Growth, but not as we know it
Precious plastic

Exploring the latest trends in the UK consumer credit and payments market

2013
Introduction

Welcome to Precious Plastic 2013

Having first enjoyed the benefits of more than a decade of rapid growth, then navigated the financial crisis and its immediate aftermath, the UK consumer credit and retail banking market is now entering a new and very different era.

Even with the better economic news, relatively high levels of existing debt and the continued reduction in real incomes are leaving consumers cautious about further borrowing. Graduates are saddled with increasingly high levels of debt, which could hold back their appetite and ability to take on mortgages and other forms of credit as they approach what should be their peak years of financial consumption. Lenders are also facing a generational shift as the baby-boomers head into retirement and Generation Y (born since 1980) comes of ‘financial age’. Younger people now appear readier to save and are more reluctant to borrow than their older peers. Cutting across these developments are the impact of digital, more probing regulation and ever more exacting customer expectations.

Growth will be hard won in the market that emerges from this shake-up, forcing lenders to compete vigorously for a more limited pool of lending rather than relying on rapid top-line expansion as they have in the past. The businesses that come out in front will have the sharp customer understanding needed to deliver the good customer outcomes that both regulation and market competition demand. This will in turn require new ways of engaging with and gaining insights about customers. Product simplification, more digital interaction and a shift in organisational orientation away from products and channels to a more customer-centric approach will be essential to ensure sustainable ‘good’ growth.

Part one of this report, ‘The state of the nation’, explores the key developments that are reshaping the industry. Part two, ‘Set up to succeed in the new era’, outlines what we believe should be the key strategic priorities for coming out in front in this emerging market landscape.

We hope that you find the report interesting and useful. If you would like to discuss any of the issues raised here please feel free to contact one of the authors listed on page 44.
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Executive summary

Part one: The state of the nation

Five years of paying off debt comes to an end… or does it?
Against the backdrop of an improving economy, unsecured debt grew by 4% in 2013 to £216 billion, the first rise for five years. The average level of unsecured household debt now stands at around £8,159. Despite nearly five years of diligently paying off debt, and this year’s no more than modest increase, UK consumers remain among the most indebted in the world, only surpassed by the US and Canada.

As the economic recovery starts to take hold, we project further growth in unsecured debt of around 3% a year over the next two years. However, the sustainability of the UK consumer’s relatively high debt levels remains questionable, especially once base rates begin to rise. In the longer term we therefore do not foresee a return to the rapid growth rates seen in the run up to the financial crisis.

Student debt accounts for the entire increase in unsecured debt
The overall increase of 4% in unsecured debt does not tell the full story. Following significant changes to the way higher education is funded, almost all of this year’s £8.5 billion increase in unsecured debt can be attributed to an increase in student borrowing.

We estimated that students who started university in 2012 will on average graduate with £40,000-£50,000 in debt. Even with the relatively favourable terms on which student loans are provided, this significant increase in debt levels is likely to have profound effects on future borrowing and consumption patterns. In particular, many graduates may delay taking out a mortgage or may struggle to get on the property ladder at all as a high level of residual student debt makes them reluctant or unable to increase their borrowing.

Underlying debt continues to fall
If we separate out student debt, underlying consumer borrowing (i.e. that which tends to fund consumption) stood flat in 2013 at around £5,900 per household. It has dropped by 25% since the start of the crisis in 2008.

While the rate of debt repayment is flattening out, consumers are wary of taking on more unsecured debt despite continued low base rates and improvements in the economy. Much of this reluctance may stem from limited pay increases and rises in the cost of living – real incomes fell consecutively for the last five years.

Newer forms of borrowing continue to grow
While traditional forms of borrowing such as credit cards, personal loans and overdrafts continue to decline, falling by around 1% in 2013, newer forms of borrowing, including payday and peer-to-peer lending, have increased by around 14%.

Although these newer forms of borrowing still only make up a relatively small proportion of overall consumer debt (around 1%), their continued growth underlines a shift in consumers’ borrowing habits towards smaller, shorter term and more manageable loans. We believe pressure on larger, more mainstream lenders to service this market will increase over the coming months and years.
No improvement in credit confidence since the crisis

Each year, in conjunction with YouGov, we poll more than 2,000 UK consumers regarding their attitudes towards credit. This year we ran the survey twice, initially in the first quarter of 2013, when the economic outlook was still relatively gloomy and again in the third quarter, by which time the economic prognosis was starting to improve.

The better economic news has done little to boost consumers' credit confidence, with the results of our poll revealing no discernible improvement in confidence between Q1 and Q3 (in fact on some measures confidence has deteriorated). Indeed, overall there has been no real improvement in confidence since the depths of the financial crisis in 2008. For example, 26% of respondents are worried about their ability to meet their repayments in the future (compared with 27% in 2008), 34% expect their pay to be frozen in the next 12 months (compared with 28% in 2009) and 15% remain worried about losing their job in the next 12 months (compared to 18% in 2008).

On a more positive note, the proportion of people needing to use credit to pay for essential items has fallen to 13% (compared to 15% in 2011), and among 25-34 year olds the proportion has fallen from a staggering 26% in 2012 to 15% this year.

UK consumers remain vulnerable to rate raises

For now, lenders are enjoying significant improvements in profitability, driven by the combined effect of relatively wide spreads (interest rates have remained relatively high versus record low base rates) and a significant drop in bad debts. However, in the longer term, UK consumers and by extension lenders remain vulnerable to increases in base rates. Close to five years of near-zero base rates have left consumers conditioned to low rates. We calculate that, all other things being equal, a 1% increase in borrowing costs could result in the average household needing to pay an extra £550 a year in interest payments to service their debts. Against the backdrop of the continued squeeze on real incomes, this increase represents a significant impact.

Regulation: Truly putting the customer first

Consumer credit is facing the biggest regulatory change in a generation, as responsibility moves from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA). The transition brings with it not only new rules, but also a new, more judgement-based and interventionist approach that will be focused on ensuring the industry delivers good outcomes for consumers. This transition will act as a further catalyst to lenders needing to truly put the customer at the heart of their strategy and operating model.

Part two: Set up to succeed in the new era

Having first enjoyed the benefits of more than a decade of rapid balance sheet growth, then navigated the crisis and its immediate aftermath (some more successfully than others), as the recovery starts to take hold, we believe that UK consumer credit and retail banking is now entering a new era. This new era will be characterised by relatively low growth and a significant shift towards a simpler and more customer-centric approach. In this new era, we have identified five strategic priorities that lenders will need to pursue:

1. Good growth – The pursuit of sustainable growth which is underpinned by delivering good customer outcomes and does not rely on opacity, customer inertia, complexity or cross subsidies.

2. Good cost/Bad cost – A new approach to cost reduction that focuses on identifying ‘good cost’, i.e. that which contributes customer value, and rooting out ‘bad cost’, i.e. that which does not, to deliver a simpler and leaner organisation.

3. Digital transformation – Beyond simply digital as a channel, the digital transformation will be all-pervasive and will continue to change every aspect of customer interactions and the way organisations operate.

4. A new approach to delivering change – The change agenda at most banks and other lenders is already large and unwieldy. We believe a new approach to change delivery is required, which avoids the tendency for large programmes to become weighed down by programme management paraphernalia and process as ends in themselves, and instead places a significantly greater emphasis on delivering customer and business outcomes.

5. Performance alignment – Aligning the entire organisation around the strategy and the change required to deliver it, in a way that firmly aligns culture, objectives, KPIs and remuneration and enshrines the customer at the centre.
Part one:
The state of the nation
Five years of paying off debt comes to an end... or does it?

Against the backdrop of an improving economic outlook, total outstanding unsecured debt grew for the first time in five years. But this headline growth masks some significant underlying shifts in the market.

Summary

• Unsecured debt rose by just just over 4% in 2013 to £216 billion, an average of around £8,000 per UK household.

