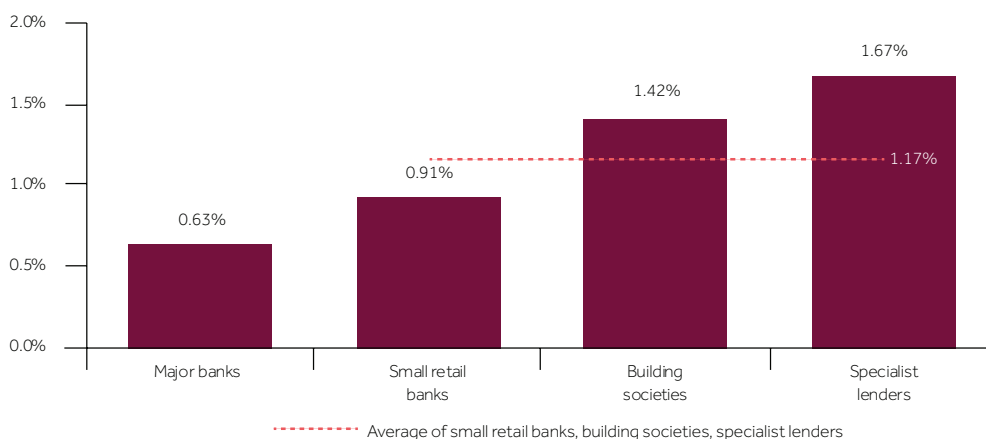
**3.5** Our analysis indicates that for the banks in our review around 13% of funding came from wholesale sources in 2016,<sup>26</sup> with the remaining 87% generated by customer deposits. Smaller banks and building societies are more reliant on wholesale funding than major banks, with around 18% of funding from wholesale sources. Reliance on wholesale funding has declined since the financial crisis.<sup>27</sup> In future, ring-fencing and the end of Bank of England funding schemes may lead to further changes in the funding mix of retail banks.

### Retail funding costs differ widely by category

**3.6** In view of the reliance on retail funding, we concentrated on analysing the differences in the costs of retail funding for different retail banking categories.

**3.7** Figure 3.1 compares the weighted average cost of retail funding in 2016 among major banks, small retail banks, building societies, and specialist lenders.<sup>28</sup> The chart shows that retail funding costs were lowest for the major banks (0.63%) and small retail banks (0.91%), and substantially less than the cost of funding for building societies and specialist lenders. The average retail funding cost of major banks was close to half that of all other banks, building societies and specialist lenders. Most categories nonetheless show a degree of variation in average funding costs.

**Figure 3.1: Average cost of retail deposits by bank category, 2016**



Source: FCA analysis

24 The Funding for Lending Scheme (FLS) and the Term Funding Scheme (TFS) were designed to encourage banks to lend to households and non-financial businesses, by providing them with term funding close to the base rate. Both schemes closed in Q1 2018, with all borrowing due to be refinanced by Q1 2022.

25 For major banks, the retail funding calculation relates only to each bank's retail banking division, as though it were a standalone business. The figure represents the proportion of the retail division's funding requirement that can be met by deposits acquired through the retail division. For some major banks this includes deposits from smaller SMEs. Deposits raised by other parts of the same banking group (such as a commercial banking division) are not included in this calculation, and would be considered as part of the 13% of funding derived from wholesale or intragroup sources.

26 FCA calculation, based on banks' submissions for 2016. Includes funding from Bank of England schemes.

27 In 2008 a group of 8 banks (Lloyds, RBS, Barclays, HSBC, Santander, Nationwide, Co-op, Clydesdale) had customer deposit balances equal to 81% of loans. In 2016 the same group plus Virgin Money had customer deposit balances equal to 103% of loans. Source: FCA analysis of companies annual reports.

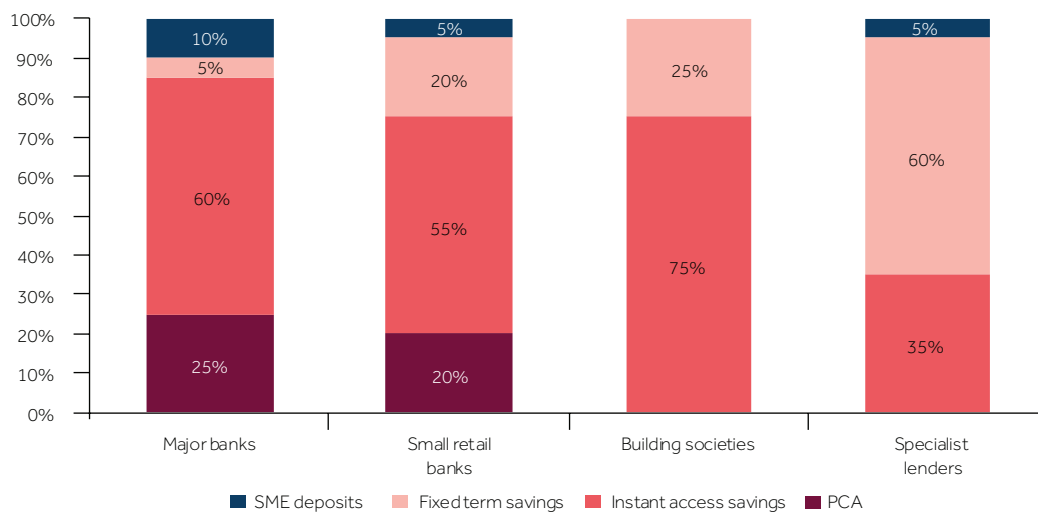
28 Calculated using total interest paid divided by average deposit balance for a subset of firms who submitted data. Number of firms in each category: 6 major banks, 8 small retail banks, 9 building societies, 7 specialist lenders.

**3.8** We now consider some of the reasons for the differences in retail funding costs. We include in this the mix of funding from different types of retail deposits, the relative price paid for similar types of deposits, the link with PCA and branch provision, and the proportion of 'back book' savings accounts and the relatively lower rates on these products. Having identified PCAs as a source of low cost funds, we consider the benefits of PCA funding for banks in terms of its stability and long tenor. Finally, we consider the role of SME banking in the provision of low cost funding for retail banks.

**The mix of retail funding sources varies considerably, and only partially explains differences in funding costs**

**3.9** Figure 3.2 illustrates the mix of retail funding sources for different categories. This shows that the funding mix for major banks and small retail banks is more diverse than that for building societies and specialist lenders. For major banks and small retail banks PCAs and SME deposits comprise around 25 to 35% of the total retail funding base. The remaining 65 to 75% is comprised of instant access savings and to a lesser extent fixed term savings. In contrast building societies and specialist lenders have little PCA or BCA funding and are largely reliant on savings. Specialist lenders rely heavily on fixed term savings.

**Figure 3.2: Mix of retail funding sources by bank category, 2016**



Source: FCA analysis

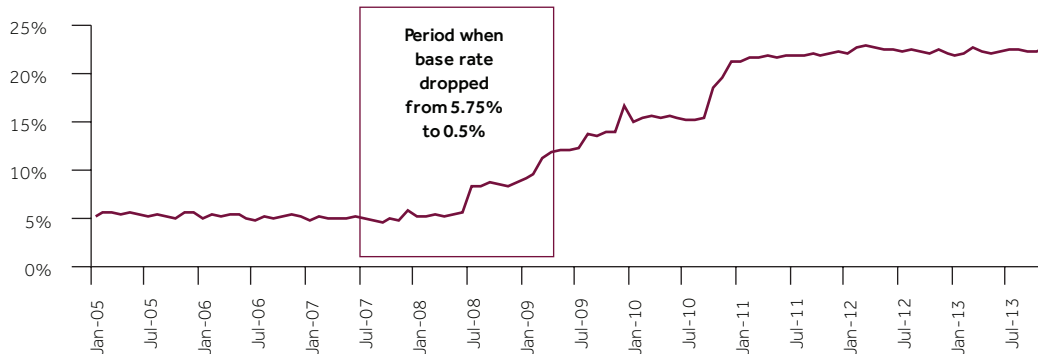
Note: Figures based on a subset of banks who provided data, rounded to the nearest 5%. Fixed term savings include deposits held in notice accounts.

**3.10** Banks with a larger personal current account customer base are likely to have benefited from customers moving balances away from interest bearing deposits in the low interest rate environment. Figure 3.3 below illustrates that non-interest bearing deposits as a percentage of total sight deposits have increased from around 5% before the financial crisis to over 20% in more recent years.<sup>29</sup>

<sup>29</sup> Sight deposits mean deposits that are available on demand.



**Figure 3.3: Non-interest bearing balances as a percentage of total sight deposits**



Source: Bank of England – non-interest bearing sight deposits from household sector (as an approximation for PCA deposits) divided by total sight deposits from household sector.

### 3.11 Major banks pay significantly lower interest rates across all types of retail deposits

Table 3.1 shows the weighted average cost of different sources of retail funding for major banks in 2016.<sup>30</sup> This shows that SME funding is the cheapest source of funding, paying on average just 0.1% interest, followed by PCAs and savings. The average cost for PCAs is 0.5% reflecting that customers with significant PCA deposits have moved towards ‘reward’ accounts. These typically pay interest to customers who meet certain eligibility criteria, such as paying in their salary each month. In 2016, a number of high interest accounts remained available, including Santander’s 123 account paying up to 3% interest (reduced to 1.5% in November 2016), and Club Lloyds paying up to 4% interest (reduced to 2.0% in January 2017). Due to reductions in rates on these reward accounts, we would expect the average cost of PCA funding to have declined in 2017.

**Table 3.1: Average cost of retail funding for major banks by source, 2016**

Deposit source	Funding cost (major banks)
SMEs (including BCAs and savings)	0.1%
Personal – PCA	0.5%
Personal – Savings	0.8%
Total	0.6%

Source: FCA calculation based on submissions by major banks. Average cost is calculated as total interest paid to customers divided by total balances.

**3.12** Table 3.2 sets out the median interest rates paid on a range of deposit products by different types of bank in February 2018. The table shows that BCAs and PCAs pay no or very low rates of interest. Instant access deposits pay notably lower than fixed term savings rates across all types of providers.

<sup>30</sup> Cost of different sources of retail funding were weighted by balances.

**Table 3.2: Median on-sale deposit rates, non-ISA, as at 1 February 2018**

Account type	Major banks	Small retail banks	Building societies	Specialist lenders	Whole market
BCA	0.00%	0.00%	0.10%	0.00%	0.00%
PCA	0.00%	0.00%	0.10%	0.00%	0.00%
Savings – instant access	0.35%	0.50%	0.50%	1.05%	0.50%
Savings – 1 Year	0.60%	1.20%	1.00%	1.55%	1.20%
Savings – 2 Year	0.80%	1.10%	1.40%	1.61%	1.40%

Note: excludes childrens' accounts, help to buy, and regular saver accounts.

Source: Moneyfacts.

**3.13** From Tables 3.1 and 3.2 respectively we note that the weighted average interest rate paid on PCA funding from 2016 was higher at 0.5% than the median rate of 0% for the PCA market as a whole in early 2018. This reflects that some customers with higher balances have earned interest on PCA deposits in recent years (see paragraph 3.11), but the majority of accounts pay little to no credit interest.

**3.14** Table 3.2 also shows that major banks pay median interest rates on savings accounts that are between 30 and 50% lower than other categories of firms. This is the key factor behind the differential in funding costs between major banks and small retail banks. Specialist lenders pay more than major banks and small retail banks for all types of savings accounts. They have more of these relatively expensive sources in their funding mix (typically not offering PCAs or BCAs), resulting in higher funding costs.

**3.15** This means that a large number of PCA customers are not only receiving no or low interest on their PCA balances but also receiving a comparatively low rate of interest on the savings balances that they hold with their PCA provider.

**Banks with PCA customers and established branch networks offer lower rates on 'on sale' savings products**

**3.16** This section considers the possible drivers of the differences in deposit interest rates by category. It includes the role of the PCA and branch network and the proportion of savers on back book products.

