Adapting to the new realities of the fast changing consumer credit and payments market

2012
Introduction
Welcome to Precious Plastic 2012

The consumer credit market has reached a critical juncture and long-established business models may now need to change. The market continues to contract. There is growing pressure from regulators, customers and consumer groups for simpler and more transparent products. The way people access credit and pay for goods and services is being transformed as the credit card’s once dominant position gives way to debit cards and emerging digital alternatives strengthen their foothold. This year’s Precious Plastic assesses how market participants should adapt to the new realities of this fast changing and increasingly challenging environment.

Part one of the report, ‘The state of the nation’, examines the major business and regulatory developments in the industry and how consumer sentiment is being affected by economic uncertainty and changes in purchasing behaviour. Part two, ‘The new realities’, explores the implications of these developments and how your business can come out on top.

We hope that you find the report useful and interesting. If you would like to discuss any of the issues raised here please contact one of the authors listed on page 54.
Contents

Executive summary 4

Part one: The state of the nation 9
UK consumers committed to deleveraging 10
Payments’ market continues to expand 14
Write-offs finally abate 16
PwC Credit Confidence Survey 17
ICB recommendations spur strategic rethink 21
Getting to grips with the regulatory shake-up 25

Part two: The new realities 29
Reality 1: The credit card’s midlife crisis 30
Reality 2: The end of free banking 36
Reality 3: Mobile payments will become commonplace 42
Reality 4: Primed for the digital tipping point 50

Giving you the edge 54

PwC refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.
Executive summary

Part one: The state of the nation

The financial crisis has accelerated disruptive threats that are challenging both the market dominance and underlying business models of traditional players.

Consumer credit market continues to contract
Against the backdrop of a highly uncertain economic environment, the consumer credit market contracted for a third successive year, with unsecured borrowing falling by around 4% in 2011. Despite paying off an average of £355 in 2011, each household is still saddled with around £7,900 in unsecured debt, leaving UK consumers still among the most indebted in the world. We project this contraction will continue for at least the next two years, with households expected to reduce their unsecured debt to around £7,500 by 2013.

Credit cards bear the brunt
Credit cards continue to feel the strain. The number of cards in circulation fell by around a million in 2011, taking us back to levels not seen for almost a decade. At the same time, total credit card borrowing fell by around 5%, leaving the average credit card balance at around £1,000.

The continued rise of the underbanked
As mainstream lenders continue to retrench, there are increasing numbers of underbanked consumers. Difficulties accessing credit from mainstream sources has fuelled rapid growth in alternative sources of borrowing such as so-called payday loans. Mainstream lenders should be alert to the possibility that what may have begun as a relationship of necessity, may endure as consumers are pleasantly surprised at the convenient and innovative service they receive from these smaller, more agile providers.

Payments’ market continues to expand
The payments’ market has sustained growth. Debit card payments grew by 10% in 2011 and now make up more than double the payments’ volume of credit cards. While growth in payments is being predominantly driven by debit cards, new and emerging payment types threaten to further disrupt the market as the industry ventures further into the digital age. The challenge for banks is how to sustain market presence in the face of competition from ambitious technology giants and other new entrants.

1 Bank of England Lending to Individuals, January 2012
2 Bank of England Lending to Individuals, January 2012
3 British Bankers’ Association, November 2011
4 British Bankers’ Association, November 2011
5 Payments Council Quarterly Statistical Report, August 2011
Write-offs abate
Credit card write-offs peaked in 2010 and while still relatively high in historic terms, 2011 saw a substantial reduction. Despite the continuing rise in unemployment and the squeeze on real incomes, we project that write-off rates will continue to fall in 2012, though they will remain stubbornly high. This improvement is the result of the combined impact of tighter underwriting criteria, enhanced collections’ strategies and consumers’ commitment to deleveraging. However, there is a significant risk that in the event of a double-dip recession, we will see write-offs creeping up again.

Getting to grips with the regulatory shake-up
The advent of the new Financial Conduct Authority (FCA) is set to usher in more intrusive supervisory scrutiny and an increased focus on consumer protection. Margaret Cole, the interim head of the FSA’s Conduct unit, laid down the gauntlet for a new era in consumer protection when she said that “the standards of conduct we have seen would not be tolerated in other industries” and referring to the mis-selling controversies of recent years, she asked: “If a supermarket sold rotten food to its customers, how long would it stay in business?” The result is likely to be a push towards the development of simpler, more transparent, better value-for-money products, which can be easily understood and sold to consumers and which do not attract excessive regulatory scrutiny and reputational risk.

PwC Credit Confidence Survey
Each year, in association with YouGov, we poll around 2,000 GB consumers regarding their attitude to credit, their ability to pay and their future borrowing intentions. In general, the survey reveals a growing reluctance to borrow, a deterioration in confidence about meeting repayments and an increase in those reliant on credit to pay for essential items. These trends will contribute to the continued contraction in the consumer credit market and should leave lenders on high alert when it comes to projecting and dealing with bad debt. Beneath the headline results, there are interesting variations between age groups. It is particularly striking that less than half of 18–24-year olds believe they will be able to meet outstanding payments and more than a quarter of 25–34-year olds admitted to needing to use credit to pay for essential items in the last six months.

6 Bank of England Lending to Individuals, January 2012
7 YouGov carried out surveys on 26–27 October 2011 and 11–14 November 2011. The surveys were conducted online. The figures have been weighted and are representative of all GB adults (aged 18+)
8 Speech by Margaret Cole, Interim Managing Director, Conduct Business Unit, FSA, launching the new FCA, 29 June 2011
Part two: The new realities

Innovative new business models are emerging which could help banks to sustain competitive relevance as the payments and consumer credit markets evolve and open up.

Reality 1: The credit card’s mid-life crisis

Nearly half a century since the credit card was first introduced, this once fast-growing market is struggling to navigate a mid-life crisis. The industry faces the dual challenge of a prolonged contraction in the size of the market and a broken underlying economic model. The market contraction is not simply the result of cautious consumers paying down their debts; the industry faces significant competition from other products (both established and emerging). Moreover, PwC’s Credit Confidence Survey reveals a clear preference among younger consumers for other payment types, underlining the industry’s struggle to reinvent itself for the digital age. Underlying issues with the economic model are being masked by widening spreads, generated by low funding costs and rising interest rates charged to consumers. When funding costs eventually rise, regulatory and market pressure will make it difficult for issuers to simply pass on the cost to customers through further increases in annual percentage rates (APR), leaving the industry with the need to find other ways to generate value. Something needs to give. In the short term, we expect to see issuers focused on taking out cost; however, in the longer term business models and customer propositions will need to fundamentally change to provide a more sustainable future for the industry.

Reality 2: The end of free banking

While most customers remain wedded to the perceived benefits of the UK’s free banking model (exemplified by free-if-in-credit current accounts and no annual fee credit cards), the lack of transparency and complexity it has created in the way customers actually pay for banking has undermined trust in the industry. This is highlighted more broadly by the fact that over the past 20 years, British banks have paid out around £15bn in compensation to their own customers and complaints to the financial ombudsman have risen from 30,000 a decade ago to 200,000 in 2010.

Moving to a paid-for banking model, where consumers pay more directly and transparently for the services they actually consume would provide clear benefits to both customers and banks. However, customer attachment to free banking has made banks naturally fearful of the consequences of being the first to break ranks. We believe a turning point is approaching in which the combined effects of a changing competitive landscape, pressure on profitability and measures recently announced by the Independent Commission on Banking (ICB), will come together to provide a telling catalyst to finally change the market. Banks and credit card issuers need to plan now for the coming ‘fee for all’.

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9 Speech by Adair Turner, Chairman FSA, 20 October 2010
10 Financial Ombudsman Service, Directors report and financial statements 2010/11
**Reality 3: Mobile payments will be commonplace**

Despite significant hype and promise, there are still a number of barriers to overcome before mobile payments can become a mainstream payment method in the UK. These include determining what customers actually want from mobile payments, and the technology and payment architecture to be used. Overcoming these barriers will require investment, but with continuing question marks over commercial models and how to apply them, building a clear investment case remains a challenge. The real value of mobile payments is likely to lie beyond core transaction processing in how value can be added to the wider consumption chain. In contrast to the experience so far, we believe the industry will need to adopt a more collaborative approach to address these challenges. Our analysis reveals that there are broadly three possible scenarios for mobile payments: i) where incumbent players retain a dominant position, ii) where new entrants erode incumbent’s position, and iii) where new entrants are able to disintermediate incumbents entirely. While the risk posed by new entrants is often overblown, existing players should take seriously the rapidly developing innovations in this market and begin to take the lead in defining the future model.

**Reality 4: Primed for the digital tipping point**

Digital technology has already revolutionised a number of industries including music, travel and retailing, forcing many companies to radically change their business models. Digital interaction is now set to redefine customer experience and expectations within banking. In turn, digital engagement and innovation will be the primary vehicles for creating and capturing value. The PwC digital ‘Tipping Point’ survey of some 3,000 consumers in nine countries found that digital, mobile and social media are pervasive across all countries, ages and social groups, and it suggests that traditional means of interacting with customers (branches, call centres, etc.) will soon be overtaken by digital channels as the primary point of contact. Those at the forefront of the digital transformation have an opportunity to bolster customer loyalty and share of wallet. While traditional channels will continue to be a source of differentiation, their relative importance will depend on local cultural factors and their role will change as they become more integrated into the digital multichannel customer experience.

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Part one: The state of the nation
UK consumers committed to deleveraging

As economic uncertainty mounts, more and more households are discarding their credit cards and cutting back on borrowing, leaving lenders faced with the realities of operating in a contracting market.

Summary

• The consumer credit market contracted for a third successive year, with unsecured borrowing falling by 4% in 2011. Despite paying off an average of around £355, each household remains saddled with around £7,900 in unsecured debt. We project this will fall to around £7,500 by 2013.

• The number of credit cards in circulation fell by nearly one million, taking us back to levels not seen for almost a decade. At the same time, total credit card borrowing fell by around 5%, leaving the average credit card balance at around £1,000.