• The majority of this 4% (or £8.5 billion) increase in debt was driven by increases in student borrowing, which will leave future graduates significantly more indebted than previous generations.

• Excluding student borrowing, underlying borrowing for consumption remained flat in 2013, and has now fallen by 25% since the beginning of the financial crisis in 2008.

• Newer forms of borrowing, including payday and peer-to-peer lending, rose by around 14%, but still represent a very small proportion of overall unsecured debt (circa 1%).
This year’s Precious Plastic report is set against the backdrop of an improving economic environment, with UK GDP growth projections recently revised upwards by both the Bank of England and the IMF. PwC’s central scenario projects GDP growth of 1.4% for 2013, rising to around 2.4% in 2014. Unemployment, which stayed relatively low through the recession compared to previous downturns, continues to fall. Retail sales rose by 2.5% year-on-year in October 2012 to 2013 and consumer confidence has risen to its highest level since 2008. However, these more positive indicators have had a very mixed impact on borrowing.

Total borrowing increased by 1% in 2013 to £1.48 trillion (see figure 1). Secured borrowing (mainly mortgages) was broadly flat and stood at £1.26 trillion. However, more recent new lending data reveals that in September 2013 new mortgage lending rose by 41% compared to September 2012, the fastest growth rate since before the crisis. On the supply side, this significant recent growth in mortgage lending has in part been fuelled by the Funding for Lending programme (now extended until January 2015) and more recently the announcement of the government’s Help to Buy Scheme (open to applications now, launching in January 2014). In addition, banks have made significant progress in repairing their balance sheets, leaving them well and truly open for business and competing hard for mortgages in certain segments of the market.

On the demand side, improving consumer confidence, the degree of certainty provided by virtue of the Bank of England’s move to forward guidance on interest rates, and rising house prices have all stoked the mortgage market. However, with house prices on average being close to seven times the average annual earnings, significantly above the long-term average of five (see figure 2), and lending in part being supported by interventions in the market, questions remain about how sustainable house prices are in the long term.

Figure 1: Total UK consumer lending and growth rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Lending (£ tr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1.15</td>
</tr>
<tr>
<td>2006</td>
<td>1.26</td>
</tr>
<tr>
<td>2007</td>
<td>1.38</td>
</tr>
<tr>
<td>2008</td>
<td>1.46</td>
</tr>
<tr>
<td>2009</td>
<td>1.45</td>
</tr>
<tr>
<td>2010</td>
<td>1.46</td>
</tr>
<tr>
<td>2011</td>
<td>1.45</td>
</tr>
<tr>
<td>2012</td>
<td>1.47</td>
</tr>
<tr>
<td>2013</td>
<td>1.49</td>
</tr>
</tbody>
</table>

Source: Bank of England, IMF, PwC Analysis
Note: Annual data is based on September position, * includes 6 months projection in student loans

1 Office of National Statistics report 2013
2 GFK (NOP), UK
On the unsecured side, following five years of diligent debt repayment, 2013 has seen a 4% increase in borrowing. This brings total unsecured debt to £216 billion, an average of £8,159 per UK household (see figure 3). As the recovery takes hold and rising house prices buoy confidence, PwC projects further modest increases of around 3% a year, over the next two years. However, despite the progress made in clearing their debts, UK consumers remain among the most indebted in the world, surpassed only by the US and Canada (see figure 4). In the longer term we do not foresee a return to the rapid growth rates seen in the run up to the financial crisis.

Figure 2: Ratio of average house price to average earnings

Source: ONS, Nationwide, PwC Analysis
Note: Average is based on arithmetic average of the price: average earnings ration from Q1 1977 – Q3 2013

Figure 3: Total UK unsecured lending and growth rate

Source: Bank of England, IMF, PwC Analysis
Note: Annual data is based on September position, 2014/15 forecasts based on 3-4% growth y-o-y. Includes 6 months projection in student loans
The overall increase of 4% in unsecured debt does not tell the full story. Behind this headline growth, there are significant changes occurring in borrowing behaviour. Following an overhaul to the way higher education is funded, and despite a 12% fall in new applications to university between 2011 and 2013, approximately all of this year’s £8.5bn increase in unsecured borrowing can be attributed to a rise in student debt (see figure 5). We estimate that students who started university in 2012 will on average graduate with £40,000 to £50,000 in debt. The average value of a student loan has increased by more than 2000% since the early 1990s to just over £8,000 (see figure 6).

Even with the favourable terms (both rate and repayment terms) on which student loans are provided, this significant increase in debt levels is likely to have profound effects on graduates’ future borrowing and consumption patterns. With house prices continuing to rise ahead of earnings, there may be a knock-on effect in terms of the timing and ability of new graduates to get on the housing ladder. In the longer term these developments could contribute to the erosion of the UK’s home ownership culture as we breed a new generation of long-term renters. Furthermore the capacity and appetite of graduates to take on unsecured debt will also be impaired.

**Figure 4: Unsecured debt per household**

<table>
<thead>
<tr>
<th>Short-term household debt, indexed (2006 UK = 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>USA</td>
</tr>
<tr>
<td>UK</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Nordics</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>France</td>
</tr>
</tbody>
</table>

Source: OECD Statistics (2012)

**Figure 5: Movements in unsecured debt between 2012 and 2013**

<table>
<thead>
<tr>
<th>Unsecured lending, £bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
</tr>
<tr>
<td>Student loans</td>
</tr>
<tr>
<td>Payday lending</td>
</tr>
<tr>
<td>Credit cards</td>
</tr>
<tr>
<td>Other (inc. overdrafts and personal loans)</td>
</tr>
<tr>
<td>2013</td>
</tr>
</tbody>
</table>

Source: Bank of England, OFT, PwC Analysis

Note: Data is based on September position, * includes 6 months projection in student loans.
Borrowing for consumption remains flat

Stripping out student debt reveals that underlying consumer debt (i.e. that which tends to fund consumption) remained flat in 2013 at £156 billion, an average of £5,980 per household (see figure 7). This represents a 25% reduction since the start of the financial crisis in 2008.

Despite improvements in the economy, continued low interest rates and the Bank of England reporting a sharp increase in the supply of unsecured credit, consumers remain wary about taking on more debt. This is further confirmed by this year’s PwC Credit Confidence survey, the findings of which are set out on pages 14 to 18. Consumers’ reluctance to increase their borrowing may in part be driven by a significant reduction in real wages, as inflation outstripped increases in wages over the last four years (see figure 8). Given the squeeze on real wages and consumers’ still relatively high debt levels (see figure 4), we believe a more enduring change in behaviour is emerging as consumers seek to rebase their debt levels to a more sustainable and palatable level.

Source: Student loan statistics, House of Commons
Note: Data for 2005/06, 2011/12 and 2012/13 refer to England only (previous are UK)

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4 Bank of England Credit Conditions report, Q3 2013
Figure 7: Average unsecured borrowing per household

Unsecured debt, £

<table>
<thead>
<tr>
<th>Year</th>
<th>Unsecured debt (excl. student loan)</th>
<th>Student loan debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>9,251</td>
<td>1,143</td>
</tr>
<tr>
<td>2009</td>
<td>8,389</td>
<td>1,318</td>
</tr>
<tr>
<td>2010</td>
<td>8,260</td>
<td>1,500</td>
</tr>
<tr>
<td>2011</td>
<td>7,951</td>
<td>1,706</td>
</tr>
<tr>
<td>2012</td>
<td>7,890</td>
<td>1,917</td>
</tr>
<tr>
<td>2013</td>
<td>8,159</td>
<td>2,179</td>
</tr>
</tbody>
</table>

Source: Bank of England, PwC Analysis
Note: Data is based on September position,* Includes 6 months projection in student loans

Figure 8: UK Real wage growth

Real wage year-on-year, %

Growth in real wages       Decline in real wages

Source: ONS, Bank of England, PwC Analysis
Note: Data series continues to May 2013
Traditional forms of borrowing show least sign of recovery, with credit card, personal loans and overdrafts together falling by around 1% in 2013. Credit card balances and the number of cards issued remain at their lowest levels in nearly a decade (see figure 9).