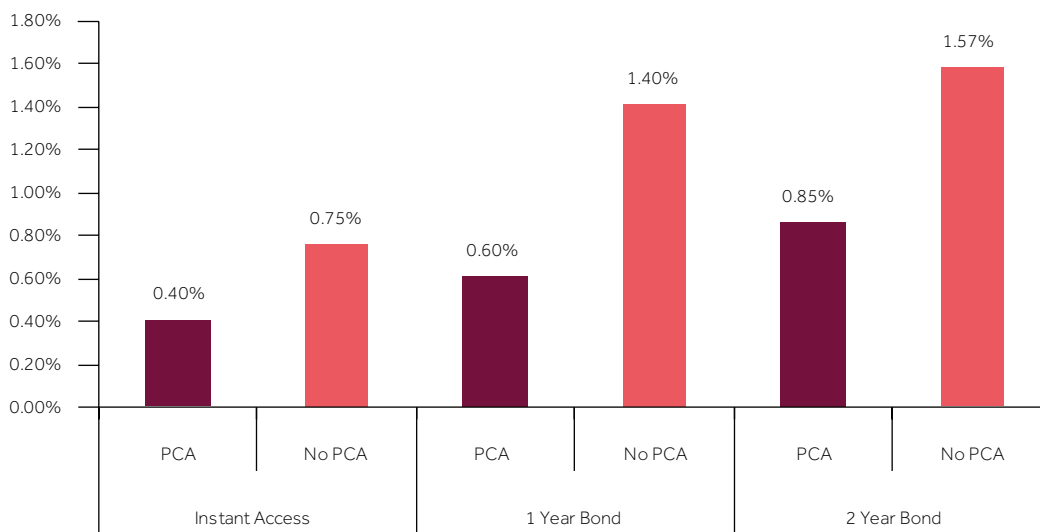
**3.17** We have explored the relationship between funding costs and PCA and branch provision, using data on interest rates on 'on-sale' savings products.

**3.18** Figure 3.4 shows median interest rates paid on instant access and fixed term savings products by banks with and without PCAs.<sup>31</sup> The chart shows that banks that offer PCAs pay lower rates on both instant access and term savings products. They also pay a smaller premium for term products relative to instant access.

31 Source: Moneyfacts, February 2018 on-sale savings accounts.



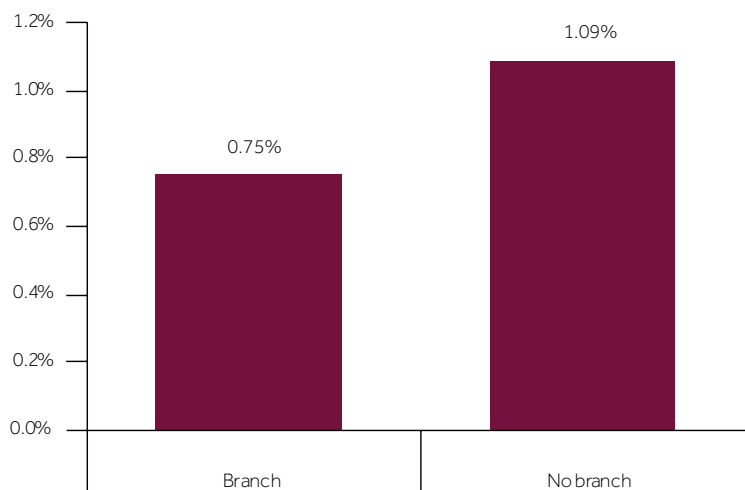
**Figure 3.4: Median interest rates for on-sale savings products by banks offering PCAs vs. not offering PCAs**



Source: Moneyfacts February 2018 all on-sale savings accounts, internal analysis

**3.19** Figure 3.5 distinguishes median on-sale instant access savings rates for banks with and without branches but without a PCA offering, indicating that higher rates are offered by banks with no branch network.

**Figure 3.5: Median on-sale instant access savings rates offered by non-PCA providers**



Source: Moneyfacts, FCA analysis

**3.20** This analysis shows that there remains a differential between the major banks and others, consistent with our cash savings market study (2015) which found that on average the top five PCA providers paid lower interest rates on easy access accounts than those offered by smaller PCA providers or non-PCA providers. The average interest rate offered by the top five PCA providers on easy access savings accounts opened in the last 2 years was 0.47% while the equivalent rate offered by other providers was 1.65%.<sup>32</sup>

32 Paragraph 5.33 <https://www.fca.org.uk/publication/market-studies/cash-savings-market-study-final-analysis.pdf>



### **Many customers leave savings in accounts opened several years ago and paying lower rates than those opened more recently**

- 3.21** The cash savings market study also found that providers had significant amounts of customers savings balances in accounts opened over five years ago.
- 3.22** For easy access products, 33% of large providers' balances were in accounts opened over five years ago. This compared to 27% and 23% for small and medium sized banks and building societies respectively. This was consistent with smaller providers attracting more 'rate chasers' than larger providers.<sup>33</sup>
- 3.23** The interest rate paid on accounts opened more recently was on average higher than on older accounts. For easy access products, interest rates were on average 82 basis points higher for accounts opened in the last two years than on those opened over five years ago.<sup>34</sup>
- 3.24** We have implemented a number of remedies as a result of the 2015 cash savings market study to improve the switching process and the way firms communicate with their customers. We remain concerned that providers hold significant amounts of savings in older accounts that pay lower interest rates. We are exploring whether competition in the cash savings market can be improved.

### **Personal current account funding is a significant and stable long term funding source for retail banks**

- 3.25** PCA deposits and associated savings balances are not only valuable to banks because of their low cost, but also because of their long behavioural tenor (or average longevity). In theory, PCA and instant access savings balances can be withdrawn with no notice. In practice, only a small proportion of balances are withdrawn at any one time. This reflects very low levels of switching. BACs latest results<sup>35</sup> show that less than a million consumers switched their PCA account in 2017. Banks have to date been able to rely on PCA and other types of retail deposits staying put for relatively long periods of time. This has reduced liquidity risk associated with selling long-term lending products such as mortgages whose behavioural tenor may be many years.
- 3.26** To illustrate this point further, Figure 3.6 shows interest rates on wholesale inter-bank funding according to the tenor<sup>36</sup>, compared to the indicative cost of PCA funding. The chart shows that the wholesale interest rate increases with tenor, reflecting the increased risks of lending money for a longer period of time, whereas PCA funding costs remain invariant to tenor.

33 Paragraph 5.8 <https://www.fca.org.uk/publication/market-studies/cash-savings-market-study-final-analysis.pdf>

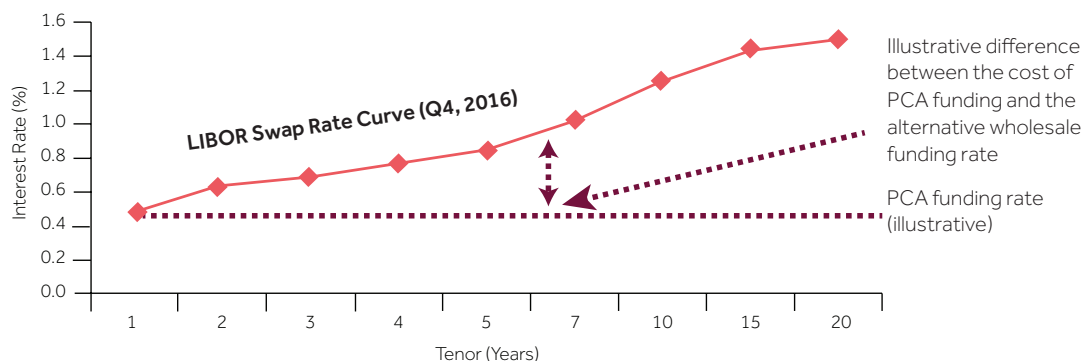
34 Paragraph 5.6 <https://www.fca.org.uk/publication/market-studies/cash-savings-market-study-final-analysis.pdf>

35 BACS Current Account Switch Service Annual Report (2017):  
[https://www.bacs.co.uk/documentlibrary/current\\_account\\_switch\\_service\\_annual\\_report\\_2017.pdf](https://www.bacs.co.uk/documentlibrary/current_account_switch_service_annual_report_2017.pdf)

36 We have used the LIBOR SWAP Curve as an illustrative approximation of the floor for wholesale funding costs.



**Figure 3.6: LIBOR Swap Rate Curve (Q4, 2016) versus PCA funding cost**



Source: FCA analysis (LIBOR Swap Rate Curve used to illustrate the wholesale funding cost floor and the impact of tenor).

**3.27** This indicates that the interest rate that a bank would need to pay for wholesale funding of an equivalent tenor is considerably higher than the cost of PCA funding. This is an important factor in the economics of PCA provision and is reflected in the value that banks attribute to PCA funding in their management accounts, which is known as the Funds Transfer Price (FTP) and is typically based on the price of alternative wholesale funding of equivalent tenor.

**3.28** The FTP rates applied to PCA deposits differ by bank. These rates net of interest expense generally ranged between 0.5% and 1.8% for major banks over the two years observed. There was a wide range around the average, and year on year variation within firms, reflecting varying assumptions for the marginal cost of alternative funding.

**3.29** Based on these rates, the value of PCA funding can be quantified by multiplying the FTP rate of the firm by average PCA deposit balances. On this basis we find that on average for banks which offer PCAs the funding benefit equated to 40% of total PCA revenues in 2016,<sup>37</sup> with the other 60% coming from fees and charges including those from overdrafts. Chapters 4 and 5 cover the economics of PCAs in further depth.

**SME customers are an important source of funds**

**3.30** We analysed the ratio of SME lending to deposits using firms' own management information and based on the definitions of SMEs within their retail banking divisions.<sup>38</sup> Firms have different thresholds for the inclusion of SMEs within their retail banking division; however they tend to be at the smaller end of the scale with turnover below £6.5 million.

**3.31** Figure 3.7 shows the ratio of lending to deposits for SMEs compared to that for personal banking customers. The chart shows that lending to SMEs was on average around 25% of the total amount held in SME deposits, or in other words, SMEs deposit on average around four times as much as they borrow. This compares to an average loan to deposit ratio (LDR) of approximately 108% for personal banking customers.

37 Analysis completed using account level data and corroborated by the CMA's Findings on the contribution of funding benefit to PCA income.

38 Where SMEs are not included within the retail banking division, we have analysed the smallest business banking segment of the commercial/ corporate bank.



**Figure 3.7: Average loan to deposit ratio for major banks**



Source: FCA analysis based on five major banks' submissions for 2015/16.

Notes: Weighted averages. SME definitions vary between banks. Personal Banking LDR is a weighted average of firms' total retail bank LDR, excluding SME lending and deposit balances.

- 3.32** The implications are that major banks use SME deposit balances to finance loans to personal or corporate banking customers or to fund lending activities in other parts of the group. Whilst SME deposits are a fraction of retail deposits (around 10% by value for the major banks (see Figure 3.2)) they are nevertheless a material component of overall funding.
- 3.33** A possible factor behind the low LDR is that we are observing it at a point in time when demand for SME lending is low. SMEs have been accumulating cash over a number of years. UK Finance notes that in the period December 2011 to December 2017 for GB, total SME current and deposit account balances grew by around 43%, whereas the value of loans outstanding decreased over the same period.<sup>39</sup> Current account balances have been rising particularly fast, up 77% since December 2011.
- 3.34** We are also exploring other possible reasons for the much lower LDRs for SMEs compared to personal banking customers. It may be that SME lending is unattractive relative to other retail bank activities, for example due to high capital requirements, pro-cyclicality or a combination of the two. This means other lending opportunities could be seen as more attractive. We intend to understand more about the profitability of SME lending as our review progresses.
- 3.35** Our analysis indicates that LDRs are lower still for the smallest SMEs. The LDR for small businesses, for example non-relationship managed SME customers, are generally below that of SME Banking as a whole. There are considerable differences between banks depending on their approach to customer segmentation.
- 3.36** It may be that very small businesses have less need for borrowing compared to larger businesses or retail customers. BDRC research indicates that almost half of SMEs can be described as 'permanent non-borrowers', with either no use for finance or little appetite for it.<sup>40</sup> In addition, loans and overdrafts granted to smaller SMEs are less likely

<sup>39</sup> UK Finance, SME Finance Update, Q4 2017, <https://www.ukfinance.org.uk/q4-2017-sme-manufacturers-borrow-more-while-service-businesses-retrench/>

<sup>40</sup> BDRC, SME Finance Monitor, Q4 2017, [https://www.bdrcc-group.com/wp-content/uploads/2018/03/RES\\_BDRCC\\_SME\\_Finance\\_Monitor\\_Q4\\_2017.pdf](https://www.bdrcc-group.com/wp-content/uploads/2018/03/RES_BDRCC_SME_Finance_Monitor_Q4_2017.pdf)



to be secured than those granted to larger businesses, and a significant proportion of SMEs (30%) reportedly use personal funds to support their business.<sup>41</sup>

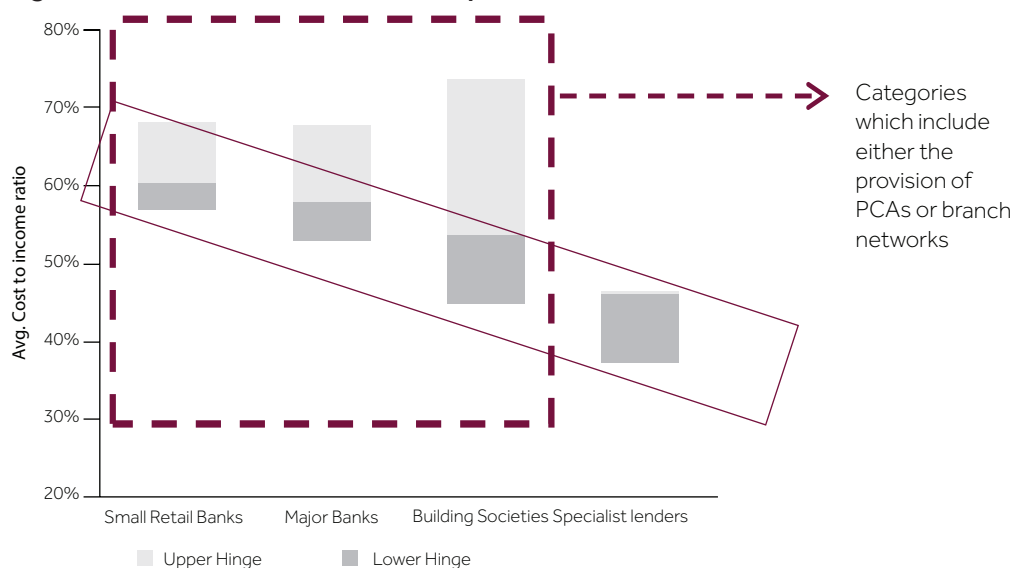
**Operating costs associated with the PCA, BCA and branch network may reduce the funding cost advantage**

**3.37** Most banks do not routinely allocate costs towards their PCA, BCA or branch network, instead managing costs centrally or by function. Nevertheless it is reasonable to assume that some additional operating costs are associated with the provision of PCAs, BCAs, and branch networks. Such costs may include additional customer service staff, ongoing maintenance costs and depreciation of transactional banking IT systems, and high street lease and other branch network costs.