• As mainstream lenders continue to retrench, there are increasing numbers of underbanked consumers seeking loans from alternative lenders. This has underpinned significant growth in areas such as payday lending and pawnbroking.
**Kicking the habit**

This year’s Precious Plastic report is set against the backdrop of an uncertain economic outlook and increasing restraint over spending and borrowing. The recovery has slowed to a virtual standstill, with GDP contracting by 0.2% in the final quarter of 2011.\(^{12}\) Average incomes have fallen by nearly 3.5% in real terms over the past year.\(^ {13}\) While our main scenario is for a rise in GDP of around 0.6% in 2012,\(^ {14}\) there are considerable risks that this may not materialise.

The economic uncertainty is weighing heavily on consumer confidence. In 2011, total UK household borrowing fell by 0.17% to £1.45 trillion (see Figure 1). Secured loans (mainly mortgages) increased by 0.55% to £1.24 trillion, while unsecured borrowing fell by 4.3% to £206.6 billion (see Figure 2). In 2011, each UK household paid off an average of around £355 of their unsecured debt, and despite three successive years of net repayments, UK households remain among the most indebted in the world, each saddled with around £7,900 in unsecured debt.\(^ {15}\)

The continued contraction in UK consumer credit is in sharp contrast to developments in the US. The Federal Reserve recently reported that in November 2011, consumer credit grew at an annualised rate of around 10%, the largest increase in a decade.\(^ {16}\) Historically, US consumer behaviour has been seen as a lead indicator for how UK consumers may behave. However, we believe that this will not be the case on this occasion. Unlike the US, the predominant fiscal policy in the UK has been one of austerity and deficit reduction, and we believe this has had a strong influence on consumer confidence and attitudes towards debt in the UK.

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\(^{13}\) The Guardian. UK incomes fall 3.5% in real terms, ONS reveals, 23 November 2011

\(^{14}\) PwC analysis

\(^{15}\) Bank of England Lending to Individuals, January 2012

\(^{16}\) US Federal Reserve, January 2012
Looking ahead, the latest PwC Credit Confidence Survey reveals that consumers plan to cut all forms of borrowing in the future (see Figure 3). While these intentions may differ from the actual behaviour that transpires, we believe the sentiments highlighted in Figure 3 provide a strong indication that UK consumers are committed to reducing their borrowing. Projections prepared in conjunction with PwC’s Economics team suggest that overall, consumers will continue to pay off their debts for at least the next two years, repaying around £240 in 2012 and £160 in 2013. By 2013, this would leave the average household with around £7,500 in unsecured credit, compared to £7,900 today.

The credit card’s midlife crisis

The downward trend in credit card numbers and borrowing continued through 2011 (see Figure 4). Consumers discarded nearly one million credit cards in 2011, taking the number of cards in issue down to levels not seen for almost a decade. At the same time, total outstanding balances fell by around 5%, leaving the average card balance at just over £1,000. The fact that credit card borrowing has declined at a faster rate than overall unsecured borrowing underscores the particular challenge faced by this segment of the industry. In addition to the macroeconomic headwinds faced by the consumer credit industry as a whole, credit cards have lost market share to other payment types (most notably debit cards) and have been scarred by the scrutiny they’ve received from regulators and the media over the last few years. In Part Two of this report we explore how these and other factors are contributing to the credit card’s ‘midlife crisis’ and what the industry should do about it.

Alternative lenders extend their reach

The overall contraction in lending masks some fundamental underlying changes in the way people are borrowing. In the previous edition of Precious Plastic we highlighted the rise of the ‘underbanked’ – people who are finding it difficult to gain access to mainstream lending. With the supply of credit constrained, mainstream lenders are continuing to be selective about whom they lend to and have effectively redrawn the boundaries of what constitutes prime and sub-prime (see Figure 5). At the same time, we believe that credit scores across the UK population have deteriorated, as consumers have struggled to cope with the challenging economic conditions (there are likely to be a large number of consumers who will have damaged their credit score as a result of missed payments over the last few years). As a result, consumers are faced with a double-whammy – lenders being more selective and the possibility that their credit score has deteriorated.

YouGov carried out surveys on 26–27 October 2011 and 11–14 November 2011. The surveys were conducted online. The figures have been weighted and are representative of all GB adults (aged 18+).
Particularly notable is the strong growth seen in so-called payday lenders, who grew to £1.7 billion in 2010, compared to £500 million in 2007, an increase of over 200%. While still relatively small as a proportion of overall unsecured lending, these smaller and more agile players are leveraging digital technology to deliver an innovative and fast service, which is particularly attractive to younger people. Mainstream lenders should be alert to the possibility that what may have started as a relationship of necessity (i.e. consumers did not have access to credit from other sources) may endure as customers are pleasantly surprised at the convenient and responsive service they receive.

The retreat by mainstream lenders is illustrated in consumer lending data from the Bank of England (see Figure 6). While the data clearly shows a relative reduction in the amount of lending by banks and building societies immediately following the onset of the financial crisis, it is interesting to note that this represents an acceleration of what appears to be a longer term trend. In addition to the retreat by banks and building societies, the rising population of underbanked consumers has created opportunities for alternative lenders. This is affecting the way consumers borrow and leading to changes in the product mix. The overall 4.3% drop in total unsecured lending in 2011 masks more varied movements for different product categories. Figure 7 shows who we believe have been the winners and losers over the last 12 months. Particularly notable is the strong growth seen in so-called payday lenders, who grew to £1.7 billion in 2010, compared to £500 million in 2007, an increase of over 200%. While still relatively small as a proportion of overall unsecured lending, these smaller and more agile players are leveraging digital technology to deliver an innovative and fast service, which is particularly attractive to younger people. Mainstream lenders should be alert to the possibility that what may have started as a relationship of necessity (i.e. consumers did not have access to credit from other sources) may endure as customers are pleasantly surprised at the convenient and responsive service they receive.

Figure 4: Credit cards in circulation and outstanding balances

![Credit cards in circulation and outstanding balances](chart)

Source: British Bankers’ Association (BBA)

Figure 5: The rise of the underbanked

![The rise of the underbanked](chart)

Source: PwC analysis

Figure 6: Retreat of mainstream lenders

![Retreat of mainstream lenders](chart)

Source: Bank of England, PwC analysis

Figure 7: Market opens up to new players

![Market opens up to new players](chart)

Source: PwC analysis

18 Financial Times ‘Crisis boosts growth in payday loans sector’, 6 December 2011
Payments’ market continues to expand

The credit card is losing out to debit cards in an expanding payments’ market. A new generation of payment innovations are threatening further disruption as the market ventures further into the ‘Digital Age’.

Summary

- Debit card payment volumes grew by 10% in the year up to June 2011 and now make up more than double the payments volume of credit cards.\(^1\)

- Faster Payment volumes grew by 40% in the year up to June 2011\(^2\) (i.e. people transferring money online between bank accounts).

- Emerging payment methods are showing strong growth, with the volume of mobile payments increasing by 94%, digital micropayments by 15% and pre-paid cards by 14% in the year up to June 2011.\(^3\)

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Figure 8: UK consumer initiated payments

Sources: Payments Council Quarterly Statistical Report, August 2011
PayPal: The UK Mobile Retail Opportunity, 2011
Marketing.co.uk: £4bn UK gift card & voucher industry experiences second successive quarter of double-digit growth, July 2011
Value Partners: Capturing the Micropayments Opportunity, 2011

Notes: Growth rates are H1 2011 vs H1 2010 except for cheques which are 2010 vs 2009
1 Excludes: CHAPS £61.6bn and credit transfers £3.1bn
2 Excludes business initiated cheques £832bn

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19 Payments Council Quarterly Statistical Report, August 2011
20 Payments Council Quarterly Statistical Report, August 2011
21 Value Partners: Capturing the Micropayments Opportunity, 2011
While the consumer credit market has continued to come under pressure, the broader payments market has sustained growth. This is being predominantly driven by increasing use of debit cards and faster payments, and the move away from cash, cheques and credit cards (see Figure 8).

Although emerging payment methods such as mobile and online micropayments are still relatively small in volume compared to debit and credit cards, they represent a significant development for card providers as they are often used as substitutes for traditional card payments.

Technology giants, small start-ups, mobile operators and payments’ networks are at the forefront of payment innovations such as paying by voice-activation or via a mobile phone. For example, a smartphone can now be adapted for use as a card payment terminal, with the potential to tap into the small business and self-employed markets. Figure 9 outlines some of the innovations that are spurring a shake-up in the payments marketplace.

As Figure 10 highlights, these innovations are paving the way for the shift from an ‘Industrial Age’ of payments, where cash, cheques and traditional cards predominated, to the ‘Digital Age’, which will be characterised by online and other digitally enabled payment mechanisms. Banks have traditionally held dominant positions as both the owners and enablers of consumer access and as facilitators of funds transfer. In the ‘Digital Age’, banks’ role as owners and enablers of consumer access is under threat. If relegated to the role of purely facilitating funds transfer, margins may come under further strain as this has the hallmarks of a commoditised service. These challenges are explored in more detail in Part Two of this report.
**Write-offs finally abate**

Having soared in recent years, bad debts have finally begun the decline.

**Summary**

- Credit card write-offs peaked at almost 10% in 2010, but have decreased significantly in 2011 to 7.0% as the impact of improved collection strategies and changes to underwriting criteria filters through.
- PwC projects that bad debts will drop slightly to 6.8% in 2012.
- Personal insolvencies are levelling off as the impact of debt relief orders and individual voluntary arrangements are felt.

In 2010, credit card write-offs reached £5.3 billion (up from £4.12 billion in 2009), accounting for 9.5% of outstanding balances (see Figure 11). In 2011, we saw a significant decrease in write-offs to 7.0% as the impact of changes to underwriting criteria and enhanced collection strategies started to filter through. However, we believe that bad debts will continue to make up a stubbornly high proportion of outstanding balances in the near term, as total borrowing continues to contract while write-offs reduce more slowly. Projections prepared in conjunction with PwC’s Economics team suggest that bad debt will fall slightly through 2012 to around 6.8%.