In contrast, newer forms of borrowing, such as payday loans, continue to grow more rapidly, with total outstanding borrowing increasing by around 14% in 2013, though they still only make up a small proportion of overall unsecured debt (circa 1%). While new lending volumes for payday lenders continue to grow, the rate of growth is slowing significantly. New payday loan volumes grew by 17% in 2012, which is roughly half the growth rate seen in 2009. As regulatory attention and scrutiny of this segment of the market increases (e.g. the Financial Conduct Authority’s recently announced measures on payday lending), we believe this growth rate will continue to slow (and the market will perhaps even start to contract). There will also be increasing pressure on mainstream lenders to service this market and reverse the retreat from unsecured lending seen over the last few years (see figure 10).

Figure 9: Credit cards in circulation and outstanding credit card debt

<table>
<thead>
<tr>
<th>Year</th>
<th>Outstanding balance, £bn</th>
<th>Number of cards in issue, millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>2004</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>2005</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>2006</td>
<td>55</td>
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<tr>
<td>2007</td>
<td>60</td>
<td>60</td>
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<tr>
<td>2008</td>
<td>65</td>
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<tr>
<td>2009</td>
<td>70</td>
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<tr>
<td>2010</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>2011</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>2012</td>
<td>65</td>
<td>65</td>
</tr>
<tr>
<td>2013</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>

Source: British Bankers’ Association
Note: Data series continues to August 2013

Figure 10: Sources of consumer lending

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks and building societies</th>
<th>Other consumer credit lenders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2005</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Jul 2005</td>
<td>90</td>
<td>90</td>
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<tr>
<td>Jan 2006</td>
<td>110</td>
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<td>Jul 2006</td>
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<td>Jan 2007</td>
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<tr>
<td>Jul 2007</td>
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<td>Jan 2008</td>
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<td>190</td>
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<tr>
<td>Jul 2008</td>
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<td>210</td>
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<tr>
<td>Jan 2009</td>
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<td>230</td>
</tr>
<tr>
<td>Jul 2009</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Jan 2010</td>
<td>270</td>
<td>270</td>
</tr>
<tr>
<td>Jul 2010</td>
<td>290</td>
<td>290</td>
</tr>
<tr>
<td>Jan 2011</td>
<td>310</td>
<td>310</td>
</tr>
<tr>
<td>Jul 2011</td>
<td>330</td>
<td>330</td>
</tr>
<tr>
<td>Jan 2012</td>
<td>350</td>
<td>350</td>
</tr>
<tr>
<td>Jul 2012</td>
<td>370</td>
<td>370</td>
</tr>
<tr>
<td>Jan 2013</td>
<td>390</td>
<td>390</td>
</tr>
</tbody>
</table>

Source: Bank of England, PwC Analysis
Note: Data series continues to end of Q1 2013
Kicking the habit?
The 2013 PwC Credit Confidence Survey

Despite an improving economy and five years of consumers paying off their debts, PwC’s credit confidence survey provides little evidence that credit confidence has improved since the depths of the financial crisis in 2008.

Summary

• There has been a deterioration in consumers’ confidence about meeting repayments on their existing debts, with 26% feeling ‘worried about their ability to meet their repayments’, compared to 24% last year and 27% in 2008.

• 34% of survey participants expect their pay to be frozen in the next 12 months, which although improved compared to last year’s 39%, still represents a significant deterioration from 2008, when only 28% believed their pay would be frozen.

• However, people feel significantly more secure in their jobs, with 15% worried about losing their job in the next 12 months compared to 21% last year and 18% in 2008.

• Around two thirds of people did not expect to use a credit card, overdraft or personal loan in the future, while 42% intend to save more over the next 12 months, compared to 37% last year and 35% in 2008.
Now in its sixth year, the PwC Credit Confidence survey provides one of the most comprehensive and up-to-date pictures of the trends in UK consumer credit. In conjunction with YouGov, we poll around 2,000 UK consumers regarding their attitude towards credit, ability to repay and future borrowing intentions. This year we ran the survey twice, initially in the first quarter of 2013, when the economic outlook remained relatively gloomy, and again in the third quarter, by which time the news was starting to improve.

Despite improvements in the economy and five years of consumers paying off their debts, this year’s survey reveals no discernible improvement in overall credit confidence between Q1 2013 and Q3 2013 (in fact on some measures confidence has deteriorated). Indeed, credit confidence has hardly improved since the depths of the financial crisis in 2008.

“I am worried about my ability to repay all of my outstanding debts”

Despite the improving economic picture between Q1 2013 and Q3 2013, there has been a marked increase in the number of people worried about their ability to repay their debts (see figure 11), with 26% in Q3 2013 stating concerns compared to 22% in Q1 2013. Stripping out those aged over 55, this increases to close to a third of people being worried about their ability to repay.

Figure 11: I am worried about my ability to make repayments on my debt in the future

![Chart showing the percentage of respondents worried about their ability to repay debts by quarter and age group]

Source: PwC Credit Confidence Survey 2008-2013
“I am able to make repayments on all of the outstanding debt I have”

Confidence in being able to service existing debts has remained much the same as last year (see figure 12), with 67% feeling confident in their ability to repay (compared to 68% last year), but remains worse than the 70% seen in 2008. Concerns are strongest among 18-24 year olds, where less than half (44%) feel confident in their ability to repay.

“\[\text{Figure 12: I am able to make repayments on all of the outstanding debt I have}\]"

There has been some improvement in the number of people needing to use credit to pay for essential items (see figure 13), which has fallen from 15% in 2011 to 13% in 2013. The strongest improvement was seen among 25-34 year olds, where last year a staggering 26% needed to use credit to pay for essential items, falling to 15% this year.

“\[\text{Figure 13: I have needed to use credit to pay for essential items in the last six months}\]"

Source: PwC Credit Confidence Survey 2008-2013
**Jobs and pay**

People’s confidence in their employment prospects is one of the most positive areas of this year’s survey, with only 15% worried about losing their job in the next 12 months compared to 18% in 2009 (see figure 14). However, confidence in wage growth remains low in comparison to 2009, with 34% expecting their pay to be frozen over the next 12 months compared to 28% in 2009 (see figure 15). This lack of confidence reflects the fact that while unemployment didn’t rise to the extent it did in prior downturns, real wages have fallen consecutively for the last five years, leaving many consumers struggling to make ends meet.

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**Figure 14: I am worried about losing my job in the next 12 months**

![Graph showing job worry](image)

**Source:** PwC Credit Confidence Survey 2008-2013

**Figure 15: I expect my pay to be frozen or decrease over the next 12 months**

![Graph showing pay worry](image)

**Source:** PwC Credit Confidence Survey 2008-2013
Saving and borrowing

Looking ahead, the intention to save more is at its highest level since our survey began (see figure 16), with 42% intending to save more in the next 12 months, compared to only 35% in 2009. The proportion is even higher among younger consumers, with 58% of those aged 18-24 intending to save more. This runs counter to the experience of previous recessions, where consumers tended to save more during the dip, but then go on to spend and borrow as the economy recovered. This may indicate a more fundamental shift in behaviour and further underpins our belief that overall borrowing will not materially increase in the coming years. All other things being equal, less borrowing is the flip side of saving more, with around two thirds not intending to use a credit card, overdraft or personal loan in the future (see figure 17).

Figure 16: I intend to save more over the next 12 months

Figure 17: Which forms of the following types of borrowing have you used in the past and which would you use in the future?
Margins in rude health... too good to last?

Lenders are enjoying strong margins, driven by the combined effect of interest spreads remaining relatively wide, significant reductions in bad debt and a focus on cost reduction. However, as the recovery gathers pace, we believe these margins will come under increasing pressure.