**3.38** To explore the impact of the branch and PCA/BCA network on operating costs, we have looked at two ratios: the proportion of operating costs to net income and the proportion of operating costs to lending assets, and how these ratios vary according to the business model category.

**3.39** Figure 3.8 shows that small retail banks and major banks had higher average cost to income ratios than building societies and specialist lenders. Specialist lenders have the lowest cost to income ratio. We observe a similar pattern when looking at cost to lending asset ratios.

**Figure 3.8: Cost to income ratio comparison, 2016**



Source: FCA analysis, sample includes 7 small retail banks, 6 major banks, 9 building societies and 6 Specialist lenders.

**3.40** Banks with PCA/BCAs and branch networks have higher average cost to income ratios. The large differences in cost to income ratios within categories indicate that there are other factors behind the variations. Smaller retail banks have higher cost to income ratios than the major banks, suggesting that scale economies may be at play. And the wide dispersion in ratios between firms suggests the potential for firm-specific factors such as efficiency to be significant.

41 BDRC, SME Finance Monitor Q4 2017 [https://www.bdrc-group.com/wp-content/uploads/2018/03/RES\\_BDRC\\_SME\\_Finance\\_Monitor\\_Q4\\_2017.pdf](https://www.bdrc-group.com/wp-content/uploads/2018/03/RES_BDRC_SME_Finance_Monitor_Q4_2017.pdf)



### Capital requirements are an important consideration for banks

**3.41** Incumbent banks using the IRB may, depending on the extent to which they are constrained by the leverage ratio,<sup>42</sup> have to hold significantly lower regulatory capital than banks on the SA for certain types of assets of similar risk. This is particularly so for residential mortgage lending.<sup>43</sup> This may place SA banks at a competitive disadvantage in lower LTV mortgages, potentially pushing SA firms to increase their exposure in riskier lending segments. To improve the safety and soundness of SA firms, the PRA has put initiatives in place to address the IRB vs SA gap in low LTV residential mortgages.<sup>44</sup>

### Developing a more complete picture of the drivers of return

**3.42** In the next phase of our work, we will explore the costs associated with PCAs and branch networks and how these costs scale with balances. This will allow us to develop a more complete picture of the funding cost advantages associated with PCAs and branch networks once these costs have been taken into account.

**3.43** We will consider how these combine with other factors to reduce the costs of major banks. These other factors include economies of scale and scope and lower capital requirements. We want to understand the extent to which banks pass these cost advantages on to consumers in the form of cheaper lending, or retain them as profits. It is also possible that some banks have inefficiently high operating costs which offset the benefits that they get from lower funding costs. This will provide a more comprehensive analysis of how net interest margins and underlying returns have varied over time and between different categories.

**3.44** This analysis will look at the scope for future cost reductions to see how business models might change. For example, in Chapter 6 we consider the branch closure programmes and how the role of bank branches is changing. This is one way that major banks are reducing operating costs.

**3.45** Costs are increasing in other areas, like IT, where major banks are making big investments in technology. This is partly to improve service levels, and partly to counter cyber security risks. These factors may reduce the scope for cost reductions.

**3.46** We will build on this understanding of the competitive advantages and disadvantages of alternative business models – based on the drivers of net interest margins and return on equity – to evaluate the scope for future change to impact different categories.

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42 The Internal Ratings Based (IRB) approach allows banks to determine capital requirements based on their own risk models, whilst the Standardised Approach (SA) prescribes set requirements for specified asset classes.

43 See paragraph 9.111 of the CMA's final report : <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>

44 For further details see the PRA Annual Competition Report, 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/pr-a-annual-competition-report-2017>.



## 4 Other benefits of transactional banking: fees and charges and cross-selling

In addition to the funding benefits accounting for around 40% of PCA income, the income earned from PCAs includes:

- Income from overdraft fees and charges, comprising on average over 30% of PCA income.
- Other fees and charges, including those related to interchange and foreign currency, comprising on average close to 30% of PCA income.

PCAs also indirectly contribute to profitability through:

- Benefits from cross-selling with our analysis indicating customers frequently turn to their PCA provider for a personal loan, mortgage, or credit card. Over 60% of consumers take out a savings product with their PCA provider, almost 30% for credit cards.
- Cross-sold BCAs, with analysis by the CMA indicating that around 50% of start-ups turned to their PCA provider to open a BCA.

Our analysis indicates BCAs make a meaningful contribution through:

- Fees and charges reflecting ability to charge for transactions and account offerings. Our analysis indicates they contribute about 55% to BCA revenues, including overdraft revenues.

**4.1** This chapter examines other revenues and benefits of transactional banking including overdrafts, fees and charges, and cross-holdings. This helps to provide the broader context for our work on overdrafts as part of the High-cost Credit Review.<sup>45</sup>

### Overdrafts are high margin compared to other credit products

**4.2** Overdraft charges relating to PCAs can be levied in the form of interest charges on overdrawn balances or daily or monthly usage charges or on a transaction by transaction basis. These types of charges may be combined, and may differ according to whether or not the overdraft is pre-arranged. Banks may levy a transaction fee for accepting (paid item fee) or denying (unpaid or returned item fee) a payment that would take a customer beyond a pre-agreed or internally determined maximum borrowing limit. Overdrafts usually include buffers, which are small money allowances that do not trigger fees when borrowed.

**4.3** Banks tend not to analyse the profitability of overdrafts separately from their PCA business. We have analysed the profitability to banks of providing overdrafts as a line of credit, and compared it with other forms of credit. As a result, we rely on our

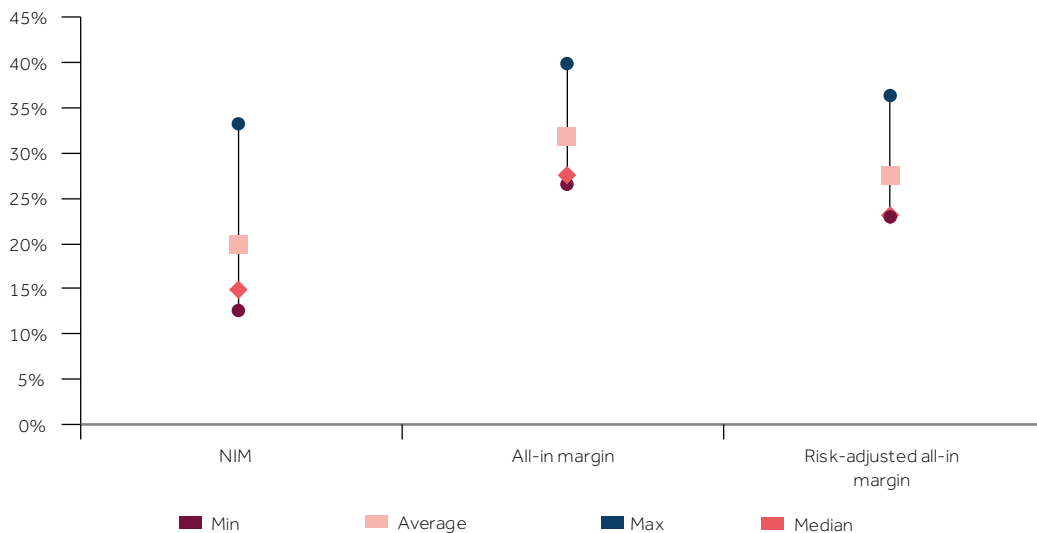
<sup>45</sup> FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018).

own methodology to look at overdrafts profitability based on the information made available to us from some of the major banks.

**4.4** Since the choice of whether to charge customers interest or usage charges or both varies by bank, we calculated an 'all-in margin', combining net interest and fee income.<sup>46 47</sup> The balance between interest and charges varies significantly among banks, and is a function of the pricing structure retained by each institution as well as internal accounting assumptions such as the FTP. For three major banks, fee income represents between a fifth and a half of the total income attributable to overdrafts.

**4.5** We deducted impairments from the all-in margin, based on impairment rates reported by three major banks of between 3-4% of the average lending balance.<sup>48</sup> This calculation results in an average 'risk-adjusted all-in margin' of 28% for these three major banks in 2016.<sup>49</sup> Figure 4.1 illustrates the bridge from net income margin to risk-adjusted all-in margin, and highlights the variance in interest income, fee income and impairment rates across three major banks for which data were available.

**Figure 4.1: Bridge from net interest margin to risk-adjusted all-in margin for overdrafts, and variance amongst institutions (2016)**



Source: FCA analysis. All-in margin defined as NIM, plus yield on fee income. Risk-adjusted all-in margin deducts impairment rates. Data are based on simple averages for three major banks. The picture does not change materially if weighted averages are used.

**4.6** Figure 4.2 below compares the average risk-adjusted all-in margin for overdrafts with that of credit cards and unsecured personal loans for three major banks. This indicates that risk-adjusted all-in margins are considerably higher for overdrafts at 28% than for credit cards at 8% and unsecured personal loans at 5%.

46 Net of banks' FTP.

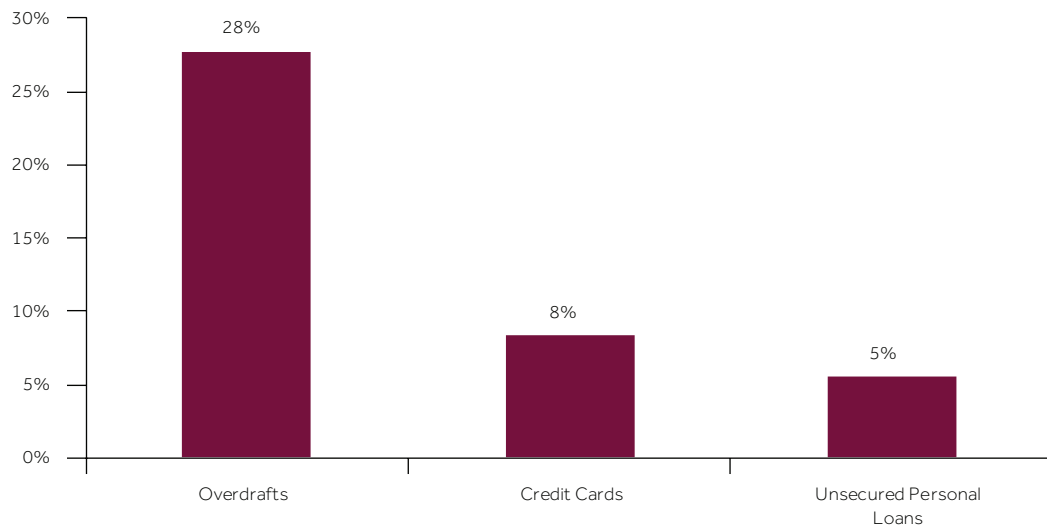
47 Fee income includes fees related to both arranged and unarranged overdrafts, as well as paid and unpaid item fees. We categorised interest and fee income following each firm's classification, where available.

48 This is not homogeneous across banks, suggesting differences in customer risk profile across various banks, with an observed range from 2.5% to 6%.

49 This metric remains similar for 2015 at 26%, a period for which data are available for a fourth major bank.



**Figure 4.2: Average risk-adjusted all-in margins for overdrafts, credit cards and unsecured personal loans (2016)**



Source: FCA. All-in margin defined as NIM, plus yield on fee income. Risk-adjusted all-in margin deducts impairment rates. Overdraft data are based on simple averages for three major banks. Credit cards and UPLs are the simple averages for four major banks. The picture does not change materially if weighted averages are used.