Personal insolvencies in England and Wales peaked at 35,682 in the first quarter of 2010 (see Figure 12). Insolvencies dropped by 14% to 30,685 in the final quarter of 2010 and have since remained broadly flat, reaching 30,219 in the third quarter of 2011. As Figure 12 highlights, the big story is the fall in bankruptcies. In the third quarter of 2011, 9,567 people entered bankruptcy, down 31% on the corresponding period in 2010 and the lowest quarterly figure since 2004. The decline in bankruptcies has to some extent been offset by the growth in the Government’s out-of-court debt relief orders (DROs), which reached 7,604 in the third quarter of 2011, an annual rise of 7.6%. Individual voluntary arrangements (IVAs) increased by 0.7% to reach 13,048 in the third quarter of 2011.

**Figure 11: Credit card write-offs as a proportion of outstanding balances**

<table>
<thead>
<tr>
<th>Year</th>
<th>Credit card write-offs as a percentage of outstanding loans</th>
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</thead>
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<tr>
<td>96</td>
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<td>12</td>
<td>10%</td>
</tr>
<tr>
<td>13</td>
<td>10%</td>
</tr>
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</table>

Source: Bank of England

**Figure 12: Quarterly number of personal insolvencies**

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<tr>
<th>Year</th>
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<th>Individual voluntary arrangements</th>
<th>Debt relief orders</th>
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<td>11</td>
<td>30</td>
<td>10</td>
<td>20</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Insolvency Service

22 The Insolvency Service, August 2011
23 The Insolvency Service, August 2011
PwC Credit Confidence Survey

PwC’s latest Credit Confidence Survey highlights weakness in consumer confidence and feature borrowing intentions, though the headline findings mask considerable variations between regions and age groups.

Summary

- There has been a deterioration in consumer’s confidence about meeting repayments on their current debt, with 68% feeling confident in doing so, compared to 76% last year.
- Although improved since last year, 24% of consumer’s remain worried about their ability to make repayments in the future, down from 31% in 2010.
- An increasing number of people have needed to use credit to pay for essential items. This is particularly acute among 25–34-year olds, where more than a quarter have needed to do so.
- Around one in three consumers no longer expect to use a credit card, overdraft or personal loan in the future.
Each year, in association with YouGov, we poll around 2,000 GB consumers regarding their attitude to credit, their ability to pay and their future borrowing intentions. The annual survey provides one of the most comprehensive and up-to-date pictures of the trends shaping the consumer credit market.

The difficulties faced by many households across the country are highlighted by the fact that more than 15% of the people taking part in our Credit Confidence Survey had needed to use credit to pay for essential items in the past six months (see Figure 13), continuing the increase seen last year. This is most marked among 25–34-year olds (26%). This group also displayed among the highest intention to increase saving, with 54% intending to save more in the next 12 months (see Figure 19 on page 20).

In 2011, we also launched a new Regional Household Financial Stress Index, which rates the impact of developments in earnings, unemployment, house prices, personal insolvencies and public spending in different parts of the country. Although households across the country face a significant squeeze on their budgets, our index reveals a clear divide between London and the East of England on the one side and the rest of the UK on the other (see Figure 14). Wales and the North East of England have been especially hard-hit by the downturn.

The mounting economic concerns are also reflected in the fall in the proportion of consumers who are confident about meeting their current debt repayments, 68% now confident they can make the payments, down from 76% in 2010. Most worryingly of all, less than half of 18–24-year olds are confident about their ability to repay (see Figure 15).

Looking ahead, almost a quarter of consumers are worried about their ability to make repayments on debt in the future, albeit that this represents an improvement from last year’s figure of 31% (see Figure 16). As consumers begin to make progress in paying down their debt, this improvement may reflect the fact that they are beginning to see light at the end of the tunnel. However, much of this general anxiety reflects concerns over employment and salary prospects, with one in five consumers worried about losing their job within the next 12 months and nearly two in five expecting their pay to be reduced or frozen over the coming year (see Figures 17 and 18 on the following pages).

Source: PwC Credit Confidence Survey 2009-2011

Source: PwC index calculations using data from ONS, Nationwide and Insolvency Service
Figure 15: I am able to make repayments on all outstanding credit

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>18 to 24</th>
<th>25 to 34</th>
<th>35 to 44</th>
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<td>20%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Respondents who chose neither agree or disagree are excluded
Source: PwC Credit Confidence Survey 2008–2011

Figure 16: I am worried about my ability to make repayments on debt in the future

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>18 to 24</th>
<th>25 to 34</th>
<th>35 to 44</th>
<th>45 to 54</th>
<th>55+</th>
<th>ABC1</th>
<th>C2DE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>80%</td>
<td>40%</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>80%</td>
<td>40%</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>80%</td>
<td>40%</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>80%</td>
<td>40%</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Respondents who chose neither agree or disagree have been excluded
Source: PwC Credit Confidence Survey 2008–2011

Figure 17: I am worried about losing my job in the next 12 months

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>18 to 24</th>
<th>25 to 34</th>
<th>35 to 44</th>
<th>45 to 54</th>
<th>55+</th>
<th>ABC1</th>
<th>C2DE</th>
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<tr>
<td>2009</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Respondents who chose neither agree or disagree have been excluded
Source: PwC Credit Confidence Survey 2009–2011
Turning away from credit

Around one in three consumers no longer expect to use a credit card, overdraft or personal loan in the next 12 months (see Figure 3 on page 12). A similar proportion intends to save more over the coming year (see Figure 19). This reluctance to borrow is compounded by concerns over the availability and affordability of credit. Around one in five consumers have doubts about their ability to secure credit in the future and over one in four consumers believe the cost of borrowing will increase in the next 12 months.
ICB recommendations spur strategic rethink

The ICB’s recommendations are adding to the challenges already facing banks in the contracting consumer credit market.

Summary

- The ICB’s recommendations will have a direct impact on unsecured credit and payments.
- Increases in capital requirements, in particular around the primary loss absorbing capacity, may place pressure on the cost of unsecured lending.
- Measures to make current accounts easier to switch and to improve transparency will be a catalyst in ending the UK’s free banking model.
The proposed ICB reforms aim to create ‘a more stable and competitive basis for UK banking’24 (Figure 20 outlines the main recommendations). At the end of 2011, the Government announced its support for the majority of the ICB’s recommendations, and confirmed the reforms should be completed by 2019, or ideally sooner. In this section we consider the specific implications for unsecured lending, payments and current accounts.

The ICB wants banks to hold more than 10% core Tier 1 capital and have a primary loss-absorbing capacity (PLAC)25 of at least 17% to 20% of risk-weighted assets (RWAs). The Government supports this but has suggested the PLAC requirements apply only to UK operations as opposed to the global balance sheet. While this capital requirement is clearly above the Basell III requirements, a number of UK banks are already meeting the 10% Tier 1 threshold. However, the PLAC requirements may be more of a challenge. As unsecured lending has a relatively high-risk weighting (our analysis indicates a risk weighting four times greater than secured mortgages), these increases are therefore likely to have a more pronounced impact for unsecured credit. Some repricing of unsecured consumer credit has already taken place in the market, but ongoing capital requirements and a weak economic environment will maintain pressure on return on equity (RoE) across the sector. Lenders need
to decide how to respond to this RoE pressure – while increasing prices to consumers, or absorbing the impact through cost reduction are the most likely responses in the short term, we believe a more sophisticated response will be required in the longer term, which takes a more fundamental look at the business model for each product.

These rules could make lenders reassess their product offering as the returns on each product will be more heavily scrutinised to ensure sufficient returns are being received. This has been compounded by the squeezing of non interest income in relation to unsecured credit (e.g. payment protection insurance (PPI) and foreign exchange fees). Lenders may face some tough decisions as to what products can viably be offered to which customers and this may lead banks to focus more on assessing returns from customers on a holistic level as opposed to by individual product. This will require sophisticated analytical techniques in order to truly understand the value and potential of various customer segments.

**Gearing up for easier switching and greater transparency**

The ICB recommends improvements to the process of switching current accounts between banks. Specifically, it calls for the setting up of a redirection service which would:

- operate for 13 months after the switch
- cover credit transfers, direct debits and recurring debit card payments
- be free to customers and backed by a no-loss guarantee
- send reminders to direct debit originators.

The Payments Council has endorsed these recommendations. This includes a commitment to switching within seven working days, consultation with stakeholders and the £650–£850 million investment required.

The ICB’s account switching recommendations present significant challenges for banks as the costs are considerable, the timetable is short (by September 2013) and there are a number of potential complications. These include the inclusion of recurring debit card payments, which operate on different systems to direct debits, and often require manually processed termination and reissue. Some of the biggest challenges will be faced by small banks that access payments’ systems through agency arrangements. The underlying difficulty for all banks is the limited incentives for originators to complete their part of the switchover process. Customers should also have greater transparency into the benefits of switching, due to the ICB's recommendation that banks disclose interest foregone on current accounts.

In isolation, these changes may not fundamentally change the competitive landscape, but in combination with the other market developments, they may act as a catalyst for change in the current account market, particularly in ending the UK’s free banking model, which we explore in more detail in Part Two of this report.

26 Payments Council media release, 15 September 2011
Ring-fencing would increase cost and complexity for payments

The ICB recognises the critical importance of payments to the banking system and so recommends that a ring-fenced bank (RFB) must be a member of the payments’ systems it uses, or outsource to another RFB for its payments. Banks can provide payment services to other financial institutions as long as regulatory approved safeguards (e.g. prudential limits on exposures) are in place. The result is a number of potential options for the location of the payments’ operation, each of which has cost and complexity implications (see Figure 21).

On top of the higher ongoing costs of each of these options, moving to the new structure is likely to generate considerable disruption for banks, coupled with significant transition costs, including legal, technology and process redesign expenses. As a result, ring-fencing could make it more difficult for banks to realise the full revenue potential opened up by the rapid changes in the retail payments’ market. Overall, the ICB recommendations may spur some banks to consider outsourcing more of their payment activities as a way to reduce costs.

Dealing with the implications

The ICB report and the Government’s response are expected to set off major changes in the banking industry, though it is only one of a number of significant developments in technology, regulation and customer behaviour that are reshaping the payments and lending markets. Banks need to look at these developments in the round rather than addressing the ICB recommendations in isolation. For example, how might greater transparency and competition affect a bank’s ability to attract and retain higher margin customers, and what opportunities are created by new technology for greater differentiation in this more fluid marketplace? What is certain is that those institutions that are able to promptly address the ICB reforms, as well as the wider web of interlinked changes that are taking place across the industry, will be in a strong competitive position. Many of these themes are explored further in Part Two of this report.

