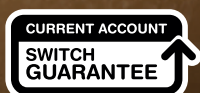


WHAT CONSTITUTES AN EFFECTIVE AND COMPETITIVE CURRENT ACCOUNT MARKET?

April 2017

A Bacs Research Paper





1 FOREWORD

I am delighted to introduce our latest research report on the competitiveness and effectiveness of the personal current account market. This follows on from our recent publications which detailed how we have worked to understand the dynamics of the market and key learnings that we drew from our research into what drives consumer engagement. This new report consolidates the findings from that research and provides insights into how a more effective market might be created.

As owners and operators of the Current Account Switch Service (CASS), we know that understanding the end-to-end customer journey is key to tailoring our product development strategy to better satisfy customer needs. Having pioneered research into customer behaviour with the University of Bristol, which examines the customer's complete learning journey and identifies the systemic market dynamics at play, we have now begun to analyse what the effect of changes in the market will have on customers. Our Market Dynamics Model demonstrates that product innovation and promotion is key to prompting consumers to consider whether they should switch accounts and our research confirms that the CASS brand plays a vital role in lowering the actual and perceived barriers to switching.

This paper identifies how the customer groups most likely to benefit from switching behave, and comments on how changes in the market, for example the development of Open Banking, will affect whether they consider switching accounts. We use the measures of competition identified in research we commissioned from the Social Market Foundation to critically evaluate these insights and to consider what constitutes an effective current account market. Looking ahead we also investigate how further interventions might foster competition.

We are committed to working with the wider community, to share our insights and findings, whilst ensuring that we do everything we can to support a better functioning current account market. Following feedback from this report we will further develop our measurement framework for a competitive market and encourage debate on what interventions will be most effective in engaging consumers and how we can support these through further developments of the CASS brand and product.

Anne Pieckielon

Director of Product and Strategy, Bacs Payment Schemes Limited

2 INTRODUCTION

In September 2013 Bacs launched the Current Account Switch Service (CASS), which was designed to make it quick and easy for customers to switch their current account provider. Since launch, Bacs has been committed to driving awareness of and confidence in CASS amongst consumers through brand building and advertising campaigns. However, despite the continued promotion and operational success of CASS, only around 3% of consumers switch annually. This report aims to consolidate Bacs' wide-ranging research into the factors that drive consumer engagement in the UK current account market.

Before the launch of CASS, Bacs set out to understand the extent to which consumers were searching the market and switching their current account products. To this end, Bacs and the University of Bristol undertook a thorough review of research into consumer switching behaviour and the complex market dynamics at play. This research drew out two reinforcing feedback loops acting on the market: The Trust Loop and The Inertia Loop. Both these loops limit consumers' active consideration of switching: The Trust Loop depicts how customers build trust with their current provider, therein reducing their likelihood of considering switching¹ and The Inertia Loop illustrates the perceived risk in the process of the switching.² Analysis of these loops and the development of an agent-based simulation model of the market has helped us to understand what drives an effective, competitive current account market.

Complementary to the research with the University of Bristol, in September 2016 the Social Market Foundation (SMF) produced a report identifying six measures of competition and how they have changed in recent years.³ In their assessment, the current account market has shown clear, positive development in the level of product innovation and differentiation, value for money, and the number of new entrants to the market. However, there has been limited progress in the quality of customer service, the concentration of provider's market share, and the extent to which consumers are searching and switching. It is through these measures that we will explore what is driving consumer engagement and what constitutes an effective market.