#### **We are seeking further information on the costs of overdraft provision**

- 4.7** To establish overdraft contribution to profitability, we gathered information on regulatory capital. Aside from impairments, regulatory capital was the only other cost associated with overdraft provision that banks cited as material.
- 4.8** The amount of regulatory capital that banks are required to hold is partly dependent on the risk of their lending activities. This risk is mainly expressed through risk-weighted assets (RWA).<sup>50</sup> The level of RWA depends on the credit risk measurement techniques used by the firms and whether they use the Internal Rating Based (IRB) approach or the Standardised approach. For overdrafts, we observe a significantly higher level of RWA for banks using the IRB model than for institutions that follow the Standardised approach. The RWA density, the ratio of RWA to overdraft lending balance, stands between 130% and 200% for three major UK banks. In comparison, smaller institutions using the Standardised approach had an overdraft RWA density of approximately 75%. This difference in density between major banks and smaller retail banks could be explained by the requirement for IRB to hold capital against undrawn balances as well as drawn balances.
- 4.9** Other costs relating to overdrafts are more challenging to measure. They correspond to acquiring and servicing overdrafts as distinct from the PCA. They could include a range of various functions. These range from affordability checks when overdraft facilities are extended, to dealing with overdraft inquiries, customer operations, and services involved in collection and recovery of accounts in default. Quantifying such costs will be part of our follow-up work.
- 4.10** As we develop our analysis we will consider different levels of RWAs between ODs, credit cards and UPLs. The objective is to establish whether different levels of RWAs

<sup>50</sup> Based on discussions with banks, we decided not to allocate any operational RWA to overdrafts, as they primarily relate to the provision of Personal Currents Account.



between overdrafts, credit cards and unsecured personal loans are consistent with the observed differential in risk-adjusted income.

#### **Banks are changing their overdraft propositions**

**4.11** A number of banks have changed or are in the process of changing the charges levied for overdraft usage on PCAs. This is partly in response to the implementation of the Maximum Monthly Charge (MMC), introduced in August 2017. The MMC was introduced as part of a package of remedies following the CMA's Market Investigation into Retail Banking. This requires banks to specify and clearly display the maximum amount that a consumer could incur in a given month for exceeding or attempting to exceed a pre-agreed credit limit. Our analysis does not capture the impact of changes implemented post 2016. In the next phase of our review, we will examine how these changes will reduce banks' income from overdrafts going forward and whether banks will try to recoup any revenue shortfall from other sources.

**4.12** In May, the FCA published a paper on overdrafts, as part of the High-cost Credit Review.<sup>51</sup> The paper included a consultation on rules to increase customer engagement and make it easier for customers to manage their PCAs. This included text message alerts on forthcoming charges and fees and online tools including a fee calculator and eligibility tool. The paper also highlighted the potential harm arising from the complexity of pricing structures and the high level of fees and charges for overdrafts. The paper put forward the following package of measures for further discussion which we are in the process of modelling:

- A ban on all fixed fees including daily, monthly and allowed payment fees, for arranged and unarranged overdrafts. This would not include refused payment fees.
- Arranged overdrafts to be charged using a single interest rate on each individual account. This could vary for different account types, or even different customers holding the same account, but could not have different tiers within a single account.
- Introduction of a rule to require firms to provide a representative APR advertising of arranged overdrafts, as currently required for other forms of consumer credit.
- Alignment of arranged and unarranged prices. Unarranged overdrafts are also to be priced using a single interest rate, no higher than a fixed percentage uplift of the interest rate for arranged overdrafts. We will carry out further work to determine what this uplift should be or whether unarranged should be no more expensive than arranged.

**4.13** Any final package of remedies may impact the financial contribution of overdrafts to banks' operating profit.

#### **Other fees and charges on PCAs are significant in aggregate**

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**4.14** Figure 4.3 shows fee income from interchange, monthly account fees on packaged accounts, foreign currency, and other fees on personal current accounts as a percentage of overall PCA income.<sup>52</sup> These fees and charges are significant in

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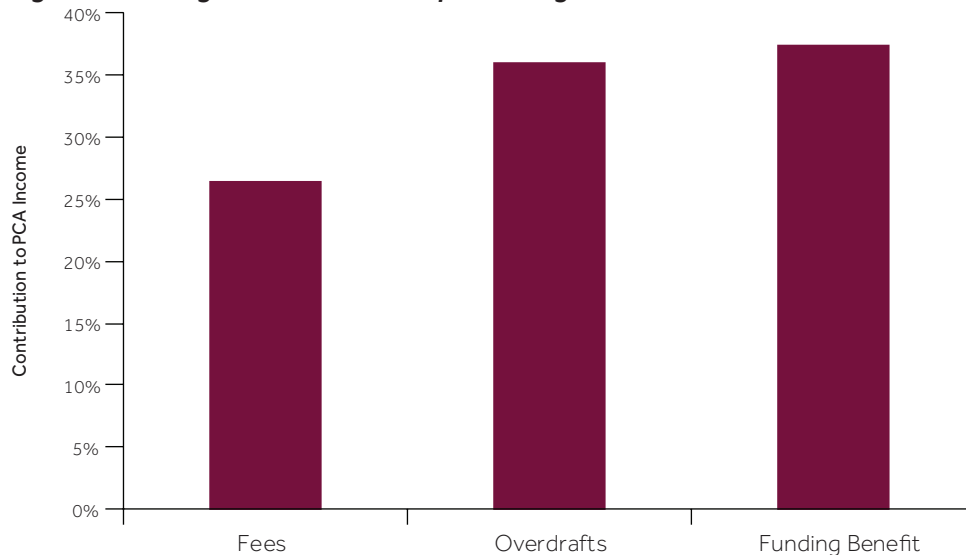
51 FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018).

52 Based on an average of 2015 and 2016 account level data, Major Banks only.



aggregate, making up on average close to 30% of total PCA income including the value of funding. Our analysis is based on account level data across 2015 and 2016 for major banks, and is corroborated by CMA analysis showing that around 27% of PCA revenue comes from these sources.<sup>53</sup>

**Figure 4.3: Range of PCA fees as a percentage of total PCA income**



Source: FCA analysis (based on an average of 2015 & 2016 account level data, major banks only).

**4.15** Fees are also an important contributor to BCA revenues. The ability to charge for transaction types and monthly account fees results in fees and charges, including overdraft revenues, contributing up to 55% of BCA revenue.<sup>54</sup> This is consistent with the CMA's findings on BCAs.<sup>55</sup>

### Interchange revenues

**4.16** Interchange revenue from debit card and direct debit transactions appears on average to be the highest component of other (ie non-overdraft related) fees and charges on PCAs. Debit card transaction volumes and fee per transaction are the key variables in determining revenue from debit card interchange. Gross interchange fees are between 0.2%-0.3% of the transaction value depending on whether the transaction was settled by debit card, credit card, contactless and whether it is in or out of the European Economic Area (upwards of 0.7% of transaction value).

**4.17** Our review of firm pricing models indicates that debit card volumes can vary to some extent with the channel of customer acquisition. Those customers who are acquired digitally are more inclined to transact via debit card compared to customers acquired in branch. However there may be other more material determinants including demographics like customer age and/or income decile.

### Monthly account fees

**4.18** Packaged accounts generally make up a small proportion of PCA accounts resulting in relatively small revenue contributions.

53 CMA Retail Banking Market Investigation Final Report, table 5.7 <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>

54 Based on analysis of a limited sample of firms for 2015/2016.

55 CMA Retail Banking Market Investigation Final Report, Appendix 7.2, Table 1 <https://assets.publishing.service.gov.uk/media/57a9c58ded915d097100000c/retail-banking-final-report-appendices-7.1-to-10.2.pdf>



**4.19** The key variables we have observed that affect packaged account revenue in each bank include the proportion of packaged accounts vs FICC accounts, the level of monthly fees and the direct costs associated with the benefits offered with the account, including any insurance and cash-back features.

### Foreign Exchange revenue

**4.20** Foreign Exchange related revenue is also important and we have observed four key elements that determine its contribution to retail banking revenue: the extent of any transaction fee; the spread or difference between the buy and sell rates offered to customers; foreign currency transaction volumes and the average foreign currency transaction amount.

**4.21** We have previously taken action to address misleading marketing in the foreign exchange market, following complaints made to us and to the Advertising Standards Agency. In May 2016 we wrote to firms offering foreign exchange services to consumers to express concern at the use of the interbank rate in marketing, and to remind firms of their obligations under relevant legal and regulatory provisions.<sup>56</sup>

**4.22** We have begun to explore the drivers of transactional revenue streams. By determining their contribution and how they are derived, we can understand how technology and consumer behaviour may change things. It also provides us with an insight into the impact of the potential loss of certain revenue streams, and how this could impact other areas.

## Many consumers hold other products with their PCA provider

**4.23** We analysed the level of cross-holdings across major banks using transaction data for PCA consumers of major banks covering a two year period from January 2015 to December 2016. These data included savings balances.<sup>57</sup> We supplemented these data with CRA data on credit products held with major banks and other providers. Our data consisted of approximately 87,000 PCA consumers, with approximately 14,500 consumers per bank. We weighted the results by banks' market share estimated by GfK.<sup>58</sup> Numbers presented below are averages over a two-year period.

**4.24** Our analysis shows that PCA consumers often hold other products with their PCA provider, particularly savings and credit cards. Table 4.1 below shows the proportion of all PCA consumers holding other products with their PCA provider.

**Table 4.1**

	What proportion of all PCA consumers hold the following products with their current account provider?			
	Savings <sup>59</sup>	Credit cards	Mortgages	Personal loans
All banks average	54%	28%	9%	7%

Source: FCA analysis. The numbers presented include consumers who may hold products with both PCA and other provider.

56 <https://www.fca.org.uk/publication/corporate/currency-transfer-firms-email.pdf>

57 Note that we used a flag for non-zero savings balances in our analysis rather than considering the number of savings accounts.

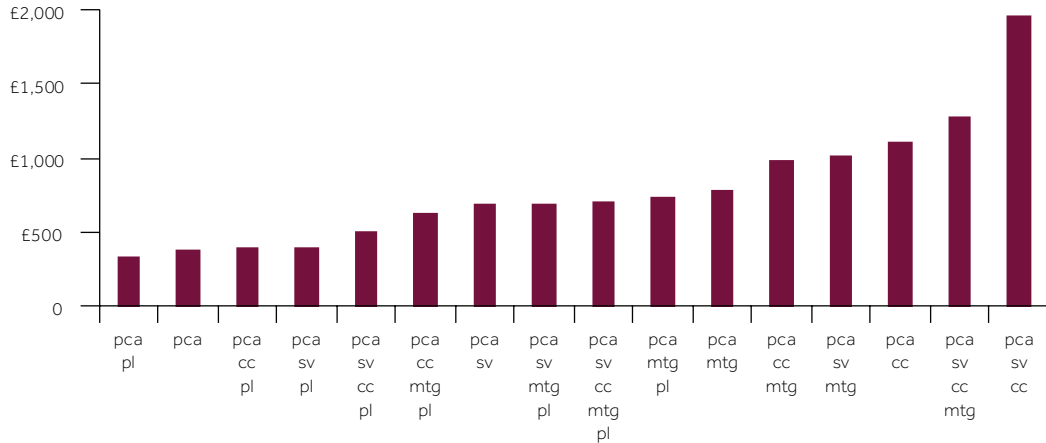
58 GfK Financial Research Survey. Market shares used cover all current accounts in Great Britain and are based on 3 months data ending December 2017.

59 The Cash Savings market study found that over 80% of large providers' total balances in easy access savings accounts are held by consumers who also hold a PCA with the same provider.



**4.25** Figure 4.4 shows average PCA balances according to the other product holdings of the consumer. The chart shows that consumers who held the combination of PCA, savings, and credit card had the highest PCA balance (£1,970), while consumers who held a PCA and a personal loan had the lowest PCA balance (£328).

**Figure 4.4: Median PCA balance by cross-holding**

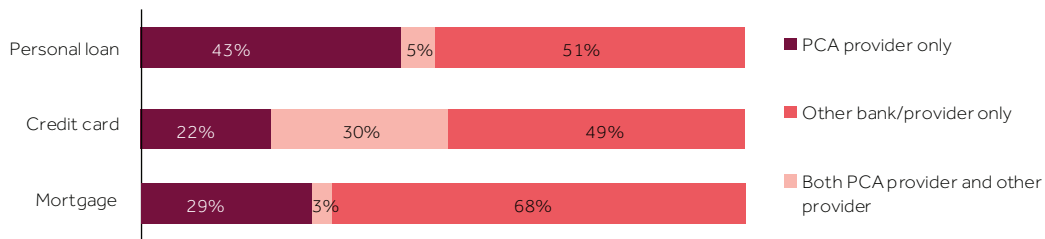


Source: FCA analysis. *pca* stands for personal current account, *sv* stands for savings, *cc* stands for credit card, *mtg* stands for mortgage and *pl* stands for personal loan

**4.26** Figure 4.5 below shows that many consumers go to their PCA provider when taking out credit products such as personal loans, mortgages and credit cards.