Figure 21: Options for the location of payment services

<table>
<thead>
<tr>
<th>Options</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment services located in the RFB, no services provided to the non-RFB or to other financial institutions</td>
<td>If having the RFB as the only user results in a significant decline in payment volumes, there may be a corresponding increase in pricing as banks attempt to reduce the impact on margins</td>
</tr>
<tr>
<td>Payment services located in the RFB, payment services provided both to the non-RFB and other financial institutions</td>
<td>The requirement to provide services outside the ring-fence on an arms-length basis would involve the additional costs of developing service level agreements, transfer pricing and continuity arrangements (if the non-RFB were to fail). Implementation of separate accounting and SWIFT queues may not be enough to satisfy this stipulation</td>
</tr>
<tr>
<td>Payment services outside the RFB, but providing services to the RFB</td>
<td>Meeting the arms-length requirements (as described above) will make the costs more significant, which could be passed on to the customer</td>
</tr>
<tr>
<td>Two payments units, one in the RFB and one outside</td>
<td>The duplication of infrastructure and operations will make this option commercially unviable for banks that do not have large volumes of payments on both sides of the ring-fence</td>
</tr>
<tr>
<td>Outsource payment services</td>
<td>Given the complexities mentioned above, some market players may look to outsource the payment services function</td>
</tr>
</tbody>
</table>

Source: PwC analysis, ICB, September 2011
Getting to grips with the regulatory shake-up
Section written in conjunction with Hogan Lovells

Firms are facing a change of regulatory approach which, coupled with new powers, will put pressure on them to change the nature of the products they sell, how they are marketed and managed.

Summary

• The Financial Conduct Authority (FCA) will replace the Financial Services Authority (FSA) in early 2013 and we expect it to take over the regulation of consumer credit from the Office of Fair Trading (OFT).

• The FCA will take a more intrusive supervisory approach. This includes ongoing monitoring and possible changes to products to address potential problems before they develop.

• The FCA’s powers over consumer protection and competition are likely to lead to increasing challenges about the way that products are priced. In particular, it seems likely that charges will be seen as a key indicator of whether or not a market is competitive.
In 2011, Margaret Cole, the interim head of the FSA's Conduct Business Unit, laid down the gauntlet for a new era in consumer protection when she said that the "standards of conduct we have seen would not be tolerated in other industries". Referring to the mis-selling controversies of recent years, she asked: "If a supermarket sold rotten food to its customers, how long would it stay in business?27"

The FCA will replace the FSA in early 2013. As well as covering the activities currently regulated by the FSA, the Government has proposed powers to enable it to take over the regulation of consumer credit from the OFT. Firms that must already contend with the ICB’s structural changes will also be subject to the biggest regulatory change since the launch of the FSA in 2000, and the greatest change for consumer finance firms since the mid-1980s. Even before the FCA formally opens for business, the FSA has already begun to adopt a tougher stance on consumer protection, seemingly emboldened by its success in winning the PPI judicial review. Although the personnel within the FCA may remain largely the same as the current FSA team, the FCA will have access to a range of proposed new powers that will allow it to take a more intrusive approach to supervision and intervene earlier to protect consumer interests.

Impact on product design
The FCA’s objectives will include ‘consumer protection’ (defined very widely to go well beyond traditional ‘consumers’) and delivering ‘efficiency and choice’ in the market, both of which could have an impact on product design and delivery. To support these objectives, the FCA will be given new powers to impose requirements on specific products or even ban them altogether. While such a move would be subject to consultation with stakeholders, the FCA could impose a temporary ban while it carries this out. In practice, the threat of such a ban is in itself likely to require a change in behaviour as few firms will want to see their product removed from the market under such circumstances, even if they later persuade the FCA that their concerns were unwarranted.

Although the FCA does not intend to preapprove products, it is likely to take a more proactive interest in product design and build on some of the FSA’s recent treating customer fairly (TCF) initiatives. Firms will need to make sure that products are not only designed to meet customer needs at the time of sale, but they do in fact meet these outcomes over the lifetime of the contract. As such, firms will need to take account of any unexpected outcomes that arise and make any necessary modifications to the product to prevent regulatory intervention.

Greater pressure on prices
As the actions over bank charges highlight, pricing is coming under an ever-increasing regulatory spotlight. Although the FCA will not have an explicit role as a price regulator, its powers over consumer protection and competition are likely to lead to increasing challenges about the way that products are priced. In particular, it seems likely that charges will be seen as a key indicator of whether or not a market is competitive. In addition, recent consultations and responses on product intervention suggest the FSA thinks that value for money has a direct bearing on competition and consumer protection.

There has been a recent regulatory trend of seeking to curb any profits from ‘hidden’ ancillary charges that customers might not have expected to incur and these new powers could add further impetus to this trend. The result is likely to be a continued move towards simple and transparent pricing models.

PPI case underlines the importance of principles
The PPI judgment confirms the importance of the FSA’s principles as ‘the overarching framework for regulation’.28 This means that firms cannot simply assume that compliance with specific rules is sufficient, which is likely to provide further impetus for the change of culture and approach the FCA will be keen to promote. In particular, the PPI case raises the prospect of being judged with hindsight and again shows the importance of monitoring outcomes continuously throughout the life of a product to

27 Speech by Margaret Cole, Interim Managing Director, Conduct Business Unit, FSA, launching the new FCA, 28 June 2011

28 Judgment of the judicial review on PPI (on the application of the British Bankers’ Association (BBA) v Financial Services Authority (FSA)), 20 April 2011
Impact on consumer credit

The new powers of the FCA and the greater emphasis on principles will have an especially far-reaching impact on the regulation of consumer credit businesses, which have until now been based on a stringently rules-based approach and regulated by the OFT. Signs of the shift to an FSA-style principles-based approach can already be seen in recent OFT announcements. In relation to debt collection, for example, the OFT has now said that "there are a number of overarching principles of consumer protection and fair business practice which apply", the first of which is to "treat debtors fairly". This echoes the FSA's TCF principle, a concept that has never previously been explicitly stated in any consumer credit context.

As we have seen from the activities of claims management companies in recent years, consumer credit regulation is an area with very prescriptive rules, minor breaches of which can have draconian consequences. There may therefore be benefits for the industry of moving to a potentially more flexible principles-based approach. The risk is that the industry ends up with the worst of both worlds – continued claims on the basis of technical breaches coupled with principles-based regulation that requires lenders to continuously monitor outcomes.

Along with the potential effect on products, the change of regulator could have an impact on the size of certain parts of the credit market. While banks and other large lenders will already have established a relationship with the FSA and teams to support this, many smaller lenders will not, and may not have the resources to manage a more hands-on regulator. There is therefore a risk that this could lead to a shrinking or consolidation of those parts of the credit market that are traditionally dominated by non-bank lenders.

Regulatory round-up

Structural change is not the only regulatory development on the agenda for 2012. In addition, key new initiatives include:

Greater transparency over bank charges

From the end of 2011, customers will receive annual statements showing how much they have paid for their bank account over the previous year. Combined with the simpler switching process being designed by the Payments Council, this aims to encourage customers to compare costs and move their accounts where a better alternative is available.

From March 2012, banks will provide text alerts (on an opt-in basis) to help customers manage their accounts better. From March 2013, all customers will be made aware of a 'grace period' to put their accounts back into order and will benefit from a small buffer zone, which will be immune from charges.

Store cards

The Government is keen to tighten up on how store cards are marketed. From mid-2012, retailers will no longer be able to offer discounts, free gifts, or other incentives at the point of sale, or within the first seven days to encourage people to sign up for store cards. These inducements are an important part of how store cards are currently marketed to customers, so this is likely to have a major impact on product design and sales for such cards. Retailers will need to find other ways to encourage customers to take up the offer of a card, which may lead to further development of long-term loyalty incentives to encourage spending on the cards.

The Government is also concerned about the lack of training for some of the staff selling cards and the incentives they receive. As a result, there will be a ban on direct commission to sales’ staff and a good practice training scheme to improve the standards of selling within retailers.

29 OFT General Principles of Customer CareAuthority (FSA), 20 April 2011
Payment Services Directive
A review of the Payment Services Directive by the European Commission will take place in 2012. Payment service firms should consider now how best to engage in that review.

Dealing with the implications
Consumer credit and payments’ providers are facing concerted pressure for change. The media, consumer groups and customers themselves are joining regulators in pushing firms towards the development of simple, transparent, value-for-money products, which can be easily understood and sold to consumers and do not attract excessive regulatory scrutiny and reputational risk. A box-ticking approach to compliance will no longer be enough, with the FCA wanting to see a change in culture within firms. The new environment also calls for ongoing monitoring and changes to products to address potential problems before they develop.
As the consumer credit contracts and digital developments become increasingly important, businesses will need to overhaul their strategies and business models.

They will also need to contend with potential disruptive competition from a range of new entrants. In many respects, the newcomers are setting the pace in the marketplace and traditional players will need to make up significant ground before it is too late.

In this section, we describe the ‘new realities’ of a very different commercial environment, the forces that are shaping competitive developments and how companies can turn the changes to their advantage.

Reality 1: The credit card’s mid-life crisis
Reality 2: The end of free banking
Reality 3: Mobile payments will become commonplace
Reality 4: Primed for the digital tipping point
**Reality 1: The credit card’s midlife crisis**

Credit cards in the UK have just celebrated their 45th birthday, and while a long way from retirement, the business model is likely to need major reshaping if it is to retain its dominance and relevance.

**Summary**

- The credit card market is shrinking as people cut back on debt and younger people move towards debit cards and other emerging alternative payment types.
- The economic model underpinning credit cards is in jeopardy. The currently high spreads cannot be sustained once funding charges begin to rise. Regulation is putting further pressure on fees.
- Something needs to give. The industry needs to find new ways to generate value. In the short term we expect to see issuers focused on taking out cost; however, in the longer term, business models and customer propositions will need to fundamentally change to provide a more sustainable future for the industry.
The credit card has been one of the most successful financial products in the UK since it was first launched in 1966. Consumers quickly came to appreciate it as a convenient way to pay and for being a relatively accessible and flexible form of credit.