¹ Bacs Consumer Engagement in the Current Account Market: Trust Loop
https://www.bacs.co.uk/documentlibrary/cass_switch_report_2_may.pdf

² Bacs Consumer Engagement in the Current Account Market: A Better Functioning Market
https://www.bacs.co.uk/documentlibrary/cass_switch_report_1_nov.pdf

³ SMF A Switch in Time
<http://www.smf.co.uk/wp-content/uploads/2016/09/Social-Market-FoundationSocial-Market-FoundationA-switch-in-time.pdf>

TNS FIVE STEPS TO SWITCHING

The Current Account Switch Service is an operational and functional success, but consumers will only switch when they see benefits in doing so



1 Would I **CONSIDER** switching?

2 What is the **VALUE** of my existing current account?

3 What are the **BENEFITS** of switching for me?

4 Will switching be **EASY AND STRESS FREE?**

5 Have I made the right **CHOICE?**

3 CUSTOMER SATISFACTION AND TARGETED PROPOSITIONS

Consumer research suggests that, for most consumers, the current account product works well.⁴ In fact, 91% of customers stated that they were satisfied with their current account product, with more than half of those consumers reporting very high levels of satisfaction.⁵ However, we have identified certain customer groups that are not getting the best deal and could benefit from switching their current account. These groups exhibit two characteristics:

1. Frequent Use of Overdrafts – those consumers paying large overdraft fees and interest on debit balances, particularly those using unauthorised overdrafts
2. High Credit Balances – account holders with consistently high, positive balances.

We have also identified two factors which indicate whether a customer may fall into one of those two groups: changing life circumstances and financial disengagement. These factors are not mutually exclusive and work in two ways. Customers experiencing life events and changes in their financial situation have changing requirements for their current account and, as such, are more likely to not hold the best value account for their needs. Indeed, those consumers who could be classed as 'financially disengaged' can be defined as having little interest or incentive in managing or taking control of their financial situation. These consumers are not limited to those in debt or those having financial difficulty, but encompasses consumers that do not actively consider their needs and what products are on offer.

A key challenge in fostering an effective and competitive current account market will be to identify the specific segments that are disengaged and are likely to benefit from switching. The Market Dynamics Model, developed with the University of Bristol, can aid in determining the most effective method for accessing the 'headroom' (the potential to consider and switch) for each affected segment. However, our analysis reveals that changes we can make centrally to our communications and product development strategy would have a very limited impact on the market. This is best explained through the 5 Steps to Switching identified by TNS.⁶ Upon inspection, we can see that CASS only has a direct effect on the fourth step: ease of switching. This means that, whilst continued promotion of CASS plays a key role in lowering the perceived procedural risk in switching, to engage these consumer groups effort must be expended on the third step: ensuring consumers can clearly see the benefits of switching.

⁴ University of Bristol PFRC Personal current account switching
<http://www.bristol.ac.uk/media-library/sites/geography/pfrc/pfrc1604-personal-current-account-switching-report.pdf>

⁵ CMA Retail Banking Market Investigation – Provisional Findings Report
https://assets.publishing.service.gov.uk/media/563377e8ed915d566d00000f/Retail_banking_market_investigation_-_PFs_V2.pdf

⁶ TNS – Tesco Bank White Paper
http://library.the-group.net/tesco_bank/client_upload/file/tesco_bank_tns_white_paper.pdf

Lack of transparency in current account pricing makes it difficult for consumers to assess the value of their current account



4 A DIVERSE RANGE OF PRODUCTS AND SERVICES

The CMA identified that the annual gains from switching for overdraft users can be three to four times higher than for customers who do not use an overdraft and, for around 1% of the market, customers could gain up to £540 a year.⁷ As part of Bacs' continued development of CASS, we have been seeking to understand the attitudes that overdraft users have to switching and why these customers might not be taking advantage of better deals. This research suggests that, for some, the perceived barrier to switching is much higher, whilst others feel they want to pay off their overdraft to have a 'fresh start'.

We can explain this pattern through both the Trust and Inertia loops. Heavy overdraft users are creating trust in their provider as the bank continues to support them through an overdraft facility, whilst perceiving the barriers to switching to be higher because of this fact. Our simulation modelling suggests that the best method for engaging these consumers is through provider innovation and new targeted, customer-focused propositions. Though, without a perception that switching is easy and stress free regardless of their overdraft, these customers are unlikely to switch. Therefore, both strengthened customer propositions and a lower perception of risk in the process of switching is required to access the headroom within the overdraft user group.