- 52% of PCA consumers with credit cards have one with their PCA provider
- 32% of PCA consumers with mortgages have one with their PCA provider
- 48% of PCA consumers with personal loans have one with their PCA provider.

**Figure 4.5: Of all PCA consumers holding other financial products, what proportions chose to do it with their PCA provider vs other providers (including non-banks)?**



Source: FCA analysis. Percentages in the chart may not add up to 100%, as they are rounded to the nearest percent. Out of all PCA customers in our dataset, 55% have credit cards, 28% have mortgages, and 14% have personal loans (with either PCA provider or other providers).

**4.27** Our Cash Savings Market Study found that many consumers hold savings products with their PCA provider and this was particularly the case for easy access accounts, with 62% of easy access accounts and 54% of easy access Cash ISA accounts respectively held with the main banking provider.<sup>60</sup>

<sup>60</sup> See Figure 17 on p.35 of the Cash Savings market study final report (MS14/2.3). The results are based on a consumer survey conducted by the FCA: <https://www.fca.org.uk/publication/market-studies/cash-savings-market-study-final-analysis.pdf>



- 4.28** BCAs are often opened with the main personal banking provider. The CMA found that around 50% of start-ups ended up taking out their BCA with their main personal banking provider.<sup>61</sup> At least 84%, according to the CMA, reported that branches are either very important or quite important to their decision of who to bank with.
- 4.29** SMEs are highly likely to take out lending and savings products with their main BCA provider: a joint CMA/FCA study found that 91% of SMEs obtained instant access deposit accounts from their BCA provider only and 81% of SMEs with a term or notice deposit accounts obtained those from their main BCA provider only.<sup>62</sup> The CMA found that more than 90% of SMEs went to their main bank for overdrafts, business loans and credit cards. Over two thirds went to their main bank for invoice discounting and factoring, and more than three quarters for commercial mortgages. Over half of SMEs only considered one provider when seeking lending.<sup>63</sup>

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61 SME follow-up survey results, page 7 and 8, published by the CMA on 20 August 2015: [https://assets.publishing.service.gov.uk/media/55d5c7c540f0b61525000001/SME\\_follow-up\\_survey\\_results.pdf](https://assets.publishing.service.gov.uk/media/55d5c7c540f0b61525000001/SME_follow-up_survey_results.pdf)

62 Banking Services to small and medium sized enterprises, A CMA and FCA market study, table 4.3: Linkages between BCAs and other products, based on a survey from 2013. [https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report\\_final.pdf](https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf)

63 CMA Retail Banking Market Investigation Final Report, p.297: <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>



## 5 Distributional analysis and who pays for PCAs

Our initial distributional analysis across a large sample of PCA customers suggests:

- Banks generate a positive contribution to profits from the majority of PCA customers in a number of ways, including funding benefit from customers' deposits.
- Around 10% of customers generate between a third and a half of contribution to PCAs. These are a mix of consumers with different behaviours and characteristics.
- We are concerned that unarranged overdraft charges are more likely to be incurred by vulnerable customers, whereas our data suggest banks receive more funding benefit from less vulnerable customers with larger balances.

### Our analysis builds on existing analysis of distributional issues

- 5.1** In the UK, most people hold a free-if-in-credit (FIIC) PCA (63% in 2015).<sup>64</sup> This has caused public debate about whether FIIC banking creates distributional issues, where some consumers pay more – or less – than others depending on their mix of products and/or how they use them. This is particularly relevant in PCAs, where some groups of consumers are more likely to use overdrafts.
- 5.2** In its retail banking market investigation, the CMA looked at the distribution of revenues across PCA customers and did not find strong evidence that banks are cross-subsidising across customers,<sup>65</sup> or that poorer customers may be paying more for PCAs.<sup>66,67</sup>
- 5.3** We have built on the CMA's work. We have focused on whether potentially vulnerable consumers<sup>68</sup> tend to pay more for their PCAs, and considered the cost to banks of serving different consumers.
- 5.4** We have also carried out this analysis in conjunction with the work on overdrafts conducted as part of our High-cost Credit Review.<sup>69</sup>

64 CMA Retail Banking Market Investigation Final Report, para 6.165. 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 paragraph 37 of the CMA's final findings.

65 Paragraphs 6.169 and 6.203-6.205, CMA Retail Banking Market Investigation Final Report.

66 Paragraph 6.206 and 6.229, CMA Retail Banking Market Investigation Final Report.

67 To do this work, the CMA looked at consumer-level transactions data to estimate the price of PCAs to consumers, including interest forgone. The CMA's transactions data were from 2014, from 19 banks, for 120,000 accounts sampled by GfK for the CMA's survey on PCAs. A sample of 97,509 records were matched to an external contractor's (Runpath's) database of fees and charges for each PCA product, where these fees and charges were at a point in time. See CMA Retail Banking Market Investigation Final Report Appendix 5.2. Interest forgone is calculated as BoE base rate on average credit balances net of payments to consumers.

68 As part of our consumer protection objective, we have a particular interest in outcomes for vulnerable consumers, and are more likely to intervene if vulnerable consumers may be harmed. 'Our Mission 2017: How we regulate financial services', FCA, p.20 and 24.

69 FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018).



- 5.5** Our initial analysis covers all PCAs. As a next step, we will extend our analysis by splitting out different types of PCAs, particularly basic bank accounts and FIIC accounts, to understand better the relative contributions they make to banks' profits and the impact of this on different consumer groups.
- 5.6** We use transaction-level data for 2015 and 2016,<sup>70</sup> covering over 1 million customers randomly sampled from the six largest UK banks.<sup>71</sup> We combine this with data from these banks on net funds transfer prices (FTP) and unit costs, and data on population demographics by geography, including the Index of Multiple Deprivation (IMD) for 2015.
- 5.7** We focus on contribution to banks' profits – in other words, we look at the extent to which the revenues and benefits that banks get from each PCA customer cover their marginal costs of serving that customer,<sup>72</sup> and how this differs between different types of customer.
- 5.8** The revenues and benefits include an attributed funding benefit from PCA deposits, which is sensitive to firms' own assessments of their FTPs. We discuss funding benefit and FTPs in more detail in paragraph 3.27 onwards.
- 5.9** It is possible that the same customer can generate different types of revenues, for example both overdraft charges and funding benefit, in the same month.<sup>73</sup> So we summarise our analysis below both by source of revenue and by grouping customers based on whether they mainly<sup>74</sup> incur overdraft charges or generate funding benefit.
- 5.10** We use contribution estimates in this analysis as an indicative way of comparing customers and the value that banks generate from their PCAs. There are some known missing marginal costs, e.g. of holding capital against overdraft lending. We have also relied on firms' cost estimates.
- 5.11** The contribution estimates should therefore not be interpreted as absolute profits per consumer, and cannot be used to assess whether profits generated by banks on PCAs are reasonable. Annex 3 gives further details on the data and methodology we used in this analysis, as well as data issues to be aware of.

### A mix of consumers pay more for their PCAs

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- 5.12** Overall, our initial analysis suggests that the consumers who generate the most contribution for banks on their PCAs are not any one specific group of consumers in terms of vulnerability. This is mainly due to the importance of the funding benefit banks receive on deposits. However, some consumers who are potentially vulnerable are contributing significantly through unarranged overdraft charges. We are considering steps to address this through our High-cost Credit Review.
- 5.13** PCA customers with cross-holdings tend to have higher PCA balances than those who only hold a PCA with their bank, as set out in section 4. Banks may therefore be earning even more contribution from some customers with high PCA balances than shown

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70 We build on the dataset first collected for the prompts and alerts policy work carried out in 2017.

71 Barclays, LBG, HSBC, Nationwide, RBS and SanUK.

72 We define these as 'avoidable' costs that would not be incurred if that individual PCA consumer were no longer served.

73 For example if they dip into their overdraft some days of the month, but maintain a positive balance after being paid.

74 Where over 50% of that consumer's revenues are derived from overdraft charges or funding benefit.



by this initial analysis, since we have not included the contribution from their cross-holdings.

**5.14** Our analysis is based on data for 2015 and 2016. Changes due to the interest rate environment, the advance of technology and regulatory initiatives such as Open Banking and PSD2 could affect how much consumers pay for their PCAs and how they do so.

**5.15** We summarise our initial analysis so far on:

- how contribution is distributed between consumers
- how much contribution is derived from potentially vulnerable PCA consumers
- who generates the highest contribution to banks' PCA profits

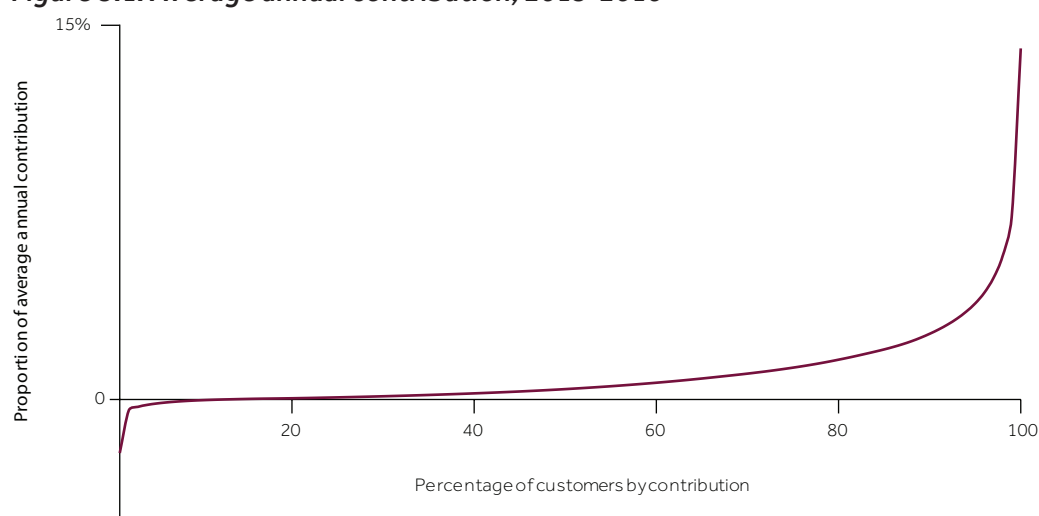
**A small proportion of consumers pay significantly more for their PCAs**

**5.16** Banks generate a positive contribution to profits from most PCA customers in a number of ways, including from the funding benefit of customer deposits. This suggests that 'free' banking is a misnomer, even if in credit.

**5.17** A small proportion of consumers pay significantly more than others. Around 10% of PCA consumers generate between one-third and a half of contribution to PCAs. Broadly similar proportions of the revenues from these consumers come from funding benefit and overdraft charges, with a slightly higher proportion from overdraft charges (at over 40%).

**5.18** Only around 10% of consumers make a small loss<sup>75</sup> for banks, subject to the cost issues set out above. This is summarised in Figure 5.1 below. Losses on consumers with the lowest contribution are driven by bad debt costs (charge-offs) on overdrafts.

**Figure 5.1: Average annual contribution, 2015-2016**



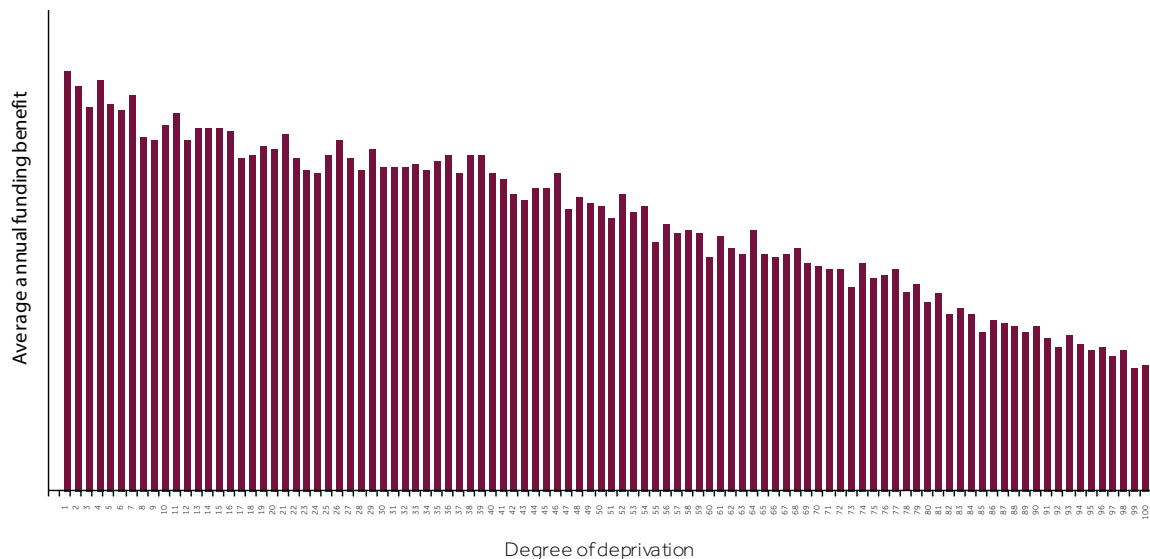
<sup>75</sup> Of more than 1p.