However, over the years, the debit card has eroded the credit card’s dominance and a new generation of digital alternatives are now coming to the fore. At the same time, consumers have fallen out of love with their credit cards, with trust eroded by opaque and complicated pricing and the national focus on austerity and deficit reduction feeding through to consumer’s attitude towards their own debts. Regulators continue to scrutinise the industry and clamp down on other less transparent charges. In short, the credit card is not in the shape it once was and simply continuing in the current vein looks like an increasingly unviable option for issuers.

**Contraction in demand**
The contraction in the credit card market started well before the financial crisis (see Figure 4 on page 13). Figure 22 highlights the degree to which credit cards have lost ground to other payment types. The main threat has come from debit cards, which now account for around 40% of payments.

The move from credit to debit card is set to be accelerated by younger people’s preference for the latter, which was highlighted in this year’s PwC Credit Confidence Survey (see Figure 23). While this may to some extent be inherent in the nature of the two products (i.e. credit cards being primarily a credit facility that may be less accessible to younger consumers), we do not believe this fully explains the split. Card issuers must urgently identify ways to make the credit cards more relevant and attractive to this vital demographic.

Further threats are coming from payment innovations such as mobile payments and digital wallets, which are beginning to gain a foothold in the market and will come to the fore in the near future. These will be particularly attractive to the generation now approaching financial maturity and choosing their primary banking relationships. The growing popularity of the new payment methods in the fast-growing online, social and mobile areas of commerce is especially noticeable.

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**Note:** Rounded to nearest percentage so may not add up to 100

**Source:** Mintel Debit and Credit Cards, July 2011

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*Frequently is defined as using the card on more than ten occasions a month*

**Source:** PwC 2011 Credit Confidence Survey
In 2009, the European Commission agreed a temporary multilateral interchange fee (MIF for cross-border transactions) level with MasterCard of 20BPS for debit cards and 30BPS for credit cards. This agreement does not close the legal battle, but has ended the European Union's investigation. It is of particular interest that these MIF-rates are higher than the domestic rates in most markets. For providers of both credit and debit cards, the volume shift (from credit cards to debit cards) has a negative net impact on their revenue. In the UK, debit card domestic interchange income per £100 consumer spend is, on average, roughly five times lower than credit card interchange fees.31

The EU's recent Green Paper on an integrated payments market32 is likely to put further pressure on interchange fees by seeking greater transparency over the true costs of payments with the suggestion that retailers should be permitted to surcharge to recover costs and influence cardholders' use of different payment methods.

Other fee income from credit cards is coming under increasing regulatory pressure. Recent examples include the OFT's investigation of foreign-exchange charges for using cards abroad, which follows a complaint from independent watchdog, Consumer Focus.33 The threat is amply highlighted by the damages and loss of revenue emanating from the judicial review of PPI.

Annual fees have up until now been mostly associated with reward propositions and tend to appeal to a small portion of the population such as frequent travellers. The threat to 'free banking' could make annual fees for credit (and possibly even debit) cards more prevalent.

30 Europa, MasterCard’s decision to cut cross-border Multilateral Interchange Fees (MIFs) and to repeal recent scheme fee increases, 1 April 2009
31 OFT Payment Surcharges, 10 June 2011
32 "Towards an integrated European market for card, internet and mobile payments", 11 January 2012
33 Consumer Focus media release, 23 September 2011
Factors affecting credit card returns

Figure 25: Factors affecting credit card returns

<table>
<thead>
<tr>
<th>Driver</th>
<th>Line item</th>
<th>Future P&amp;L impact</th>
<th>Observation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Interest Income</td>
<td>📊</td>
<td>• APRs are at all time high leaving little head room for further increases</td>
</tr>
<tr>
<td></td>
<td>Interchange</td>
<td>🟢</td>
<td>• Continued pressure from regulators and merchants</td>
</tr>
<tr>
<td></td>
<td>Fees</td>
<td>🟢</td>
<td>• Continued pressure from regulators, and little consumer appetite for more fees</td>
</tr>
<tr>
<td>Cost</td>
<td>Bad debt</td>
<td>🟢</td>
<td>• Depends on economic recovery, and regional differences will impact exposure</td>
</tr>
<tr>
<td></td>
<td>Funding cost</td>
<td>🟢</td>
<td>• Funding cost at all time low, impact depends on funding mix and hedging strategy</td>
</tr>
<tr>
<td></td>
<td>Acquisition cost</td>
<td>🟢</td>
<td>• Declining customer base is expected to lower conversion rates</td>
</tr>
<tr>
<td></td>
<td>Operating expenses</td>
<td>🟢</td>
<td>• Continued regulatory activism will drive cost • Fixed cost will be spread over lower volumes</td>
</tr>
</tbody>
</table>

Source: PwC analysis

Narrow income stream

It is increasingly clear that business models seeking to generate most of their income from a particular segment of customers are ripe for overhaul and innovation (and might also attract more regulatory interest). The two predominant models are either lending-based (e.g. balance transfers or 0% purchase cards), or payment-based (like the cashback or airline reward cards).

The lending-based model relies on those customers with outstanding balances to generate the dominant share of its income from interest payments. The weakness is that customers who remain indebted for a long period contribute a significant portion of the overall income while those who do not revolve a balance effectively, receive the product for free. The payment-based model focuses on another customer segment, who tend to pay off their debt balance each month, benefiting from a month’s interest-free credit and strong reward propositions. The income for card issuers in the payment-based model comes primarily from interchange. The weakness here is that consumers get a relatively high reward for which they contribute relatively little themselves (like some annual fees and foreign-exchange charges).

What the contraction in the market and issues with the business model mean is that relatively high returns and strong customer demand may have come to an end. This begs the question: ‘How will you stay in the game?’ Some players are already heading for the door. While many of the other players will continue to see valuable potential in credit cards, the model will need repair and updating to remain relevant.
Doing more for less – Players must act to move down the cost curve, but also seek ways to shift the curve downwards, i.e. doing more for less.

**Figure 26:** Doing more for less – Players must act to move down the cost curve, but also seek ways to shift the curve downwards, i.e. doing more for less

<table>
<thead>
<tr>
<th>Level of savings</th>
<th>25%+</th>
<th>15-25%</th>
<th>5-15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Move down cost curve**

**Shift the curve**

**Cut costs**
- Reduce team sizes
- Eliminate low-value activities
- Reduce or eliminate duplicative spend
- Reduce contractor spend
- Reduce/arbitrate contract spend
- Reduce/eliminate free activities
- Reduce/eliminate low-value activities
- Reduce/eliminate duplicative spend

**Redefine cost structure**
- Outsourcing and offshoring
- Near-shoring/create captive
- Payments
- Reduce/decommission IT platforms
- Learn/Six Sigma
- Straight-through processing
- Create shared services
- Consolidate functions and locations

**Create efficiencies**
- Attack errors and rework
- Reduce and eliminate
- Reduce/arbitrate contract spend
- Reduce/eliminate duplicative spend

**Increasing sustainability**
- Sharpen cost competitiveness
- Strategic cost reduction (SCR) would help issuers to sustain margins, while they could still monitor innovation and follow where necessary. Companies looking to strengthen scale could opt for further consolidation. Other players may prefer a niche strategy.

In light of the declining demand and pressure on margins, incremental and short-term cost reduction in areas such as discretionary spending may not be sufficient. It will also be important to improve overall efficiencies through steps such as the rationalisation of functions and services. Other options include further offshoring and near-shoring (see Figure 26). At the same time, companies should not erode the competitively crucial value created by particular functions such as collections, and should make business teams more accountable for costs.

The effectiveness of the cost control programme depends on a clearly defined customer strategy and operating model. For example, it would be counterproductive to force a highly valuable customer to use self-service options if that customer would prefer to speak with a representative. At the same time, there is no benefit in offering services that are not valued like credit lines for dormant customers. This customer strategy will be part of a wider banking relationship for some players, focusing on multi-product customer-level profitability by different customer segments.

**Sharpening cost competitiveness**

Source: PwC analysis
The real path to growth

The market is opening up to innovative new business models. In particular, there are clear openings for companies that can enhance convenience, provide valuable incentives and rebuild customer trust, while finding new ways to generate income for themselves. To make the most of these opportunities, issuers may need to look beyond the traditional focus on the transaction and consider the wider consumption chain and how they can innovate and take value from other parts of this process.

In the US, credit card issuers have been developing a number of innovative approaches, which could provide a possible model for the UK. Of particular note are measures to enhance customer trust by giving cardholders more control over repayments. Examples include JP Morgan’s Blueprint, which allows customers to choose between different forms of repayment for specific transactions. In the UK, a number of companies have started down this road by providing customers with analysis of their spending.

Daily offers provide a further opening for market development. A number of card issuers have been looking to offer such incentives, attracted by the successful growth of companies like Groupon. The big question for card issuers is how to differentiate themselves in a crowded and competitive field. Do they use their insights into a customer’s spending patterns to improve the targeting of sales promotion offers? Alternatively, do they use their brand, or existing relationship to help get them noticed by customers being inundated by offers?

Figure 27 outlines how card issuers could enhance convenience, play a part in helping consumers to compare offers and manage their spending more effectively.

![Figure 27: The consumption chain](Source: PwC analysis)

- **Customer activities**
  - Research goods online and via mobile
  - Review social media and peer recommendations
  - Compare prices
  - Select product and channel
  - Choose payment method based on convenience, availability of funds, cost and habit
  - Authorise payment
  - Check receipt and complete transaction
  - Store receipt for return/refund purposes
  - Reconcile transaction against (monthly) statements
  - e.g. Exchange / return goods
  - Others – varied, depending on product or service purchased

- **Examples of innovation**
  - Daily deals: Groupon
  - Spend control: JP Morgan Blueprint
  - Payment method selection: Barclaycard Freedom
  - Person to person: Visa
  - Mobile apps: American Express
Reality 2: The end of free banking

The UK’s ‘free’ banking model is neither genuinely free nor sustainable in the long-run. Moving to paid-for banking would provide clear benefits for both customers and banks.

Summary

• The UK’s free banking model is unusual by international standards and is no longer sustainable.

• The free banking model has contributed to a lack of transparency and understanding of how consumers are actually paying for banking services.

• It is likely that cross-subsidisation between consumers and products is occurring, placing a disproportionate burden on certain customer segments.