Summary

• The average spread on consumer lending has increased following the crisis, for example credit card spreads stand at circa 17%, which represents a circa 600 bps increase since the pre-crisis period.

• In parallel with increasing spreads, bad debts have now fallen back to pre-crisis levels, with credit write offs falling from their peak of 10% in 2010 to just over 3% in 2013.

• The combined effect has been to significantly increase margins for lenders. We believe these relatively high margins will come under pressure on a variety of fronts including regulation, possible interchange reduction, base rate rises and increased completion.

• In the longer term, pricing models will come under pressure as various stakeholders continue to push for simpler, more transparent models that reduce the perceived cross subsidy between customers.
Over the last four years unsecured lenders have maintained a relatively wide spread between the record low base rates (a proxy for funding costs) and the rates of interest charged to consumers. In fact, in the case of credit cards, the average spread has increased by 6 percentage points since 2009, to an average of 17% today. See Figure 18.

In the immediate aftermath of the crisis, these widened spreads represented an essential cushion, as lenders struggled to cope with record levels of bad debt (see figure 21) and significant funding and capital constraints. However, since then bad debt levels have fallen significantly. Credit card write offs, which peaked in 2010 at £5.3 billion (close to 10% of outstanding balances), have fallen below 4% (see figure 19 overleaf) in 2013, the lowest level in over a decade. This rapid reduction is a function both of the steps taken by lenders to tighten lending criteria and improve collection strategies and the fact that improving macro-economic conditions (particularly improving unemployment numbers), continued low base rates and restraint in terms of unsecured borrowing levels have helped consumers stay on top of their debts. This trend is also reflected in the number of personal insolvencies, which fell by 8% year-on-year to around 26,000 in the third quarter of 2013 (see figure 20).

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Source: Bank of England, PwC Analysis
Note: Data series continues to August 2013
Despite progress on cost reduction, bad debts falling back to pre-crisis levels and the easing of funding and capital constraints, spreads have remained relatively wide. In part we believe this represents a structural change, as lenders look to make up for the reductions in other sources of revenue (e.g. ancillary insurances, particularly payment protection insurance) along with the repricing of risk. However, these structural changes aside, we believe margins will come under pressure in the short to medium term from a variety of fronts, including regulation, possible interchange reduction, rising base rates and increased competition.

Regulation: While the FCA has been at pains to point out that it is not, and does not intend to be a price regulator, it will continue to use high returns as a factor in shaping where to focus its scrutiny. Where high returns are being achieved, the FCA will want to understand what underpins those returns and whether the business model and products in question are delivering good outcomes for consumers. The recent announcement of measures to curb the payday lending industry is an example of this. Lenders should proactively review all aspects of their products (front and back book) to measure their activity against through the lens of customer outcomes.
**Interchange:** In the US the ‘Durbin Amendment’ regulating the levels of interchange fees on debit cards was recently criticised by a federal judge following a case brought by a group of retailers. The amendment was found to be ‘fundamentally deficient’ and had actually resulted in an increase in the interchange fees charged for smaller value items. The Federal Reserve Board will now reconsider how it regulates interchange fees, perhaps moving away from setting a ‘rate ceiling’ approach and also reconsidering what cost categories it considers when assessing interchange fee levels. The EU has also recently criticised the levels of interchange fees, proposing a 0.2% ceiling on debit card interchange fees and a 0.3% ceiling for credit cards. On the assumption that interchange income is materially curtailed, we envisage annual fees becoming more widespread (particularly for products that either offer rewards programmes or are at the entry point of the market for higher risk consumers) and that issuers will seek to preserve or increase their current spreads.

**Base rate rises:** UK household debt stands at more than 130% of disposable income, and while this ratio has fallen from its peak in 2007, it remains high by historical standards (see figure 21). Even with recent increases in asset values (mainly housing and equities) the affordability of these relatively high debt levels remains fragile. Following nearly five years of record low base rates, consumers have become accustomed to these favourable (for borrowers at least) levels. We estimate that every 1% increase in borrowing rates will cost UK consumers an additional circa £557 a year just to service the increased interest cost on their borrowing. In the context of real incomes remaining subdued, this represents a significant cost and many may struggle to adapt. The Resolution Foundation estimated that in 2012 over 3.6m UK households were spending more than 25% of their disposable income on debt repayments. It also estimated that in a scenario where interest rates reached 4% by 2017 (albeit that this is significantly higher than PwC and market forecasts), the number of households spending more than 25% of their disposable income on debt would increase to around 4.8m. For the most vulnerable customers, we believe lenders should plan now by proactively identifying them and looking to put in place more sustainable arrangements (including considering forbearance options). For the wider population, lenders will need to carefully consider the extent to which increased funding costs can or should be passed on to the consumer, and the extent to which these should be absorbed within the relatively higher margins already in place.

**Figure 20: Quarterly number of personal insolvencies**

![Graph showing Quarterly number of personal insolvencies](image)

Source: The Insolvency Service

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**Note:** The Resolution Foundation, Closer to the Edge: Prospects for household debt repayments as interest rates rise, July 2013
Increased competition: A number of developments are set to change the competitive dynamics of the market and lead to significantly increased competition. These include the attractive margins currently being seen in unsecured lending attracting new entrants, and significant changes to the composition of the industry (e.g. new challenger banks emerging). We’re also seeing increased lending from non-bank lenders (see figure 10) and an easing of the funding and capital constraints which curbed the supply of credit following the crisis. Given that we do not anticipate significant growth in overall demand, this increased supply of lending (both from incumbents and new entrants) will start to erode margins. Lenders should be pinpointing the customer segments where they believe they can differentiate and win, and avoid the less targeted pursuit of top-line growth observed in the run up to the crisis.

In addition to these short to medium-term factors, we continue to believe that in the longer term the charging mechanics and pricing models of products will come under pressure from regulators and other stakeholders. These stakeholders will pursue simpler, more transparent models that seek to better align what is being paid and how value is delivered, such that the perceived cross subsidy between customer groups, particularly where more vulnerable customers are perceived to be cross subsidising others, is diminished. Sue Lewis, who recently started a three-year term as the head of the Financial Services Consumer Panel, has indicated that cross subsidies are a particular area of interest.7

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**Figure 21: The affordability of the UK consumer debt**

[Graph showing Key household debt ratios (%)]

Source: Bank of England, ONS, PwC Analysis

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7 The Independent on Sunday, 2013
Regulation: Truly putting the customer first

Consumer credit is facing the biggest regulatory change in a generation, as responsibility moves from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA). This transition brings with it not only new rules, but also a new approach, with a more interventionist, judgement-based regulator that will be focused on customer outcomes.

Summary

• Regulation of consumer credit passes to the FCA from 1 April 2014, and while this transition brings new and revised rules and new prudential requirements for some firms, the FCA is clear that it is judgement, culture and consumer outcomes that will be the predominant drivers of its approach.

• We believe the transition to the FCA will change the structure and dynamics of the industry. Many firms may exit the market while others will need to significantly change the way they operate. These changes will create opportunities for some players.

• The shift creates a strong impetus for developing simpler and more transparent products and putting customers at the centre of strategy.

• Elsewhere, the wider regulatory agenda continues to move on apace. Key developments include the UK Mortgage Market Review, the recommendations of the Independent Commission on Banking (ICB) and Banking Reform Bill and the Mortgage Credit Directive in the EU.
What to expect

The transfer of consumer credit to the FCA is a challenge for the regulator and firms alike. An estimated 50,000 firms could apply for interim permissions, potentially tripling the number of firms under the FCA’s jurisdiction. The breadth and diversity of these firms is also significant – from established banking entities already familiar with the FCA, to culturally distinct OFT-regulated subsidiaries and non-bank lenders and brokers. The net will also catch a long tail of non-FS firms – from asset finance firms (including motor dealers, white goods and furniture retailers) to those involved in short-term lending and debt management activities.