In addition, those consumers with high credit balances should also be actively considering whether their current account product is best meeting their needs. Defaqto suggested, in their review of personal current accounts, that the average gains from rewards accounts for a model high balance user could be up to £330 annually.⁸ A possible explanation of why more people aren't taking advantage of these accounts is the current state of low interest rates on savings accounts and the wider fall in the saving ratio.⁹ This could mean that consumers aren't recognising the opportunity reward-based current accounts provide or that they are seeking alternative solutions, such as an offset mortgage. Indeed, the free-if-in-credit (FIIC) model of retail banking compounds the inertia in the market through the lack of transparency in current account product pricing. Indeed, empirically assessing the quality of service being offered by providers is increasingly difficult as more and more customers use self-service channels (i.e. mobile and internet banking) to bank. The CMA is seeking to address this through their package of remedies, and the BBA is leading the way to developing a comparative performance measure. This makes it more difficult to compare products, particularly reward accounts, and forces consumers to rely on their perception of providers.¹⁰

⁷ CMA Retail Banking Market Investigation – Final Report, 65million active accounts
<https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>

⁸ Defaqto Review of Personal Current Accounts
<https://www.defaqto.com/siteassets/corporate-section/2016-releases/current-account-report---06062016.pdf>

⁹ ONS - The Saving Ratio
http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/dcp171776_408856.pdf

¹⁰ University of Bristol PFRC Personal Current Account Switching
<http://www.bristol.ac.uk/media-library/sites/geography/pfrc/pfrc1604-personal-current-account-switching-report.pdf>

One in three new accounts opened in 2015 were rewards accounts



In support of this observation, the SMF report pointed to the increase of reward accounts as a good indicator of more competitive offerings but warned that the complexity of how rewards are obtained through these accounts makes it more difficult to assess the value on offer.¹¹ However, Faith Reynolds suggests – in her report on the consumer perspective of Open Banking – that new digital comparison tools will enable consumers to better compare complex product pricing, after the launch of standardised Open APIs.¹² This development could lead to further growth of reward accounts as more consumers become aware of the potential gains from using them; some even suggest that we are quickly moving to a 'Reward-If-In-Credit' model of banking as 34% of new accounts opened in 2015 were reward accounts.¹³

Considering this shift, our modelling work has allowed us to explore the potential impact Open Banking use cases may have on the market, particularly around how consumers can compare offerings from different providers. This research has shown that, when taken in isolation, new applications using Open APIs are not enough to see significant movement from customers as their direct effect in enabling consumers to make more rational, informed decisions about their current account is not sufficient to drive significant increases in switching or consideration. It is only when all actors on the supply-side are working together to lower the perceived barriers to switching, whilst driving the creation of innovative and competitive current account products, that the model shows significant increases of consideration and switching. In other words, whilst Open Banking will make it easier to search, customers will not switch unless there is a greater incentive to do so and it is down to the providers to drive that change by developing and marketing new products that are tailored to consumer need at the optimum price.

¹¹ SMF A Switch in Time

<http://www.smf.co.uk/wp-content/uploads/2016/09/Social-Market-FoundationSocial-Market-FoundationA-switch-in-time.pdf>

¹² Faith Reynolds Open Banking: A Consumer Perspective

<https://www.home.barclays/content/dam/barclayspublic/docs/Citizenship/Research/Open%20Banking%20A%20Consumer%20Perspective%20Faith%20Reynolds%20January%202017.pdf>

¹³ CMA Retail Banking Market Investigation – Final Report

<https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>

There is sufficient capacity for a new entrant to enter the market and gain scale, but the 'success to the successful' pattern still prevails



5 NEW ENTRANTS GAINING SCALE AND MARKET CONCENTRATION

The SMF report concluded that there have been encouraging signs in the number of new entrants to the current account market in recent years; our own research revealed there have been 21 new entrants to the current account market since 2011. These include an ever-expanding list of both mobile-only offerings and traditional branch-based banking services. Whilst the number of these new players is encouraging, we have yet to see any significant growth of market share amongst them.