### Unarranged overdraft (UOD) charges are concentrated on more vulnerable consumers

**5.19** On average, most PCA revenues in our customer sample for 2015 and 2016 come from funding benefit (around 40%), followed by arranged and unarranged overdraft charges (together over 30%).

**5.20** Consumers living in less deprived areas (who are less likely to be vulnerable) generate higher amounts of contribution on average. This is mainly because they generate higher amounts of funding benefit on average. The figure below shows how funding benefit (averaged over 2015 and 2016)<sup>76</sup> differs across consumers living in areas with different levels of deprivation. The highest levels of funding benefit are generated from consumers living in the least deprived areas, and lower levels of funding benefit are generated from those in more deprived areas.

**Figure 5.2: Funding benefit by deprivation, 2015-2016**



(Note: 1 =least deprived, 100 =most deprived.)

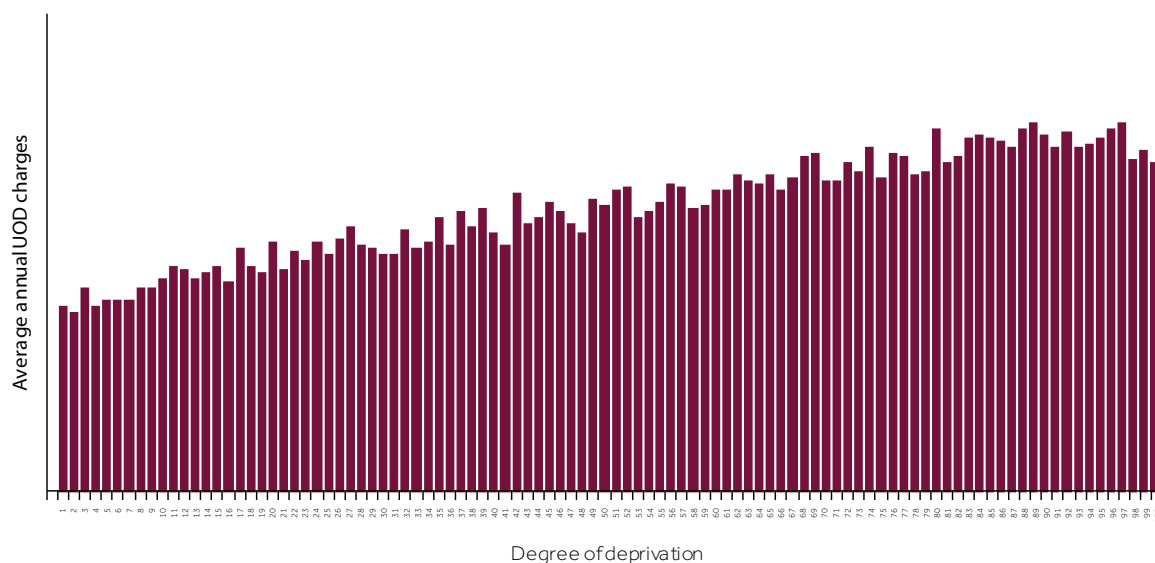
**5.21** However, consumers living in more deprived areas (who are likely to be more vulnerable) incur higher UOD charges on average. This is illustrated by the figure below, which shows how UOD charges (averaged over 2015 and 2016)<sup>77</sup> differ across consumers living in areas with different levels of deprivation. The lowest UOD charges are paid by consumers living in the least deprived areas, and higher UOD charges are paid by consumers living in more deprived areas.

<sup>76</sup> Funding benefit levels are shown in relative terms, since we focus on how funding benefit varies with deprivation.

<sup>77</sup> UOD charges are shown in relative terms, since we focus on how UOD charges vary with deprivation.



**Figure 5.3: UOD charges by deprivation, 2015-2016**



(Note: 1 =least deprived, 100 =most deprived.)

**5.22** UOD charges are paid by less than 20% of consumers, and most UOD charges are paid by a small subset of those. This is also set out in our High-cost Credit Review discussion paper.<sup>78</sup>

**5.23** Given this, we are concerned that UOD charges are concentrated on consumers who are potentially more vulnerable. We are considering pricing and other interventions to address these as part of our High-cost Credit Review work on overdrafts.<sup>79</sup>

**5.24** Our initial analysis does not show any particular trend between consumers living in more or less deprived areas and the arranged overdraft (AOD) charges they incur.

**A mix of consumers generate the highest PCA contribution**

**5.25** The 10% of consumers who generate the highest PCA contribution are a mix with different behaviours and characteristics.

**5.26** Within this group, consumers who mainly incur overdraft charges collectively generate the most contribution for banks. They account for around 45% of the contribution generated by this group. They are not materially more vulnerable than those in our wider sample on average.<sup>80</sup> However, a small minority of consumers within this group who mainly incur UOD charges (around 9% of the most profitable consumers) are potentially more vulnerable.<sup>81</sup>

**5.27** Consumers who mainly generate funding benefit make up around 40% of contribution within this group. Although they are slightly fewer, these consumers generate a higher contribution per person than consumers who mainly incur overdraft charges. They also tend to be less potentially vulnerable,<sup>82</sup> older<sup>83</sup> and have much larger credit balances.<sup>84</sup>

78 FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018), section 4.

79 As above.

80 On average, they live in areas around median (50th percentile) deprivation for the consumers in our sample, as measured by IMD.

81 These consumers on average live in around the 60th percentile of deprived areas for consumers in our sample by IMD.

82 On average around the 40th percentile of deprived areas for the consumers in our sample by IMD.

83 On average aged 60, compared with 42 for those who mainly incur overdraft charges in this group.

84 On average around £36k in their PCAs, compared with around £460 for those who mainly incur overdraft charges within this group.





## We will be refining our analysis further

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- 5.28** There are a number of ways we will refine this initial analysis to address in more depth the questions posed in the Purpose and Scope paper about the effects of FIIC, including:
- Splitting the analysis out by different types of PCAs, in particular basic bank accounts, reward accounts and packaged bank accounts. This will help us to understand better the distributional effects of FIIC accounts versus other types of PCAs.
  - Incorporating further marginal costs, including some measure of risk-weighted assets, to refine our measure of consumer-level contribution to PCAs.
  - Looking at combinations of consumer attributes, as well as additional proxies of consumer vulnerability dimensions, based on feedback we receive on this update.
- 5.29** Our High-cost Credit Review will also draw on this analysis as part of considering interventions in overdrafts.<sup>85</sup>

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85 FCA High-cost Credit Review: Overdrafts Consultation Paper CP18/13 (May 2018).



## 6 The role of branches

There is a growing shift in customer behaviour towards banking through digital channels, particularly for transactional banking, and pressure to reduce costs is driving branch closures. There is potentially a limit to these closures because:

- The branch network has historically been a critical factor in attracting and retaining personal and SME customers. Data from our review and bank strategy reports indicate that to some extent this is still the case.
- Major banks and some small retail banks are focusing their customer retention strategies on branches that have the greatest potential to attract and service key customer groups.

The resulting changes may lead to some customers having limited access to branches now and in the future. We want to understand whether the pattern of branch closures may have had a disproportionate impact on more vulnerable customers.

**6.1** The role of the branch network is changing. Many banks are closing branches as they look to cut costs and consumers migrate towards digital channels. We are considering how these changes are affecting banks and their customers. We reviewed major banks' strategy documents and internal management information, and external reports.

### **Firms are continuing to close branches due to falling branch interactions and pressure to cut costs**

**6.2** The number of UK bank and building society branches fell by 22% between 2012 and 2016 to 8,981 branches,<sup>86</sup> and firms are continuing to announce further reductions. Building societies have closed proportionately fewer branches than banks in recent years.

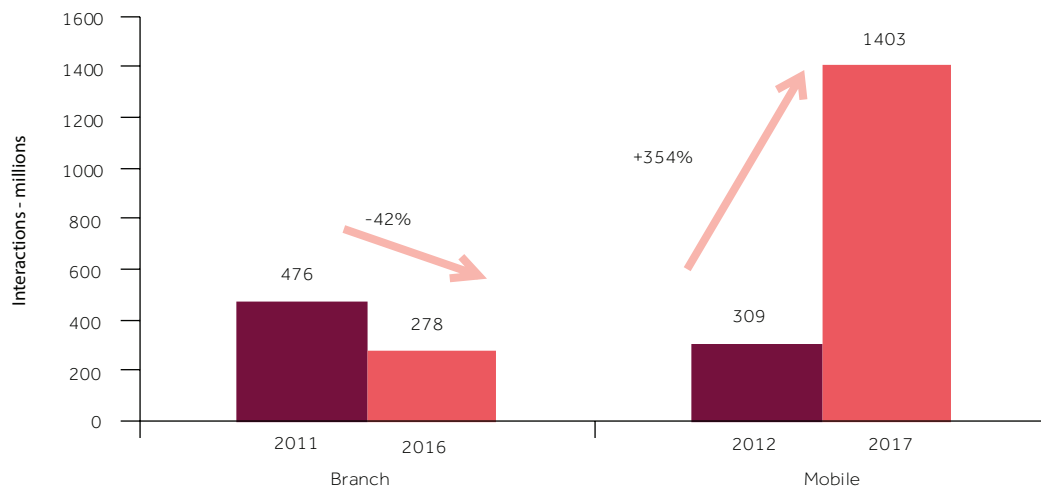
**6.3** Figure 6.1 illustrates that branch interactions have fallen sharply and mobile interactions have grown strongly: branch interactions fell by 42% between 2011 and 2016;<sup>87</sup> and total customer current account interactions via mobile apps rose 354% between 2012 and 2017.<sup>88</sup>

86 UK Finance, UK Payment Statistics 2017, page 22, Table 5.1

87 BBA, Help at Hand (2016), page 21 <https://www.bba.org.uk/news/reports/help-at-hand/>

88 BBA, An App-etite For Banking (2017), page 5 <https://www.bba.org.uk/news/reports/an-app-etite-for-banking/>

**Figure 6.1: Change in number of branch and mobile interactions**



Source, BBA: *Help at Hand and App-etite for banking reports (2017)*.

**6.4** It is likely that the main reason for the huge rise in mobile interactions is the convenience of mobile banking for non-cash based transactions compared to visiting a branch. Our 2017 Financial Lives survey<sup>89</sup> showed that in the previous 12 months more customers had used mobile banking than in-branch methods to check their balances, pay bills, transfer money to other accounts and make payments to others. But branches remain important for providing a variety of services to customers. These include depositing cash and cheques, opening new current accounts, resolving complex enquiries and providing face-to-face advice.

**6.5** As well as responding to changing customer needs, banks are closing branches because of financial pressure to cut costs. This is due to a number of factors. For example: squeezed net interest margins from continuing historically low interest rates, the need to invest in digital platforms, and competitive pressures to keep costs down.

**Firms consider similar core issues when deciding whether to close branches**

**6.6** When deciding whether to close branches, high street banks consider similar core commercial issues, such as the cost of closing a branch and likely payback period.

**6.7** They consider a range of core factors impacting on customers. Examples include whether their branch is the last in town, and availability of alternatives, such as proximity to the nearest alternative branch, ATM and local Post Office. This is in line with the Access to Banking Standard<sup>90</sup> which requires firms to notify affected customers well in advance of a branch closure and explain how the bank will continue to provide services to them. Banks also consider other factors, such as frequency of public transport to alternatives, but these vary by firm.

**Branches remain important in attracting new customers and servicing existing ones**

**6.8** Despite ongoing closure programmes, branches are continuing to play an important role in banking firms' corporate strategies.