For most firms, the transfer of consumer credit to the FCA could at first sight appear to be more of the same. But firms should not be fooled into thinking it is that simple. While much of the Consumer Credit Act (CCA) guidance has been copied into the FCA’s new ‘CONC’ handbook, some has not. Some guidance now carries the weight of formal FCA rules, whereas other previous examples of accepted methods of compliance are likely to be removed. Furthermore, the application of FCA rules will also apply to the principles of Senior Management Arrangements, Systems and Controls and will create big challenges for lenders in terms of the rigorous oversight requirements for outsourced service providers. Overall, the change is subtle but significant, and firms need to spend considerable time understanding the full implications for their businesses.

Against this backdrop, firms must also adjust to the FCA, itself a new regulator which is still shaping its own approach and exploring the use of its new powers. The FCA has already demonstrated a more intrusive, judgemental approach to supervision than its predecessor body. Upcoming initiatives are likely to prove doubly challenging for firms that are new to the regime, and trying to adapt to new rules.

The FCA’s overarching determination is to ensure that companies put good customer outcomes at the heart of their business, which will present a significant challenge to many firms. How many firms in the current CCA regime can articulate and defend their business models, demonstrate that they earn ‘good profits’ and have a strong focus on customer outcomes? This change may drive some firms to comprehensively re-think their purpose, strategy, products, culture and relationship with the end consumer. In summary, the FCA’s approach will be characterised as follows:

- **Forward looking**: The FCA will seek to tackle issues before they gestate into bigger problems. This approach will likely involve closer scrutiny of product design and approval processes and in more extreme cases interventions that could see products being withdrawn.

- **Thematic focus**: While many firms can expect close scrutiny, the FCA has signalled its intent to adopt a more thematic approach. It will be scanning the market for potential issues and acting more broadly, in addition to zeroing in on individual firms.

- **Culture and judgement over rules**: Albeit that rules will of course remain important, the FCA will also be focused on the culture of organisations and will adopt a judgement-based approach. It believes that historically firms have put excessive reliance on compliance with rules (i.e. box-ticking) rather than customer outcomes.

- **Behavioural economics**: The FCA will be interested in how consumers make choices and whether firms individually and competition in the market generally are delivering good outcomes for consumers. Traditional indicators of a well-functioning market (e.g. high switching rates, concentration, transparency) will no longer be sufficient if good consumer outcomes are not being delivered.

- **Focus on business models**: There will be a close focus on business models and how firms make money. While high returns are not deemed to be an issue per se, it is likely that they will attract the interests of the regulator and prompt closer scrutiny. Interactions with the regulator will broaden out from compliance teams to the boardroom, as strategy and business models are placed in the spotlight.

In preparation for the transfer, many firms are also reviewing their back-books, seeking to proactively remediate any legacy issues before the switch. We believe that the transition to the FCA will provide a strong catalyst and a necessity for developing simpler and more transparent products and putting customers at the centre of strategy.
**Transition process**

All consumer credit firms must proactively apply for interim authorisation before 1 April 2014. From autumn 2014 firms will be invited to apply for full authorisation on a risk-based peer group basis, with all firms having applied by April 2016 (see figure 22). Firms must ensure that all their legal entities hold the correct OFT licences before they apply for interim permission; if a firm wants to make changes after April 2014 but prior to receiving full authorisation, that will trigger an immediate full authorisation process for the firm.

While the process of applying for interim authorisation may be relatively simple, firms will face immediate obligations that are not straightforward. They will be familiar with the OFT’s existing ‘conduct of business’ rules, but will now face further overarching FCA obligations and rules which will be new to non-FCA firms. While the FCA has offered firms a ‘safe harbour’ against enforcement where they can demonstrate adherence to existing CCA rules, other FCA-only rules apply from 1 April 2014, and the standard on ‘demonstration’ of compliance with current rules could feel very different to those of the OFT. Firms should make it a priority to get to know the FCA requirements and how they will affect their business. Gap analysis of new rules would be useful in assessing the impact of the FCA’s conduct of business rules – in particular areas such as ‘Systems and Controls’, and the high-level ‘Principles for businesses’.

**Compass**

In order to assist organisations to efficiently but comprehensively prepare for consumer credit under the FCA, we have developed Compass, a web-based methodology that provides a consistent, informed and efficient approach to adopting regulations. Compass allows us to assess your compliance with the new regulations and communicate where your procedures require updates. Our methodology allows us to gather the information quickly, and because we’ve mapped the requirements into the system, we clearly communicate the relevant aspect of the regulation that is at risk. Our system also includes project management capabilities to monitor remediation and document retention to store information to demonstrate compliance.
A silver lining?

The new regulatory environment could open up opportunities for early adopters.

The existing CCA regime does not allow for the concept of ‘Principals’ and ‘Appointed Representatives’. Those familiar with the mortgage, insurance and investment distribution models of existing FCA firms are already drawing parallels to the large number of smaller firms in the CCA sector; clearly for some the early establishment of a network model could result in commercial advantage.

With a number of firms likely to exit the sector, combined with the cost and complexity of full authorisation, consolidation and acquisition activity is likely to become far more prevalent. The potential for structural market reform, particularly with a small number of large networks, with strong distribution and commercial clout, could change the structure of the market.

Technology also has an ever more important role, for example in areas like point-of-sale innovation and compliance function IT solutions being examined by firms.

Other regulatory developments

The volume of both FCA and European regulatory agendas remain equally challenging for firms.

The UK’s Mortgage Market Review (MMR) comes into force from 26 April 2014. Wide-ranging changes, covering the qualifications and professionalism of advisers, an increase in scope of ‘advised’ sales, changes to affordability, interest-only lending and disclosure documentation are requiring substantial project programs by lenders and brokers.

Running alongside the MMR, the European Mortgage Credit Directive (MCD) is under negotiation. The likely implementation of the MCD is mid-2015, but it will include further changes to disclosure including the wider application of the European Standard Information Sheet (ESIS) for consumers, changes to the APR calculation, binding offers and consideration periods. For firms already adapting systems to the MMR the almost immediate changes introduced by the MCD will not be welcome.

The government also plans fundamental reform of the payments infrastructure in the UK. HM Treasury has confirmed its intention to bring payment systems under formal regulation. This builds on a recommendation made by the Parliamentary Commission on Banking Standards. The change is aimed at access to existing payment systems opening up for new entrants. The new Payments Systems Regulator will be formed as a separate body under the FCA, but with its own board.

Opening up access is also reflected in measures from the ICB, including the recently launched seven-day current account switching service.

Other notable initiatives include the FCA’s competition market study into teaser rates in the savings accounts. Building again on switching, this market study could lead to the FCA invoking new competition powers in the sector during 2014.

An increased focus on good outcomes for consumers is the common theme running throughout the many new regulatory developments. There are many complexities that firms should be considering on an operational and strategic basis. Firms need to embrace the requirement to put good customer outcomes at the centre of business practices and put it at the centre of their culture. Firms that achieve this result and are able to demonstrate it to the FCA will be well placed to take advantage of forthcoming changes.
**Payments innovation**

Despite recent momentum and a raft of innovation, alternative payment mechanisms remain far from obtaining ‘ubiquity’ – the prerequisite for meaningful disruption of the incumbents.

**Summary**

- Overall UK retail payments grew by around 4% to 5% over the past year. Debit cards saw significant growth (+6%), while cash volumes plateaued (-0.5%) and cheques continued their rapid contraction (-16%).

- Contactless payments grew by 500% from June 2012 to June 2013. This rapid growth was underpinned by an increase in merchant acceptance and an improved customer experience.

- Rapid adoption of smartphones and tablets continues to attract traditional financial services firms, telecoms and new entrants towards the growth opportunity promised by mobile payments. While innovation in this space continues at pace, the quest for a common platform goes on (albeit that some progress has been made) and an attractive commercial model for all parties.

- Before payments innovations become accepted, it will be necessary to assure regulators, merchants and consumers that appropriate controls over fraud, security and resilience of new platforms are in place. The FCA has recently initiated a thematic review of mobile payments and banking.