• Although consumers remain wedded to the perceived benefits of free banking, both consumers and banks would be likely to benefit from moving to a fee-based model that more directly and transparently aligns the price people pay to the services they actually consume.
The free banking model manifests itself differently (and to varying degrees) across different product categories, but is the dominant model across the retail banking industry. Among the most prominent examples are free-if-in-credit current accounts and no annual fee credit cards. In this section we focus predominantly on current accounts, though the underlying principles and consequences of free banking broadly apply to other products as well.

**Stable equilibrium**

In 1984, Midland Bank shook up the UK market by being the first bank to offer free-if-in-credit current accounts. Significant customer switching followed, effectively forcing the rest of the market to follow suit. Fast forward to 2011 and access to a ‘free’ (it isn’t of course free) current account is now firmly lodged in the national psyche as an entitlement, leaving the market stuck with a stable equilibrium, as banks fear the first mover disadvantage of changing the model.

**Reaching the watershed**

By international standards, the UK’s free banking model is relatively unusual, with the majority of other markets routinely charging fees, either on a monthly or per-transaction basis. Even those relatively few markets that have historically offered free-if-in-credit current accounts en masse are now making significant progress towards a paid-for model.

The market conditions in which the UK moved to the free-if-in-credit model have changed significantly. While the model has been under increasing pressure for some years, we believe that we are now at a turning point and that the pace of change will accelerate. The primary factors driving change are:

1) **Record low interest rates**

In 1984, when the free-if-in-credit model was first launched, interest rates averaged almost 10%. In contrast, interest rates today are at an all-time low, with little prospect of increasing in the short term. The free-if-in-credit model becomes progressively less sustainable at lower interest rates, since the relative value of customer deposits declines.

2) **Retail bank profitability under pressure**

As bank profitability continues to come under pressure, banks are no longer in a position to give away one of their core services for ‘free’.

3) **Consumer and regulator rejection of the current model**

As the free-if-in-credit model has become harder to sustain, banks have had to find ways to recover their shortfall through other, arguably less transparent, means. While customers may not directly make the link between free banking and its negative side effects, the overall model is being increasingly rejected. This is highlighted more broadly by the fact that over the past 20 years, British banks have paid out around £15bn in compensation to their own customers, and complaints to the financial ombudsman have risen from 30,000 a decade ago to 200,000 in 2010, an increase of over 500%.

4) **Changing competitive landscape**

Changes to the competitive landscape will bring fresh thinking to how services should be priced. It has been mooted in the press that some players are considering a departure from the free banking model.

5) **Independent Commission on Banking**

The ICB’s recommendations include measures to make it easier for consumers to switch their current account and to increase transparency by requiring banks to communicate the value of the interest foregone on credit balances in current accounts – the hope being that this will ignite competitions and engage customers.

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34 PwC UK Economic Outlook, November 2011
**High cost of free banking**

Current accounts are, of course, not free. According to the 2008 OFT Trading Report, the industry made an estimated £8.3 billion in revenue from personal current accounts in the UK. More than 80% of this revenue was derived from net interest credit (i.e. interest forgone by customers from not receiving interest on credit balances) and unarranged overdraft charges. While there have since been relatively significant changes in relation to overdraft charges, we believe the overall revenue model has not fundamentally changed.

While consumers may perceive free banking as attractive, it is likely that a disproportionate portion of the overall cost of current accounts falls on customers who regularly pay overdraft fees, or in the interest lost by people with large credit balances. These customers are effectively subsidising the rest. A similar cross-subsidy occurs in the case of no annual fee credit cards, where those who clear their balance each month receive the benefits of using a credit card at no cost (e.g. fraud protection on transactions, a period of interest-free credit, etc.), in part subsidised by those who pay interest.

"There is of course no such thing as free banking. What it really stands for is that charges are levied inconsistently across products supplied by banks, with the consequence that some appear to be free. It also leads to what in my view are unhelpful and damaging decisions... The philosophy should be, give the public what they want but at a fair price which is transparent to them", said Andrew Bailey, Director of Banking at the FSA.

Cross-subsidisation is not necessarily an issue in itself; it is common and largely accepted in other industries. The issue in the case of banks is the lack of transparency in the cross-subsidisation and the resulting difficulty for consumers in understanding what and how they are actually paying. The knock-on effect is to make comparisons between providers difficult. When added to the limited differentiation between providers of current accounts and a cumbersome switching process, the result is low switching, which, in turn, reduces the incentive for banks to innovate or provide exceptional levels of service.

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35 OFT Trading Report, 2008
36 The Telegraph, No such thing as free banking says top banking supervisor, 25 November 2011
Moreover, the free banking model makes it difficult for new entrants to break into the market, because they lack the scale or range of products to sustain this core service being provided for free.

To generate the necessary backing for change, consumers will need to be increasingly educated on the link between the free banking model and the negative consequences of it. If consumers value the services that banks provide, and would like to see these improved and developed, it is in their interests to pay for them more directly and transparently.

**Easier switching only part of the solution**

Less than 5% of current account holders switched their account in 2010, significantly less than switching rates seen in some other industries (see Figure 28). While the ICB recommendations should improve transparency and make it easier for customers to switch, we believe that this in itself is unlikely to resolve the issue. For example, easier switching and increased competition between gas providers did not necessarily benefit consumers. One provider recently admitted it had offered cheap deals as loss leaders to attract customers and conceded that "it’s not right we are charging honest customers more to fund these deals”37.

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37 Daily Telegraph, British Gas to simplify energy bills, 24 November 2011
Fee for all?
The only major departure from the free-if-in-credit model has been packaged accounts. While around 20% of UK adults now hold such an account, they have come under significant scrutiny. Concerns centre on the suitability and value of the various insurances bundled together in the package. Although packaged accounts are relatively common, they have not fundamentally moved the industry any closer to customers paying more directly for core underlying services they are using.

As part of this year’s PwC Credit Confidence Survey, we explored consumer reactions to a number of alternative charging models for current accounts (see Figure 29). The findings underline the challenges of moving to a paid-for model, with most customers seeing direct charges for current accounts as unfair. Even offering discounts on current accounts if holders take up other services from the bank, which was seen as the least unpalatable of the various options, was still regarded as unfair by nearly two-thirds of respondents. Consumers were least receptive to charging models that included pay-as-you-go or flat monthly fees, which are common approaches in other countries. They were slightly more open to models that offer free accounts on a conditional basis such as limited branch access.

Figure 29: How fair, if at all, do you think each one of the following is as a way to charge for current accounts?

<table>
<thead>
<tr>
<th>Charging Model</th>
<th>Percentage Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay-as-you-go charges (i.e. a fee for certain current account services such as ATM withdrawals, chequebook usage)</td>
<td>(100%)</td>
</tr>
<tr>
<td>A flat monthly fee for unlimited usage of current account services</td>
<td>(80%)</td>
</tr>
<tr>
<td>Free for online banking, but charges for telephone and branch usage</td>
<td>(60%)</td>
</tr>
<tr>
<td>A certain amount of free usage of your current account (e.g. limited branch and call centre usage) after which the bank would start charging a fee</td>
<td>(40%)</td>
</tr>
<tr>
<td>A discounted current account fee if you take out other products from the same bank (e.g. credit card, savings products, etc.)</td>
<td>(20%)</td>
</tr>
</tbody>
</table>

Note: Respondents who chose a neutral response were excluded.
Source: PwC Credit Confidence Survey 2008–2011

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38 Mintel Packaged and Current Accounts, June 2011
39 BBC Packaged bank accounts face FSA action, 27 October 2011
A way forward
As banks look at how to keep pace with the pressure for change and create a financially sustainable model, we would offer the following recommendations:

Stimulate debate
Increase the quality of the debate around free banking by focusing on two key messages. First, seek to shift customers’ perceptions of fair value by highlighting the rich utility provided, and potentially its cost, in return for foregone interest. Secondly, educate consumers on the potential benefits of alternative models including increased choice, innovation, better service and, ultimately, a ‘fairer’ deal for all. Working in partnership with consumer groups and other trusted sources of advice would help to increase the credibility of this message.

Plan for different scenarios
Conduct war games and scenario analysis on how competitors may move their pricing, how consumers may respond and gauging how trigger events may act as a catalyst for change (e.g. new entrants launching, ICB transparency and switching measures coming into force).

Develop the new generation products
Identify the cost to serve different customer segments (defined by behaviour as well as traditional socio-demographic criteria) and use this to inform new product and pricing options. It will also be important to identify product features and services, customers will value, taking account of differences by segment and use this to investigate ways to enhance value for money in a paid-for account. Our research (see Reality 4: Primed for the digital tipping point) indicates that where consumers see value they will be prepared to pay, this should give the industry confidence in pursing innovation and new pricing models.
Reality 3: Mobile payments will become commonplace

Mobile payments have been widely touted as the ‘next big thing’ for some time, but we believe that the pre-conditions for widespread adoption are some way off. Before developing strategies to unlock the potential in this market, greater clarity of what mobile payments are and how they could work is needed.

Summary

- Despite significant promise, there are still a number of barriers to overcome before mobile payments can become a mainstream payment method in the UK (e.g. customer proposition, commercial model on technology and infrastructure protocols).
- The real value in mobile payments is likely to lie beyond the core transaction process in how value can be added to the wider consumption chain.
- There is still a significant amount to play for. While existing players are likely to play a role in whatever model emerges as the predominant mobile payments solution, they still risk being either disintermediated or being relegated to fulfilling only the processing role in the value chain.
The first mobile payment took place in Japan in 2004. Despite significant hype and investment across multiple markets since then, mobile payments remain a niche market in most countries. Many analysts remain enthusiastic about mobile payments with rapid growth forecasts over the next five years, but the nuts and bolts of how this will be achieved remain largely undefined. While the mobile payments market undoubtedly holds great potential, we have identified three primary barriers to its uptake as a mainstream payment method so far. These are the lack of a compelling consumer proposition, uncertainty over the commercial model and no consensus on technology standards. Based on these barriers, Figure 30 sets out a number of pre-conditions for the growth of mobile payments. The EU has recently published a Green Paper that looks at ways to remove some of those barriers and improve the single market for digital payments, including through standardisation and interoperability of systems and schemes.