89 FCA Financial Lives Survey 2017, weighted data tables, retail banking tables 11 to 20: <https://www.fca.org.uk/publications/research/understanding-financial-lives-uk-adults>

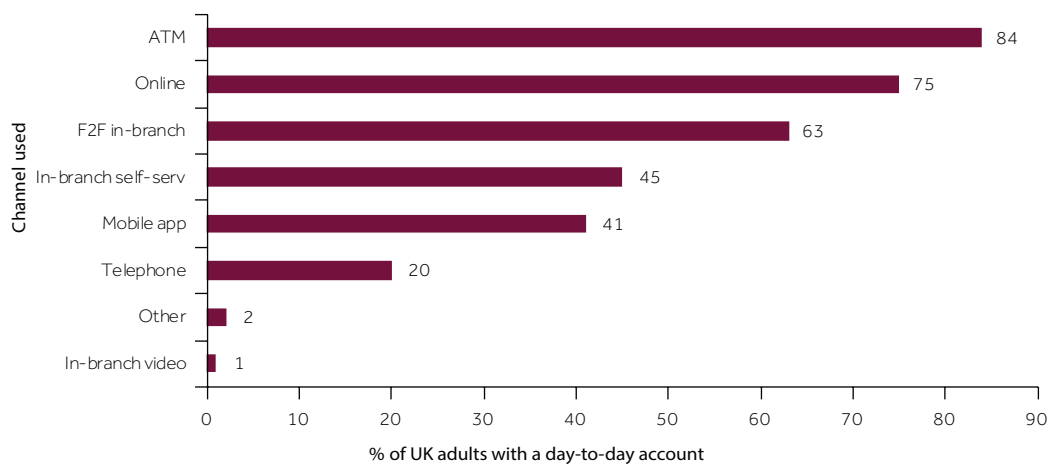
90 The Access to Banking Standard is a voluntary industry agreement supervised by the Lending Standards Board.



**6.9** Branches remain an important channel to attract customers. For example, we found that many customers visit a branch to open a new personal current account and purchase further financial products, such as savings.

**6.10** Branches remain an important channel for servicing existing customers. Our Financial Lives survey 2017 showed that nearly 2 in 3 (63%) used in-branch face-to-face services and nearly half (45%) used in branch self-service machines in the last 12 months, as shown in Figure 6.2 below.

**Figure 6.2: % UK of adults using different channels to access their main day-to-day account**



Source: FCA Financial Lives Survey 2017.<sup>91</sup>

**6.11** Firms are adopting a range of strategies in relation to branches, for example:

- Several Firms indicated that branches will continue to play an important role in the medium term as part of a wider multi-channel strategy, including digital and phone.
- Major high street banks are aiming to provide differentiated local services in their branches, whilst reducing their networks and opening some new branches in key locations. Some 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.
  - **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.
- Some smaller banks are responding to customer preferences by focusing on particular distribution channels. For example, some firms have substantially grown their branch networks, whilst others have focused on mobile banking.

<sup>91</sup> Source FCA Financial Lives Survey 2017: Question RB32B/C summary (rebased to exclude don't knows). In which of the following ways have you [checked your account balance / paid bills / transferred money to another account / transferred money to other people / made an international money transfer / deposited cash/cheques into your account / withdrawn cash] in the last 12 months? Base: All UK adults with a main day-to-day account (unweighted base: 2441/ weighted: 10,556), excluding 'don't know' responses (3%).



- 6.12** As 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. Larger firms are re-focusing their remaining branches to meet changing customer needs and improve cost-efficiencies. With people undertaking more simple transactions via digital channels, one firm noted that their branches are increasingly focusing on dealing with complex enquiries.
- 6.13** We are interested in whether there is a core number of branches that firms need to retain to compete nationally, despite falling branch interactions.
- We will consider further the impact of branch closures**
- 6.14** With ongoing branch closure programmes, some consumers may find it harder to access banking services conveniently in future.
- 6.15** We are considering the impact of branch closures on vulnerable personal customers and small and medium-sized enterprises (SMEs). This involves analysing branch closures and considering how SME's use branches and other channels to take out new products and do their day-to-day banking.
- 6.16** We are also looking at the impact of branch closure programmes on banking firms' business models and on the cost base of firms.



## 7 Mortgages

Mortgage products make up the largest proportion of major banks lending assets and gross revenues.

The majority of mortgages are sold on short term fixed rates. Over 70% of mortgages sold in 2016 were sold on 2-5 year fixes.

Customers on Standard Variable Rates (SVRs) are an important source of income for retail banks. They contribute around 30% of net interest income in respect of mortgages but only 14% of balances.

The spread between SVRs and short term fixed rates has widened in the last nine years. However the proportion of customer balances on SVRs has recently been in decline.

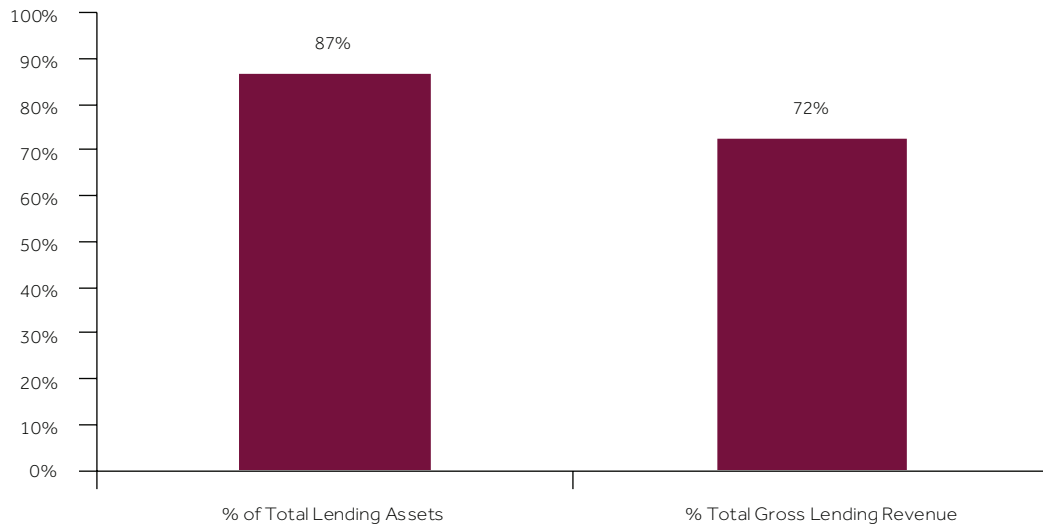
So far we have only looked at the largest lenders and have not included the impact of fees, impairments and other costs. We want to take these factors into account to understand the extent to which lenders' profits rely on customers on SVRs, how this varies between types of lenders and the extent to which this varies with risk profile.

We also want to further understand the drivers of the changes in SVR balances and rates as this will help us to understand the scope for further changes to the impact on bank business models, as part of our scenario analysis.

### **Mortgages are a major contributor to Retail banking NIM**

**7.1** Figure 7.1 shows mortgages as a percentage of total lending assets and gross lending income for major banks for 2015-2016. This shows that mortgages represent 87% of lending assets. However, yields on mortgages are low compared to other lending products – reflecting their low risk – and so represent a lower proportion of gross income: 71%. The average proportion of net interest income from mortgages compared with other products will be even lower as funding costs consume a relatively larger amount of this lower yield.

**Figure 7.1: Mortgages as % of retail bank lending**



Source – Based on averages over 2015-2016 for six major retail banks (NB for some banks a shorter period was used).

Note:

– gross revenue is defined as gross interest income + non-interest income

– retail bank lending does not include overdrafts in this analysis

**7.2** Mortgages also have relatively low impairments in comparison to other products and so attract relatively low risk weights and associated capital requirements.<sup>92</sup> This means that although mortgages contribute a relatively smaller proportion of net interest income compared to their contribution to average lending assets, they are likely to be a more significant driver of return on equity.

### Mortgages are typically sold on fixed term rates

**7.3** The majority of mortgages are currently sold on a short term 'introductory' deal basis.<sup>93</sup> These mortgages typically charge a fixed interest rate for the duration of the deal period before reverting onto another rate after the initial period ends. The reversion rate can either be a rate over which the lender has control, i.e. a 'managed rate' often known as a 'standard variable rate (SVR)', or a tracker rate which directly follows the Bank of England official Bank rate or another interest rate measure. In the current low interest rate climate, the fixed interest rate is commonly significantly lower than the reversion rate.

**7.4** Typically, when the deal period expires the customer switches onto a product with another 'introductory' deal period either with the same provider or a new provider. However, a significant number of customers do not switch their mortgage immediately on expiry of the deal period and pay a reversion rate for at least some period of time.<sup>94</sup> We are interested in understanding the extent to which lenders rely on these customers as part of their business model.

<sup>92</sup> Impairment rates on mortgages for major banks were on average lower than 10bps in 2016, compared to non-mortgage products where the rates were over 100bps.

<sup>93</sup> PSD1 Mortgage returns for 2016 showed that 64% of first time buyers of regulated mortgages were sold on a two year fixed rate basis; a further 23% were fixed for 3-5 years with less than 10% being sold as lifetime trackers. For home-movers the rate for 2 year fixes was 51% and for 5 years 22%.

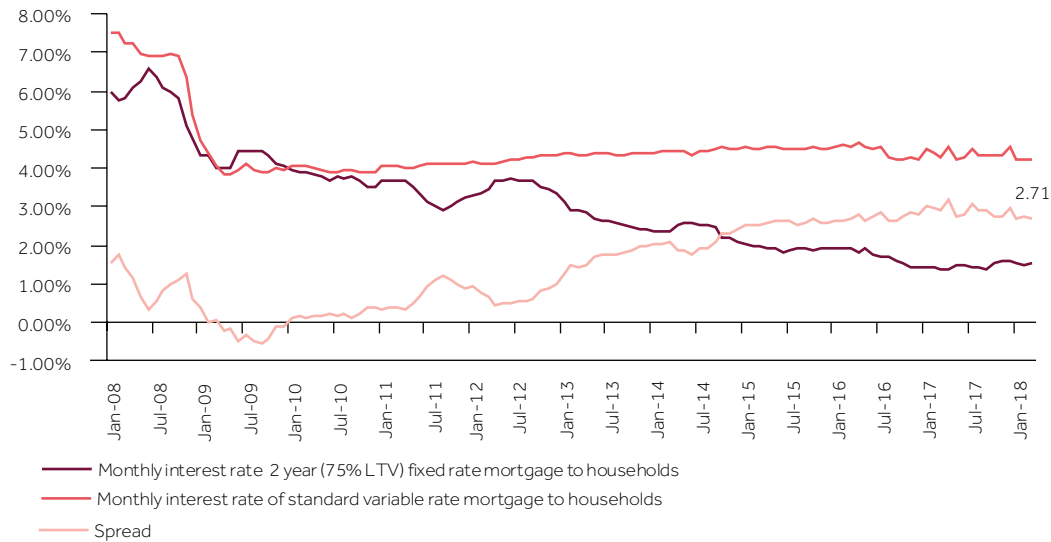
<sup>94</sup> Our Mortgage market study found that for mortgage deals expiring in 2015 27% of customers were still on a reversionary rate 3 months later. [Mortgage Market study Interim Report – Pg47.](#)



### The spread between fixed rates and SVR has widened

**7.5** As demonstrated in Figure 7.2 the spread between the average interest rate charged on a 2 year fixed rate mortgage and the SVR has widened over the last nine years.<sup>95</sup>

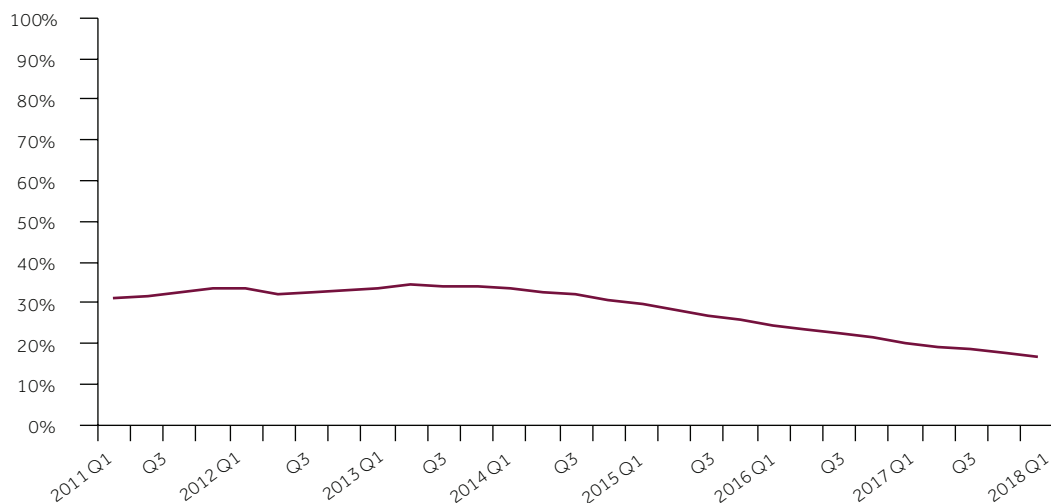
**Figure 7.2: Standard variable rates against two year fixed rates (75% LTV)**



Source: BOE lending statistics (effective household interest rates)

**7.6** Figure 7.3 shows that the percentage of customer balances on SVR has almost halved from 35% in 2013 to less than 17% in 2018. The growing spread in prices combined with a smaller SVR customer base could indicate that firms profits' are becoming concentrated on a narrower group of consumers.

**Figure 7.3: % of Mortgage Balances on SVRs**



Source: BOE lending statistics – effective rates survey.<sup>96</sup>

**7.7** Our Mortgage Market Study has looked at this area in detail and examined the extent to which customers are able or likely to switch. It found that many customers are

<sup>95</sup> The extent of the spread depends on the LTV band. Lower LTVs have higher spreads and vice versa. However across bands there has been a consistent trend in the spread increasing over time.