- Retail payments are a two-sided market, which requires any new standard to be attractive for both the merchant and consumers. Despite the availability of technology and on-going experimentation, to date a clear value proposition and/or catalyst for both merchants and consumers to rapidly replace traditional payment mechanisms with the new alternatives has not emerged.
Retail payments market continues to grow, with contactless gaining momentum

Retail or consumer-initiated payments grew to £1.5 trillion representing 4% annual growth from the second quarter of 2012 (see figure 23). Over the same period, the volume of transactions grew by 5% to 4.7 billion. Conversely, the volume and value of cheque transactions continues to fall, shrinking by around 13% in this period. Cash/ATM transactions also show signs of stagnation with the value of these declining slightly. Consumer reluctance to take on further debt, despite improving economic prospects, is reflected in the low growth (1%) seen in credit and charge card transactions. Instead, there has been a continued shift to debit cards with three times the value and volume of transactions completed via debit cards, compared to the second quarter of 2013. This equates to 2.1 billion debit card transactions, worth around £90 billion.

Although it is more than five years since the first contactless card was introduced, adoption of the technology by both consumers and merchants has been slower than expected. However, greater familiarity with the technology, increased issuance of contactless cards and marketing by the card networks is leading to transaction volumes and values increasing. 51 million contactless payments were made in the year to June 2013, amounting to £338 million. In June 2013 monthly contactless spend increased five fold year-on-year to £45.2 million, and there were 6.8m transactions, compared to 1.4 millions transactions in June 2012. There has also been greater adoption of contactless payments by merchants, for example with Transport for London now accepting contactless credit and debit cards, and the total number of contactless merchant terminals reaching 280,000. Contactless payment via mobile phones offers an additional way for consumers to use the technology and is also likely to further encourage adoption and usage.

Innovation galore...

From the ‘incremental’ (e.g. contactless, digital and apps, retail loyalty partnerships, peer to peer payments) to the ‘radical’ (e.g. in-game payments for digital assets, social media payments and even a new currency, i.e. Bitcoin), the retail payments industry stands out as an exemplar of innovation, particularly for an industry which more broadly is often the subject of criticism for its traditional mindset and lack of creativity. This is a continuing global trend and the UK is no exception.

Figure 23: Consumer initiated payments

Source: UK Cards Association, UK Payments Council
Note: Data is for Q2 2013, growth represents growth in transaction values for the year to Q2 2013

8 Visa Europe, August 2013, note figures relate to Visa cards
At the heart of these developments is the acceleration of the digital age, with widespread adoption of digital devices and growing movement of retail purchases from the physical to the virtual formats. According to a recent report by Ofcom,9 more than half of the adult population own a smartphone. According to the same report, tablet ownership has more than doubled with 25% of UK households now owning a tablet at the end of the first quarter of 2013. The UK is one of the most developed markets, with online sales accounting for 11% of total retail sales and predicted to reach 15% by 2017.10 Mobile commerce is expected to be worth some £17 billion,11 with sales through smartphones and tablets expected to be c.25% of online sales.

The irreversible rise of digitisation is attracting a lot of interest. As a result, innovation and various experiments are under way to capture the opportunity represented by use of digital devices and the internet for purchase of physical and digital goods and services, as well as making person-to-person payments.

Unsurprisingly, most innovation centres on mobiles as a form factor and an enabler of retail payment solutions, seeking to replace cards and cash. Interestingly, however, the focus of innovation is also centred on how to improve card acceptance e.g. for small tradesmen and merchants (e.g., iZettle) which bodes well for the traditional players.

Apart from creating new payment mechanisms for purchasing physical goods, we are seeing the emergence of digital currencies and virtual goods. The intersection of digital currencies and growing usage of social media could change the way loyalty programmes are developed and paid for. Starbucks recently tested a programme called Tweet-a-Coffee,12 which enables users to send a $5 gift card to their friends using only a Twitter feed. Despite concerns about money laundering, digital currencies such as Bitcoin have received significant attention and even eBay CEO John Donahoe acknowledged their importance in a recent statement.13

<table>
<thead>
<tr>
<th>Innovation categories</th>
<th>Examples</th>
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<tbody>
<tr>
<td>Mobile Wallets</td>
<td>CloudZync, a new start up Zync, launched a new mobile wallet app that lets UK customers make payments for purchases from their phone and also integrate loyalty card access and special offers. It uses QR code technology and has signed up 280 merchants</td>
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<td>Everything Everywhere (Cash on Tap) in partnership with Mastercard, joins Vodafone and Visa(Quick pass) and Orange-Barclaycard in introducing NFC-enabled mobile wallets</td>
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<td>Mastercard introduced its mobile wallet Masterpass with trials scheduled at key supermarkets by end of 2013, with a broader rollout in 2014</td>
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<td>Visa continued to add merchants such as Clarks and Dixoins to its V.me mobile wallet</td>
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<td></td>
<td>iZettle, a small card reader that plugs into smartphones and tablets, enabling small traders to accept card payments</td>
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<td>Stripe and Paymill, API based web-payment enablers launched in the UK. These target small merchants who find processing online credit card payments expensive</td>
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<td>New ways to pay for physical and online purchases</td>
<td>Vocalkin’s subsidiary Zapp has launched a new service in the UK, which enables consumers to link their bank accounts to their mobile phone numbers to make payments</td>
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<td></td>
<td>iZettle, a small card reader that plugs into smartphones and tablets, enabling small traders to accept card payments</td>
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<td></td>
<td>Stripe and Paymill, API based web-payment enablers launched in the UK. These target small merchants who find processing online credit card payments expensive</td>
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<td>Person to person payments</td>
<td>Barclays Pingit application continues to focus on growth, with the app now being available to consumers of all banks. It was downloaded 400,000 times during the first eight weeks of launch. The service is being extended to include person to business payments</td>
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<td>UK Payments Council has facilitated a project for launching an industry-wide person to person and person to business, mobile payment service in spring 2014</td>
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<td>Social media and payments for virtual/digital goods</td>
<td>Chirpify, a social commerce platform, allows users of social media sites such as Twitter to purchase content, e.g. songs, vouchers and books, via re-tweeting and promoting the content producer. The free promotion of their product is valued over any monetary gain</td>
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<td>Facebook’s European revenue from payments and fees related to the purchase of, typically low value, virtual goods nearly quadrupled between December 2010 and December 2012, rising from $17m to $66m</td>
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<td>Boku and Bango offer a “mobile web carrier billing” proposition that allows consumers to purchase virtual goods by adding the cost to their mobile phone bill. Bango has allied with Facebook to integrate its mobile web carrier billing into Facebook’s payments infrastructure</td>
</tr>
</tbody>
</table>

Source: PwC analysis

9 Communications Market Report 2013
10 Verdict, PwC Analysis
11 eMarketeer.com, PwC Analysis
12 ‘Tweet-a-coffee’: Business 2 Community, Starbucks Corporation
13 Ebay to expand the range of digital currencies it accepts, Financial Times, November 2013
...yet no clear winners and end game in sight

Despite the continuing investment in innovation, the widespread adoption of mobile payments or other alternate payment mechanisms remains elusive. More than 50% of the UK adult population own a smartphone, but less than 10% have made a mobile payment, according to a recent survey of 1,500 adults carried out by technology company MPayMe. Another survey of 2,000 adults by mobile payment operator Zapp found that perceived security risk was one of the biggest reasons (cited by some 50% of respondents) for not using mobile payments.

While there have been multiple mobile payment advances, they do not fundamentally appear to address an unmet customer need. The marginal improvement in convenience offered by the new payment mechanisms in point of sale transactions does not appear in itself to be a sufficient motivation for customers to switch from using cards and now contactless payments.