In Japan, South Korea and France, where the mobile payments market is more developed, many of these pre-conditions are in place. For each of these markets an industry body has taken the lead in shaping the mobile payment landscape. This includes setting standards, investing in merchant acceptance terminals and making payment-enabled handsets widely available. Crucially, these central bodies have also provided a clear framework for developing mobile payments and built a mobile payments landscape based on well-defined customer propositions, generally based on mass transit at first (e.g. the tram network in Nice or the subway in Japan). By contrast, in the UK, each participant has tended to take a different view of what mobile payments are and how they should work. Without a common starting point, it is unlikely that the current barriers to the development of mobile payments in the UK will be overcome in the short term.

To help bring some greater clarity to the options for development in this market, we have created a set of frameworks for mobile payments: the Taxonomy of Mobile Payments and the Periodic Table of Consumer-to-merchant (C2M) mobile payments. These frameworks provide a common starting point for developing the industry roadmap for mobile payments.

“It is critical that industries start to work together in defining future models for mobile payments. Leading the way in this area will be key to ensuring the future attractiveness and relevance of payment products to the vitally important younger demographic.”

Paul Rodford, Head of Cards, UK Cards Association

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40 Mobile FeliCa in Japan, ‘5 years of contactless mobile services: payment, loyalty and transport’, published by Innovasia, 11 December 2009
41 Mobile payments users to grow by 40% to reach 2.5 billion globally by 2015, Juniper, June 2011
42 ‘Towards an integrated European market for card, internet and mobile payments’, 11 January 2012
**Developing a clear taxonomy for mobile payments**

When considering mobile payments, many people immediately think of a contactless in-store experience. However, the range of payments that could be made using a mobile is broad; some of these are already widely used while others are in their infancy.

We have developed a comprehensive framework for classifying mobile payments based on two axes (see Figure 31). The first is whether the payment is remote or physical. In a remote payment, the location of the payer or payee has no impact on the ability to transact. For a physical payment, the handset and the payment acceptance device (in most cases a terminal) must be in close proximity. The second axis is based on the parties involved in making the payment; this can either be consumer-to-merchant (C2M) or person-to-person (P2P). A C2M transaction involves a business, typically with a merchant category code; a P2P payment takes place between individuals.

In the long term, mobile payments’ solutions may address all of the quadrants in Figure 31, but our view is that the scope of early mobile payments’ strategies should be more narrowly focused. With the value of the non-bank P2P market just £53m in 2010 and adequate solutions for electronic bank transfers already in place, P2P is unlikely to spark mass adoption of mobile payments. In contrast, the size of opportunity in the C2M market is significant and mobile payments have the potential to fundamentally change and improve the user experience in this market.

It may seem surprising that limited progress has been made in unlocking the value of this market. However, there are still questions around the return on investment on mobile payments for traditional players such as card issuers and associations. The revenue generated from mobile transactions, primarily through cash replacement for small- to mid-size transactions, although incremental, is unlikely to form the basis of a compelling investment.
case in itself. However, adjacent services such as mobile ticketing, mobile coupons and loyalty programmes, and solutions that, for example, link mobile payment analytics with targeted advertising are potentially high value.

Whichever player holds the primary customer relationship for mobile payments could be well-positioned to generate revenue from these services. Maintaining the primacy of the customer relationship is a further spur to participate in the mobile payments’ market; with mobile operators and technology firms increasing their focus on this market, there is a significant risk of disintermediation and loss of existing payment revenue. For example, emerging payment solutions that are funded directly from a current account using Faster Payments or Direct Debit could completely bypass traditional payment companies and pose an existential threat to the industry.

As evidence of the potential value of the mobile payments’ market, our research shows consumer interest in mobile payments’ services across the purchase experience and indicates that consumers are willing to pay for these services (see Figure 32). The ability to receive receipts directly on a mobile scored particularly well, but there are also opportunities for location-based marketing, loyalty scheme management and ticketing.
### The known elements of a mobile payment

The elements involved in a C2M mobile payment are not necessarily fundamentally different from those of a traditional card payment. At its heart is the transaction between the merchant and the customer. The customer must have a funding source, a means to route those funds for a payment and a mechanism for transacting with the merchant at point of sale. In turn, the merchant needs to be able to accept and verify the payment and then receive the funds. The key differences between a mobile payment and a card payment are the means of routing the funds to the merchant, the mechanism for transacting and how the merchant accepts the payment.

To clarify how mobile payments will work in practice we have gone back to first principles and have created the C2M mobile payments periodic table (see Figure 33). The periodic table provides a comprehensive framework to show all of the currently known elements that can be involved in a transaction. The categories at the top describe each step from how the customer funds the transaction through to settlement with the merchant. At least one element from all categories must be included in the transaction, with the exception of ‘Traditional’ and ‘Emerging’ funding means. However, all transactions must include at least one element from either of these funding means, or elements from both. There are also some adjacent elements such as mobile receipt services, which are closely linked to mobile payments and may be appealing to consumers, but are not integral to the transaction itself.

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#### Figure 33: The C2M mobile payments periodic table

<table>
<thead>
<tr>
<th>Merchant</th>
<th>Customer</th>
<th>Ultimate funding source</th>
<th>Traditional funding means</th>
<th>Emerging funding means</th>
<th>Transaction mechanism</th>
<th>Payment acceptance</th>
<th>Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical merchant</td>
<td>Cash</td>
<td>Where money for mobile payments comes from</td>
<td>How money is routed to the merchant</td>
<td>Mobile POS (EMV/Magstrip)</td>
<td>How the merchant receives payment</td>
<td>How funds are routed to the merchant</td>
<td></td>
</tr>
<tr>
<td>Non-physical merchant</td>
<td>Current account</td>
<td>Cash</td>
<td>Credit card</td>
<td>Prepaid card</td>
<td>Virtual POS</td>
<td>Card issuer</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mobile phone account (Pre-pay or post-pay)</td>
<td>NFC on device/SD/sim</td>
<td>Virtual wallet account (e.g. PayPal)</td>
<td>SMS</td>
<td>QR code</td>
<td>Favorable association</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mobile receipt services (e.g. iTunes)</td>
<td>NFC sticker</td>
<td>QR code</td>
<td>Contactless terminal</td>
<td>Card acquirer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Select at least one element from each category. At least one element from adjacent category is required to deliver mobile payments.

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Source: PwC analysis
The way forward

Using the periodic table, there are thousands of possible combinations in which a transaction could work; this goes some way to explaining why settling on a single mobile payments solution has been so challenging. However, we have identified the three broad mobile payment models that could come to the fore. Below are examples of how these mobile payment models could work using different elements from the periodic table; at this stage, these are designed to be illustrative rather than exhaustive.

Model 1. Existing players remain dominant

There is already a secure and reliable payments’ infrastructure in the UK (see Figure 34); using this as the basis for mobile transactions would minimise costs to providers and disruption for consumers. This model delivers the highest share of value for the card industry incumbents, but would still require challenges such as the lack of merchant acceptance to be addressed and technology standards for mobile payments to be defined. There are some scenarios that require participation from new entrants; for example, collaboration with mobile operators would be needed to provide the ‘Transaction mechanism’ for on-device and on-SIM NFC. Although this may lead to some revenue dilution, payment market incumbents would continue to capture the majority of payments revenue through control over the ‘Funding means’, ‘Payment acceptance’ and ‘Settlement’.

Figure 34: Model 1. Existing players remain dominant

<table>
<thead>
<tr>
<th>Traditional funding means</th>
<th>Emerging funding means</th>
<th>Transaction mechanism</th>
<th>Payment acceptance</th>
<th>Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronic transfer</td>
<td>Pre-paid merchant app</td>
<td>Mobile self-checkout</td>
<td>Mobile POS</td>
<td>Card issuer</td>
</tr>
<tr>
<td>Direct debit</td>
<td>Closed loop credit app</td>
<td>NFC on device/SD/sim</td>
<td>Virtual POS</td>
<td>Card association</td>
</tr>
<tr>
<td>Debit card</td>
<td>Mobile phone account</td>
<td>NFC sticker</td>
<td>Contactless terminal</td>
<td>Card acquirer</td>
</tr>
<tr>
<td>Credit card</td>
<td>Virtual wallet</td>
<td>QR code</td>
<td>QR reader</td>
<td>Faster payments</td>
</tr>
<tr>
<td>Prepaid card</td>
<td>Virtual merchant account</td>
<td>SMS</td>
<td>Operator billing</td>
<td></td>
</tr>
</tbody>
</table>

Source: PwC analysis
Model 2. Closed-loop solutions that erode revenues

Mobile prepaid apps have had early success in the US – Starbucks’ MobilePay app was used for 26 million transactions in its first year⁴⁴ – proving that conceptually mobile payments can be attractive to consumers. These could cut traditional card industry players out of a limited number of transactions. The Starbucks MobilePay app can be funded using a credit card or PayPal account, but future closed-loop propositions could be topped up directly from a current account, using Faster Payments or Direct Debit, or by using cash at a physical terminal.

Although this business model will reduce card market revenues, they are unlikely to be large-scale. However, if a number of large merchants were to successfully launch a comparable prepaid solution in aggregate, this could have a more profound effect on the card market revenues (see Figure 35).

![Figure 35: Model 2. Closed-loop solutions that erode revenues](source: PwC analysis)

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⁴⁴ Business Wire, Starbucks Mobile Transactions exceed 25 million within first year, 6 December 2011
Model 3. Existential threats that cut incumbents out of the transaction

Emerging models could eliminate card industry players from mobile transactions. New entrants could establish a payment model that bypasses card issuers and acquirers, relying instead on electronic transfers or direct debit to fund a mobile phone account, a virtual wallet, or a virtual merchant account (e.g. iTunes), which is then used to buy goods (see Figure 36). However, this alternative future would require heavy investment, not least to build a secure and reliable system for payment acceptance, verification and settlement.

There are still many uncertainties in the mobile payments’ market, but it has the potential to be high value. To unlock this requires a common language between participants and a vision of how transactions will work.

It is likely that the success of the mobile payments’ market will depend on collaboration between key participants and some experimentation with new technologies and propositions. To get to this point, we have set out a high-level roadmap with some key steps for making mobile payments a reality (see Figure 37).