Through the Market Dynamics Model, we can explore what conditions are required for a new entrant to gain scale and what their product offerings might look like. This analysis has revealed that a challenger bank can increase its market share significantly with an innovative product proposition but only with a significant promotional budget. Studying the patterns of growth challenger banks exhibit within the model shows a direct similarity with the increase in market share exhibited by historic new entrants to market. However, if the more established players respond to this new entrant by improving their own propositions or, in lieu of innovation, simply increase promotional spending they are likely to inhibit the growth of the challenger. In a different scenario, if a challenger bank were to target specific segments with tailored propositions then it would significantly benefit those segments whilst reducing its own cost of customer acquisition. Both these conditions rely on the established players not 'buying the market' through increased promotional budget. It is encouraging that our model naturally recreates the well acknowledged pattern of 'success to the successful' within the market, but we would like to explore to what extent this pattern is perpetuated by word of mouth, brand power and reach, or both.

A lot of attention has been given to innovative challenger banks in recent years. Primarily offering mobile-only propositions, these banks lack the legacy infrastructure and associated costs of the incumbent players. The volume of new entrants suggests that the barriers to entry traditionally associated with branches and IT have been lowered. However, with new consumer propositions developed through exploitation of Open Banking set to shake up the competitive landscape, how long will these propositions stay relevant? Third party providers (TPPs) will soon have access to consumer transaction data and even have the capability to initiate payments on behalf of the account owner, allowing these third-parties to build their own – provider independent – banking apps.

Open banking is set to be a potential driver of innovation, but it is innovative current account offerings that will prompt consumers to consider and switch



6 CONSIDERATION AND HEADROOM

We have seen throughout our analysis of the Market Dynamics Model that the Open Banking initiative is set to be a potential driver of innovation, but our modelling suggests that new innovative provider propositions are far more likely to drive consideration and switching amongst consumers than central service innovations. Providers can target specific segments and, through promotion of their products and services, help customers understand and manage their finances. It is the providers themselves that are responsible for moving customers through the Trust Loop, ensuring that they do not limit their customer's active consideration of the market. So the challenge for Open Banking is whether it can stimulate new product innovation, or if it simply leads to process improvements in consumers' financial management. While such an outcome would undoubtedly be beneficial for consumers it would not be reflected in changes to the measures the SMF identified, and would be unlikely to lead to an increase in switching levels.

We are now exploring ways in which the CASS promotional activity can target the consumers affected by the Trust Loop as well. CASS promotion currently targets the Inertia Loop, thus ensuring consumers are aware of the service and lowering the perceived barriers to and risks of switching. If CASS promotion were to target the Trust Loop and focus on messages highlighting the benefits from switching, the analysis shows we would be more able to access the headroom of segments not considering switching. Before this approach is adopted, more work needs to be done in identifying and targeting these audiences to ensure they are aware of the switching process and the best product to meet their needs.

7 CONCLUSION

Through our study of the current account market we can see that progress has been made since 2011 when the Independent Commission on Banking (ICB) recommended the development of CASS. Through development of the Market Dynamics Model we have shown that CASS has effectively lowered the barriers to switching. Also, high levels of customer satisfaction indicate that the current account product is working well for most consumers. Our analysis using the Model also suggests that Open Banking and other elements of the package of CMA remedies are already driving innovation and competition. But we need to understand more about the customer segments that are missing out and how to reach them effectively. Our continuing research will explore that challenge to analyse and suggest how we can engage these segments and ensure that there is a clear and valuable consumer proposition for everyone.

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