Another critical barrier for achieving greater take up is the lack of investment in upgrading the merchant infrastructure, as most are yet to be convinced of the ‘winning’ standard. This is a circular issue since the lack of clarity around the winning future standard, multiple initiatives and lack of future-proofing (i.e. functionality, scalability and interoperability) makes merchants understandably reluctant to upgrade their point of sale infrastructure. For the moment, the merchants, like their customers, are not clear about the ‘problem’ these retail payment innovations are trying to solve.

Regulation will play an increasingly key role in the evolution of the retail payments industry. The growth of mobile payments is undeniable and the regulator is keen to address the potential risks associated with these innovative technologies. In August 2013, the FCA initiated a Thematic Review (TR 13/6)14 into mobile banking and payments, highlighting its determination to be proactive in tackling potential risks. Apart from security and fraud, the regulator appears to be focused on ensuring customer transparency, anti-money laundering and for firms to manage technology risk (e.g., resilience and use of third parties).

Another objective of both the UK and European regulators is increasing competition in the payments industry. HMRC published a consultation entitled ‘Opening up UK Payments’ in March 2013 to ensure that the operation of the payment system doesn’t act as a barrier to entry to alternative providers. This is interesting, since the bulk of the retail payment innovation to date has focused solely on the customer interface, making use of the existing payment systems and underlying plumbing. Thematically, this consultation is consistent with the UK regulators’ desire to introduce greater competition in retail banking, with the introduction of current account portability and encouraging creation of challenger banks. Furthermore, the European regulators’ recent (July 2013) interchange capping proposals adds an interesting dimension to the innovation dynamic. On the one hand it challenges the economics of the incumbents, but on the other the lower interchange levels could result in a further entrenchment of merchants with the current scheme providers, making new alternatives less attractive.

This will remain a rapidly evolving landscape, with inherent uncertainty. There is growing adoption and a rise in ‘digital natives’ – people who grew up with digital technology. Yet the ‘game-changer’ which provides the catalyst for customers, merchants and the wider payments ecosystem to abandon current payment mechanisms remains elusive. It is clear the rate of innovation will accelerate as organisations in the digital and payments ecosystem continue to compete, partner and experiment. What is less clear is the precise tipping point when the customer chooses to leave the physical wallet and cash at home and only rely on their smartphones – watch this space.

14 FCA – Mobile banking and payments – supporting an innovative and secure market, August 2013
Part two: Set up to succeed in the new era
We believe that retail banking and consumer credit are entering a new era (see figure 26). While the boundaries are obviously not black and white, it is clear that the industry has been through several evolutions since its safe and simple beginnings when the local bank manager was the face of the bank, the business model was straightforward and lending volumes were relatively modest. Since then, we have been through a period of unprecedented lending growth, starting in the early 1990s, followed by the financial crisis and its immediate aftermath, which was characterised by firefighting, massive reregulation, and atonement by the industry. However, with lenders having made significant progress in repairing their balance sheets and the economic outlook improving, we believe the stage is now set to transition to a new and more forward-looking phase.

Whereas the pre-crisis era was characterised by rapid growth, massive product proliferation and a ‘pile high, sell it cheap’ product-led mentality, the new era will be characterised by a much stronger focus on the customer, lower growth rates and a radical simplification of all aspects of the industry, from products to the workings of the banks themselves. We have identified five strategic priorities that retail banks and other lenders will need to pursue to be competitive and sustainable in this new customer-centric era (see figure 24).

**Good growth** – The pursuit of sustainable growth that is underpinned by the delivery of good customer outcomes, which does not rely on opacity, customer inertia, complexity or cross-subsidies.

**Good cost/Bad cost** – A new approach to cost reduction that focuses on identifying ‘good cost’, which contributes customer value, and rooting out ‘bad cost’ which does not, thus delivering a simpler and leaner and more customer-centric organisation.

**Digital transformation** – Looking beyond digital as simply another channel, by setting in train an all-pervasive digital transformation, which will change every aspect of customer interactions and the way organisations are run.

**Making it happen: A new approach to change delivery** – Ensuring that change delivery programmes are focused on customer and business outcomes, and are not weighed down or distracted by process and programme management paraphernalia as ends in themselves.

**Making it happen: Performance alignment** – Aligning the entire organisation around the strategic priorities in a way that firmly aligns culture, objectives, KPIs and remuneration, and enshrines the customer at the centre.

Clearly, each of these strategic priorities are not mutually exclusive, rather they are fundamentally intertwined and mutually reinforcing and should be considered in combination rather than in silos. In the final pages of this year’s report we set out each of the five priorities at a high level. If you would like to explore any of these in greater detail, please contact one of the authors listed on page 44.
Figure 25: The evolution of UK retail banking and consumer credit

**Simple bricks and mortar banks**
- Branch-centric banking
- Decentralised decision making
- Simple products
- Cautious risk appetite

**Credit boom and rapid balance sheet growth**
- De-regulation
- Rapid lending growth and cross sell
- Decision making and operations centralised
- Product proliferation

**Crisis and the immediate aftermath**
- Re-regulation and restructuring
- Balance sheet repair
- Major remediation (PPI etc.)
- Cost reduction and deleveraging

**New era: simpler, more customer-centric banking**
- Consumer protection and outcomes
- Simplification (products and banks)
- Digital revolution
- Good growth

### Economy

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<th>Year</th>
<th>GDP annual growth rate</th>
<th>Bank of England base rate</th>
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### Lending

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### Bank profitability

<table>
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<th>Year</th>
<th>Return on equity (%)</th>
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<td>2015</td>
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<td>2010</td>
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An introduction to... Good growth

In the future both the sources and nature of growth for lenders will be very different from those we have seen historically. The rapid growth in lenders’ income seen from the early 1990s through to the financial crisis was in large part driven by significant increases in lending volumes, in the context of an industry that was susceptible to complexity, and a sales and product-led approach. The aftermath of this continues to be seen, for example in redress bills that continue to rise (e.g. PPI compensation payments now totalling c. £11 billion)\(^\text{15}\) We believe a number of major drivers (see below) will in combination create an irresistible push towards the pursuit of only ‘good growth’ and an industry that is truly focused on good customer outcomes:

1. **Customer demographics:** Significant changes in customer demographics are fundamentally altering customer needs. For example the combined effect of an ageing population and increased life expectancy (see figure 28) will contribute to the centre of gravity shifting away from lending products and towards savings, investments and financial planning. Furthermore, the rising number of single person households, relatively high levels of student debt and a lack of affordable housing may undermine the UK’s home ownership culture, further increasing the need for financial planning as certain segments of consumers are unable to rely on the appreciation in value of their homes to subsidise their retirement.

2. **Low levels of trust:** Trust in the industry, from a variety of stakeholders (consumers, consumer groups, politicians, the media etc.) has been severely damaged and remains weak. While customer complaint levels have fallen in recent months, they remain relatively high by historical standards. Winning back trust will require lenders to focus on service (‘serve me, don’t sell to me’), simplification (such that consumers can reasonably understand products) and a customer-centric approach that does not rely on ‘tricks and traps’ to make money.

3. **Regulatory overhaul:** The third and most potent driver underpinning the move to ‘good growth’ is the fundamental change in regulatory approach. The FCA has clearly signalled its intention to focus on ensuring the industry delivers good outcomes for consumers. The regulator will focus more on the lender’s strategy and business model to understand how it’s making money. In addition, the FCA’s new competition remit will add further scrutiny to the industry. Traditional indicators of well-functioning and competitive markets, e.g. high switching rates, low barriers to entry, transparency etc. are unlikely to be sufficient in their own right; rather the focus will be on how consumers make choices (behavioural economics) and the outcomes as a result.

We would recommend that organisations get ahead of the wave and instigate changes now to position themselves for good growth. The changes required will vary from the relatively straightforward to the more complex and we set out in figure 29 the characteristics we expect to see in the industry in this new era. Progress is already being made in some areas, e.g. an overhaul of new product approval processes and the removal of sales incentives for branch and call centre staff (with positive and in some cases unexpected results), but more remains to be done.