<sup>96</sup> Average daily balances on sterling household loans reported on form ER (effective rates). Data are not seasonally adjusted. Data from January 2016 are comprised of individuals and individual trusts only.

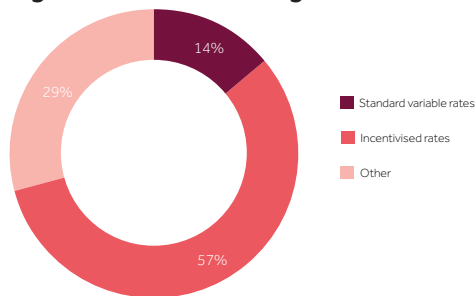


active and engaged. However, it estimated that around 800k customers could benefit from switching away from products currently on a reversion rate and that another 30k could benefit but are unable to switch. We have begun to consider remedies to help these customers switch more easily to new deals without unnecessary barriers.<sup>97</sup> Our analysis on the Strategic Review is looking at the extent to which firms' are reliant on these customers for profitability. We focus our analysis below on standard variable rate mortgages.

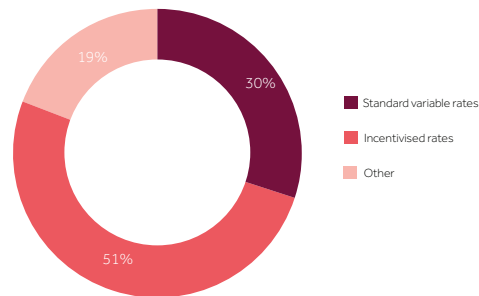
**7.8 Major Banks rely on customers on SVRs for a substantial amount of their income**

Figure 7.4 shows that in total customers of the largest six lenders on SVRs make up 14% of average mortgage balances but contribute 30% of mortgage net interest income (NII).

**Figure 7.4: 2016 Average Balances**



**2016 Net interest Income**



Information based on the management information of the largest six lenders.

Note: Information includes a range of product types depending on the lender including life-time trackers, offset products and for one firm all buy to let mortgages. Funding costs rely on firms' own FTP estimates. Incentivised rates refer to rates in a deal period which will subsequently revert onto another rates such as the SVR. These include for example; 2 year fixed rates, 5 year fixed rates, discounted tracker rates, discounted variable rates etc.

Source : FCA analysis of firm submissions.

**7.9** Most of the largest lenders also have a proportion of customers on legacy reversion rates (no longer on sale), for example mortgages which have reverted to rates which are guaranteed to track the base rate by no more than 2%. These products in the current interest rate environment have low net interest margins and may explain why balances in the 'other' rate category contribute 19% to NII despite forming 29% of balances.

**7.10** So far we have only looked at the largest lenders and have not included the impact of fees, impairments and other costs. We want to take these factors into account to understand the extent to which lenders profits rely on customers on SVRs, how this varies between types of lenders and the extent to which this varies with risk profile, as well as the reasons for the decline in balances on these rates. There are likely to be several contributing factors to the recent decline in balances on SVRs including the increasing spread between fixed rates and SVRs; consumer expectations on the direction of interest rates; firms strategies to retain existing customers through attractive re-mortgage offers and brokers increasingly following up on customers who are near the end of their initial fixed rate period.

**7.11** We want to understand the drivers of this trend and its significance further as this will help us to understand the scope for further changes to the impact on bank business models, as part of our scenario analysis.

<sup>97</sup> Mortgage Market Study Interim Report – numbers are from 2016 and refer to regulated mortgages only. Potential remedies discussed in chapter 9. [www.fca.org.uk/publication/market-studies/ms16-2-2-interim-report.pdf](http://www.fca.org.uk/publication/market-studies/ms16-2-2-interim-report.pdf)



# Annex 1

## List of participating firms

### Major banks

Barclays  
Lloyds  
HSBC  
RBS  
Santander UK  
Nationwide

### Building societies

Bath BS  
Coventry BS  
Cumberland BS  
Leeds BS  
Newcastle BS  
Nottingham BS  
Principality BS  
Skipton BS  
West Bromwich BS  
Yorkshire BS

### New banks

OakNorth  
Atom  
Monzo  
Starling  
Triodos

### Small retail banks

AIB UK  
Bank of Ireland  
Clydesdale  
Co-op Bank  
TSB  
Virgin Money  
Danske  
Handelsbanken  
Metro  
Sainsbury's Bank  
Tesco Bank

### Specialist lenders

Aldermore  
Charter Savings  
Close Brothers  
OneSavings  
Secure Trust Bank  
Shawbrook  
Paragon

### Monoline lenders

American Express  
Capital One  
The Mortgage Lender

### Credit Unions

London Mutual Credit Union  
Pennyburn Credit Union  
Leeds Credit Union

## Annex 2

# Views of stakeholders

1. In the initial letter to firms, distributed in April 2017, we welcomed firms and stakeholders to provide views on the matters covered by the review. Additionally, we met a wide range of stakeholders after the publication of the Purpose and Scope paper and the information request, which provided firms with further opportunities to share their perspectives on this review. We received responses and reflections from a variety of stakeholders, ranging from banks to trade bodies on matters related to this review.

### Views expressed by firms:

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2. Views on competition in the retail banking market and on issues outlined in initial letter and the Purpose and Scope paper varied across the different firms we engaged with. In general, the respondents supported the scope of our discovery work.

#### Large Banks:

3. In general, the large banks supported the objective of this review and believed that competition is working well in the retail banking market, with a significant increase in entrants through technological progress and regulatory interventions.
4. One response from a large bank suggested that the review should act as a vehicle to progress regulatory interventions, accelerate existing remedies, and enforce better compliance. This would ensure that existing remedies set out by the FCA and CMA are effective and regulatory interventions such as Open Banking are a success, before designing new interventions and remedies. The respondent recommended that a forward looking assessment should be carried out as part of the review. The aim would be to identify previously concerning issues and assess their applicability in the current climate, and identify new emerging issues. A forward looking approach would ensure that the FCA employs lessons learnt from previous studies in shaping competition in new markets.
5. The bank drew attention to the Purpose and Scope paper, highlighting the review's interest in whether vulnerable PCA consumers are profitable for banks. The bank advocated that the review should focus on basic bank accounts, as they are specifically aimed at consumers who are financially vulnerable. The inclusion of basic bank accounts would mean that the assessment of vulnerable PCA consumers and their contribution to PCA profitability is more robust.
6. The bank said that the review provided an opportunity for the FCA and retail banking firms to collaborate and support consumers in financial distress. The bank noted that customers in financial distress often hold multiple products across various providers and have significant wider unsecured lending; and proposed that regulatory interventions, such as Open Banking, could be utilised to coordinate the management of consumers in financial distress.
7. One large bank cautioned against attempting to allocate indirect costs to product level.



### **Small & Medium Sized Banks:**

8. Small & medium sized banks welcomed this review, and valued the importance of competition and an “equal playing field” for firms in the retail banking market. Some firms, in particular new entrants, were keen to understand how regulatory interventions like Open Banking were landing in the market and if they were successful in correcting the inefficiencies. In contrast, some firms demonstrated scepticism towards the objective of Open Banking and its effectiveness.

### **Building Societies:**

9. Building societies largely agreed that the review is timely and relevant in light of macroeconomic factors, regulatory interventions, and technological change. Some building societies were interested in understanding how banks will respond to technology shifts and regulatory interventions such as Open Banking, as building societies are also not impervious to these factors.

### **View expressed by trade bodies:**

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10. The trade bodies that engaged with us after the publication of the Purpose and Scope paper largely supported the review, and shared their perspectives on firms in the review and their business models. The trade bodies provided valuable insights into how some firms in the review have advantages due to their size and nature of their operations; but also provided insights on how new models and the emergence of entrants are changing the dynamics of competition in the market.

## Annex 3

# Data and methodology – distributional analysis and who pays for PCAs

1. This annex outlines further detail on the data and methodology for the PCA distributional analysis summarised in section 5.
2. The analysis combines three main datasets that build on existing data collected by the FCA for policy purposes:
  - Transaction-level data for 2015 and 2016,<sup>98</sup> covering 1.5 million consumers randomly sampled from the six largest UK banks.<sup>99</sup> We supplement this with data from these banks on funds transfer prices (FTP) and unit costs
  - Credit reference agency (CRA) data.<sup>100</sup> We gain some insight into PCA consumers' indebtedness and holding of credit products from these data
  - Data on population demographics by geography, including the Index of Multiple Deprivation (IMD) for 2015, the Department of Communities and Local Government's measure of relative deprivation in England.<sup>101</sup>
3. Our dataset also only includes customers aged 18-105, with balances that are more/less than +/-£10 throughout 2015-2016 (to filter for inactive customers), and residing in England only (to match with the IMD data described below). The remaining sample of transaction-level data contains around [1.1m] consumers. The sample with CRA data also matched is smaller, containing around [70k] consumers.
4. We have estimated charges and transactions for individual consumers by dividing data for their joint accounts by half, and summing these with data from their single accounts. Results are weighted by banks' market shares as at December 2015 in England and Wales.<sup>102</sup>
5. We present the IMD in this initial analysis as a proxy for a consumer's potential vulnerability, because the IMD proxies vulnerability more broadly (e.g. including measures for consumers' health by area). We also had data issues with estimating consumers' incomes directly – one method is using some measure of the credit turnover in a consumer's PCA. However, these data are quite noisy due to other transfers into the consumer's account e.g. rent or bill sharing, or if the consumer's income is irregular. We are still working on whether we can measure income directly.

98 We build on the dataset first collected for the prompts and alerts policy work carried out in 2017. Our High-cost Credit Review Overdraft Consultation Paper also draws on this dataset.

99 Barclays, LBG, HSBC, Nationwide, RBS and SanUK.

100 This dataset was first obtained for analysis in the High-cost Credit Review in 2017. See FCA "High-Cost Credit Review Technical Annex 1: Credit reference agency (CRA) data analysis of UK personal debt", July 2017, p.6.

101 The data are for small geographical areas called lower-layer super output areas (LSOAs). There are 32,844 LSOAs with an average of 1,500 residents each, used by the ONS for relatively detailed geographical statistics.

102 GfK Financial Research Survey. Market shares used cover all current accounts in England and Wales (Scotland excluded) and are based on 3 months data ending December 2015.



6. We focus on contribution to banks' profits i.e. the extent to which the revenues and benefits that banks derive from each PCA consumer cover their marginal costs of serving that consumer,<sup>103</sup> and how this differs between different types of consumers.
7. The revenues and benefits that banks derive from each PCA consumer consist of: (i) explicit fees and charges to consumers; (ii) explicit fees levied by banks on other firms, in particular card interchange fees;<sup>104</sup> and (iii) an attributed funding benefit from PCA deposits, which is sensitive to firms' own assessments of their FTPs.<sup>105</sup>
8. Based on firms' responses, the types of marginal costs we have included are: charge-offs for bad debt on overdrafts, BACS and Faster Payment Systems (FPS) costs, cheque costs, ATM and balance enquiry costs, paper communications, SMS communications and packaged bank account (PBA) costs.
9. For now, we have excluded: (i) one-off costs e.g. customer acquisition costs, since these require a significant number of assumptions to spread over a consumer's lifetime and (ii) any costs that are same for all consumers, since we are mainly interested in differences between consumers.<sup>106</sup>
10. This cost data should be treated with caution. There are some known missing marginal costs e.g. of holding capital against overdraft lending.
11. We also rely on firms' cost estimates, since we have not been able at this stage to conduct detailed cost analysis. For example, some costs reported to us, particularly charge-offs, need further checking against aggregate data. Moreover, the largest cost item in the marginal costs we have included are ATM costs, where firms have reported this as the recharge of costs that ATM operators (including banks) charge each other for their customers' use of ATMs. This contains some attribution of fixed infrastructure costs, and so is not fully comparable to the other types of marginal cost included in the analysis.
12. As set out in section 5, we therefore use contribution estimates in this analysis as an indicative way of comparing between consumers and the value that banks generate from their PCAs. The contribution estimates should not be interpreted as absolute profits per consumer, and cannot be used to assess whether the profits generated by banks on PCAs are reasonable.

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103 We define these as 'avoidable' costs that would not be incurred if that individual PCA consumer were no longer served.

104 Interchange fee revenues for each customer are estimated based on a blended average interchange fee rate (across all domestic transactions) provided by each bank, applied to the number of card transactions for each consumer.

105 This is based on firms' FTPs, net of interest paid (i.e. net interest margin), multiplied by each consumer's deposit.

106 Packaged bank account costs have only been included for two banks – other banks supplied no or incomplete information. We also received some foreign transaction costs, but further cleaning of the foreign transactions data is required.