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**Figure 36: Model 3. Existential threats that cut incumbents out of the transaction**

<table>
<thead>
<tr>
<th>Traditional funding means</th>
<th>Emerging funding means</th>
<th>Transaction mechanism</th>
<th>Payment acceptance</th>
<th>Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronic transfer</td>
<td>Pre-paid merchant app</td>
<td>Mobile self-checkout</td>
<td>Mobile POS</td>
<td>Card issuer</td>
</tr>
<tr>
<td>Direct debit</td>
<td>Closed loop credit app</td>
<td>NFC on device/SD/sim</td>
<td>Card association</td>
<td>Card</td>
</tr>
<tr>
<td>Debit card</td>
<td>Mobile phone account</td>
<td>NFC sticker</td>
<td>Virtual POS</td>
<td>Card</td>
</tr>
<tr>
<td>Credit card</td>
<td>Virtual wallet</td>
<td>QR code</td>
<td>Contactless terminal</td>
<td>Faster payments</td>
</tr>
<tr>
<td>Prepaid card</td>
<td>Virtual merchant account</td>
<td>SMS</td>
<td>QR reader</td>
<td>Operator billing</td>
</tr>
</tbody>
</table>

Source: PwC analysis

**Figure 37: A roadmap for mobile payments**

1. Validate the consumer experience and value proposition
   - Research consumer needs and behaviours across the purchase experience to understand ‘hooks’
   - Explore attitudes to technology and current mobile use

2. Build consensus on technology standards and payment models
   - Conduct a full review of mobile payment technologies
   - Review international pilots and initiatives to understand drivers of success and failure

3. Develop a business-case for merchants
   - Engage merchants and payment partners to understand key tenets of the investment case
   - Develop strategy for gaining merchant buy-in for mobile payments

4. Identify required delivery capabilities
   - Define the operating model for delivering the consumer experience
   - Identify which elements require partnership; build mobile payments ecosystem around this

5. Develop go-to-market strategy
   - Develop and pilot consumer propositions
   - Identify key merchant targets and engage sequentially

Source: PwC analysis
We have reached a digital tipping point. Digital banking is set to become the chief source of customer interaction and enabler of a more engaged customer relationship. Card and payment providers will need to assess the impact on their business and how to keep pace.

Summary

- A far-reaching global survey carried out by PwC suggests that traditional means of interacting with customers (branches, call centres, etc.) will soon be overtaken by digital channels as the primary point of contact.45
- Digital interaction can enhance customer engagement and account ‘primacy’, leading to greater loyalty and market share.
- Digital transformation could also be disruptive as new entrants look to pick off valuable areas of the market and take control of the customer relationship.

45 The PwC ‘Tipping Point’ survey looked at the attitudes to digital banking of some 3,000 consumers across Canada, China, France, Hong Kong, India, Mexico, Poland, the UAE and the UK (for interactive analysis of the survey results, including breakdowns by country, demographic and market segment, please visit: www.pwc.com/digitaltippingpoint)
Increasing regulatory intervention and competitive challenges are forcing the banking industry to deleverage and look for fresh sources of value. A key source of value is the ability to secure primacy over the customer relationship (the preferred and main bank for a customer) through efforts to regain trust and build customer engagement. This is equally important for credit card issuers and full service retail banks. Primacy is generally reflected in the active use of a current account (or credit card) and opens the way to a deeper customer relationship. Customers are far more likely to buy additional financial services products from the primary relationship provider (see Figure 38).

Customers prefer digital
Digital interaction will play an instrumental role in delivering this new value model. The preference for digital is now pervasive globally (see Figure 39). As Figure 40 highlights, it is especially valued by Generation Y (the definition varies widely, but broadly, it refers to those people born in the 1980s and 1990s). As this age group begins to form its primary banking relationships, the quality of the digital offering is an important factor in their decision process. Banks will need to act now if they are to attract these customers and thereby lock-in future value. To do this, their digital strategies will need to move beyond traditional cost reduction objectives.
Broadening digital capabilities

The full extent of what digital can offer customers goes beyond the basic mobile and internet banking services that are now widely available, although there is still value in delivering these basic services well. Digital banking will evolve into a richer set of offerings, providing new sources of value for banks and their customers through a new ‘digital feature set’, based on innovations in user experience, mobile devices and networks, social media and collaboration, customer analytics and channel integration. By embracing digital, banks can deepen their existing customer relationships, as well as accessing new sources of revenue.

At present, most banks are at an early stage of digital transformation, offering limited ‘one-way’ monitoring solutions such as reviewing recent transactions on a current account or credit card. More advanced players offer ‘two-way’ banking on the mobile/tablet. For example, apps for depositing cheques are now available from many providers in the US and proving to be popular. However, most existing digital offerings use only the basic elements of the new ‘digital feature set’. This leaves lots of space to differentiate and outpace the competition.

Digital can be disruptive

Digital has also opened up the industry to a number of innovators – big and small. In markets where financial services are widely accessible, we believe that while these new entrants will secure a place as part of the market ‘ecosystem’, there is little evidence to suggest that they will be successful in taking over the entire customer relationship from incumbent players. Despite challenges to this position, banks remain the most trusted providers of banking services by customers. In growing markets where the underbanked population is sizeable, the threat of being out-competed by new entrants could potentially be greater.

Provides a platform for innovation

Mobile is coming of age and is moving beyond simple banking functionality to embrace mobile payments (explored in more detail in Reality 3 on page 42) and other innovative offerings such as marketing services, sophisticated authentication mechanisms, location-based personalisation, etc. These innovations offer a superior customer experience, one that the customer is willing to pay for. This willingness to pay may be a critical factor.

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Figure 41: Appetite for innovative digital services

Which of the following would you be willing to pay for? Please rank your top 3.

<table>
<thead>
<tr>
<th>Service</th>
<th>UK</th>
<th>UAE</th>
<th>Poland</th>
<th>Mexico</th>
<th>India</th>
<th>Hong Kong</th>
<th>France</th>
<th>China</th>
<th>Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. I can be notified by Twitter/Facebook for a transaction occurring</td>
<td>66.3</td>
<td>67.1</td>
<td>69.0</td>
<td>73.7</td>
<td>85.1</td>
<td>76.6</td>
<td>75.7</td>
<td>75.2</td>
<td>75.9</td>
</tr>
<tr>
<td>2. My bank will store loyalty cards and convert points to cash</td>
<td>64.6</td>
<td>67.7</td>
<td>61.8</td>
<td>62.8</td>
<td>65.3</td>
<td>67.2</td>
<td>64.1</td>
<td>74.6</td>
<td>62.8</td>
</tr>
<tr>
<td>3. My bank can offer spending analysis tools</td>
<td>56.1</td>
<td>61.2</td>
<td>66.7</td>
<td>61.3</td>
<td>58.7</td>
<td>58.3</td>
<td>55.4</td>
<td>56.1</td>
<td>58.5</td>
</tr>
<tr>
<td>4. My bank can offer me relevant third-party offers</td>
<td>54.6</td>
<td>49.0</td>
<td>53.4</td>
<td>46.4</td>
<td>43.6</td>
<td>52.6</td>
<td>48.7</td>
<td>44.2</td>
<td>56.9</td>
</tr>
<tr>
<td>5. My bank would store key documents in a virtual vault</td>
<td>57.0</td>
<td>56.1</td>
<td>47.4</td>
<td>52.7</td>
<td>57.2</td>
<td>45.2</td>
<td>50.7</td>
<td>63.9</td>
<td>54.8</td>
</tr>
</tbody>
</table>

Level of interest (Scored ranking results (rank 1 = 100, 2 = 50, 3 = 25); average 0-100)

Source: PwC Digital Tipping Point Survey 2012
in fixing the broken credit card pricing model as issuers seek new sources of revenue to replace income streams that are coming under increasing pressure. As Figure 41 highlights, consumers show a consistent level of interest in some of these innovations in many countries, including the UK.

**Success through strategic partnerships**

While banks have traditionally preferred to ‘build’ their own capabilities, we believe a quicker and more effective approach would be to acquire or partner with innovators that are acting as catalysts for change. The alternative for those banks that accept the need to change is to develop these capabilities alone – an expensive and risky effort. We believe that the real battle will take place over how to secure primacy of the customer relationship. Slower moving banks could lose market share in the changing banking landscape.

**To do it yourself or partner?**

Banks rarely have all the systems’ capabilities in place to compete in this fast-evolving market. Many payments’ companies have therefore used acquisitions to drive innovation. Prominent examples include American Express’s acquisition of Revolution Money as part of the development of ‘Serve’ and MasterCard’s purchase of Orbiscom to support its ‘in-control’ service. This trend highlights the need for banks to consider alternatives to in-house development. However, funding for acquisitions may not be available, which would point to partnerships as a pragmatic alternative. Figure 42 illustrates some of the main sourcing options and highlights considerations in using each approach.

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**Figure 42: Alternative sourcing arrangements for innovation**

<table>
<thead>
<tr>
<th>Within core business</th>
<th>In ‘skunkworks’ laboratories</th>
<th>Via partnership / networks</th>
<th>Via acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use if...</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Understanding of the strategic context is key</td>
<td>– Breakthrough innovations the focus</td>
<td>– Initial selection and set-up can be difficult (e.g. incongruent objectives)</td>
<td>– Funding is available</td>
</tr>
<tr>
<td>– Incremental innovations the focus</td>
<td>– Risk averse culture in core business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Core business has capacity</td>
<td>– Core business has no capacity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Be wary of...

- Reversion to traditional thinking
- Delivery can be problematic
- Initial selection and set-up can be difficult (e.g. incongruent objectives)
- Danger of ‘crowding out’ innovation post-integration

*Source: PwC analysis*
The consumer credit and payments’ markets are undergoing significant change, demanding a more innovative and competitive approach from market participants. We are a leading adviser to the consumer credit and payments’ sector. Our insights are based on our experience of working with all types of market participants across multiple functions, including major banks, card issuers, retailers, specialist lenders and brokers. The team has extensive experience advising and assisting clients with:

- Strategy and business plans
- Strategic cost reduction
- Market and economic analyses
- Partnership strategies and contract negotiations
- Debt portfolio strategies
- Valuations
- Regulation and the business response
- Due diligence
- Transaction and investment decisions

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