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\(^{15}\) Speech by Martin Wheatly, Chief Executive of the FCA, at the British Bankers’ Association annual conference in London 17.10.13
An introduction to... Good cost/Bad cost

As we have set out, while the economic outlook is improving, top-line growth is unlikely to ever return to pre-crisis levels, particularly given the demise of various revenue sources that are no longer sustainable (e.g., PPI, late payment fees etc.). Against this backdrop, the cost line assumes greater significance and should continue to be an area of focus. Many organisations have responded to this imperative with a variety of cost reduction initiatives announced and underway.

However, traditional approaches to cost reduction risk leading to erosion of customer value and tend not to deliver sustainable cost savings. Fundamentally, these approaches often fail to address the underlying complexity within the business and also don’t delineate between good costs that drive customer value and bad costs that don’t. Common consequences of not recognising this delineation include a decline in customer satisfaction and service levels, ‘lean’ and ‘fat’ functions being equally penalised and costs returning to the system. In our experience, less than 30% of programmes hit their target and according to a recent PwC CEO Survey, more than 60% of CEOs launch cost reduction initiatives every three to five years.

Figure 28: Good cost/Bad cost

![Good cost/Bad cost diagram]

Source: PwC analysis
Organisations need to concurrently pursue customer-centric growth, manage conduct risk and reduce costs. It’s therefore important to ensure that cost reduction aligns the cost base to customer value, i.e. good cost. This has to start with a clear and detailed understanding of what customers value and are willing to pay for, normally through quantitative customer research techniques (e.g. conjoint research) which forces customers to trade off between different aspects of the value proposition and reveals their underlying willingness to pay.

Armed with this insight, it is then possible to map the cost base across the business and operating model to identify the ‘good costs’ and expose the bad costs (see figure 31). Finally, like all cost reduction, the sustainable elimination of ‘bad costs’ demands financial discipline, culture change and strong cost governance. While appearing obvious, our experience indicates that it is lack of focus in these critical areas which results in failure of most cost reduction initiatives.

Figure 29: Cost reduction framework

<table>
<thead>
<tr>
<th>Focus of activities</th>
<th>Savings levers</th>
<th>Opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructure the cost base ‘Do different’ (20%+ savings)</td>
<td>Closures and exits</td>
<td>Closure or divestment, sub-scale lines of business, customer segments and/or product offerings.</td>
</tr>
<tr>
<td></td>
<td>Strategic sourcing</td>
<td>Consolidate sourcing of activities and vendors, create shared services, outsource non-core processes and platforms, off-shoring, and core systems replacements.</td>
</tr>
<tr>
<td>Reduce infrastructure ‘Do with less’ (15-20% savings)</td>
<td>IT consolidation</td>
<td>Consolidate IT platforms, hardware, infrastructure and data centres.</td>
</tr>
<tr>
<td></td>
<td>Property optimisation</td>
<td>Review property demand to maximise space utilisation, identify asset disposal opportunities and reduce all property-related spend via sourcing and vendor reviews.</td>
</tr>
<tr>
<td>Create efficiencies ‘Do better’ (10-15% savings)</td>
<td>Process improvement</td>
<td>End-to-end process improvement to reduce complexity and errors and rework and standardise around key processes, applying Lean and Straight Through Processing.</td>
</tr>
<tr>
<td></td>
<td>Business simplification</td>
<td>Simplification and de-duplication of roles and activities; consolidation and rationalisation of similar functions and activities.</td>
</tr>
<tr>
<td>Cut costs ‘Do without’ (5-10% savings)</td>
<td>Activity and headcount reduction</td>
<td>Review and challenge of team activities, workload capacity and line management structures and reporting lines leading to headcount reduction.</td>
</tr>
<tr>
<td></td>
<td>Spend reduction and demand management</td>
<td>Demand challenge and discretionary spend reduction, and policy compliance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Reduce/eliminate discretionary spend</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Reduce contractor spend</td>
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<tr>
<td></td>
<td></td>
<td>• Re-negotiate vendor contracts</td>
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</tbody>
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Source: PwC analysis
An introduction to... Digital transformation

What started out as a new (and exciting) channel is now driving an all-pervasive digital transformation, which will dominate the future retail bank investment agenda. We believe the three key questions businesses will need to consider to align digital developments with the new good growth agenda are: what is the digital transformation, what do I need to invest in and what customer interactions do I need to offer?

What is the digital transformation?

Three fundamental changes are driving the digital transformation. The ‘digital natives’ are becoming the dominant customer type, smart mobiles (like smartphones, tablets and ‘phablets’) are becoming the dominant digital devices, and mobile internet will become ubiquitous.

![Figure 30: A new and different type of customer is emerging in the digital age](image)

Digital natives are the people brought up with computers in the home. They will become the biggest customer type before 2020 (see Figure 30). A key underlying trend is that tablets are expected to outsell PCs/laptops by 2016.\(^{16}\)

Smart mobiles change the interaction dynamics with customers, because they open the way to greater transparency, they are more personal and social, they offer a better user experience (through game-like interfaces) and they can be enriched in completely new ways (e.g. customer level data, geo-location, and image recognition).

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16 Gartner press release from October 2013
It is PwC’s viewpoint that the combination of the three drivers (customer, device and connectivity) will lead to three digital waves of opportunity for banks:

- **First digital wave – digital commerce:** Improve eCommerce profitability with a better customer experience, more compelling propositions, more effective distribution or smarter pricing. Reduce cost by creating operational integration across your supply chain.

- **Second digital wave – digital consumption:** Develop propositions that encourage your customers to share their consumption data by enabling outcomes for them. That way you increase customer loyalty, increase revenue and reduce operating costs even further.

- **Third digital wave – digital identity:** Act as a trusted fourth party on behalf of customers to aggregate their digital data, and to meet their needs through managing relationships with companies offering products and services.

Many banks are exploring the different opportunities to make the most of these interactions. In our experience, however, the investment needed to deliver the benefits is considerable and making the right decision is non-trivial.

**What do I need to invest in?**

With the current investment agenda dominated by regulatory imperatives, there can be little left to invest in digital. Careful targeting of the limited funds available for digital investment is therefore crucial. During our discussions with the boards of UK banks, we have found it useful to evaluate digital investment priorities by four themes (see Figure 31). An appropriate budget can then be allocated by theme and then priorities set within each theme (which may vary). This will ensure a balanced digital investment portfolio in line with current digital capabilities and strategy.
What digital interactions do I need to offer?

Most banks and card issuers have made considerable progress in supporting their clients with digital transactions/payments, what we call the use-stage of the customer journey. Developments such as online banking and mobile apps are becoming commonplace. We believe companies should take the next step and join the digital transformation. We expect a complete shift to online/digital in the overall customer journey (see Figure 32).

Customers prefer digital in almost any interaction, as long as it is seamlessly multichannel. For example, customers are willing to go online for query resolution, as long as they can call a knowledgeable person should this not resolve their problem quickly. Customers also want a better digital service when researching/applying for products (the inform-step), and expect to be able to go into the branch if need be (for example during the buy-step). This is illustrated in the mortgage product customer journey in Figure 33.
An introduction to… A new approach to change delivery

Making the required changes to deliver on good growth, good cost/bad cost and the digital transformation presents a paradox; the change required is large, complex and cuts to the heart of the organisation, and yet the record for successfully delivering such change programmes is relatively poor. The change agenda at most banks is already large and in many cases unwieldy. We therefore believe a new approach to change delivery is needed, which places much greater emphasis on business and customer outcomes.

Changing the traditional programme approach

While the common success factors of large programmes are widely reported and understood (see figure 34), the success rate of programmes remains unacceptably low. While strong programme management disciplines are of course required, in our experience large programmes have a tendency to become weighed down and distracted by a deluge of programme management paraphernalia and process (e.g. RAG reports, Gantt charts, issues and actions logs etc.) and tend to lose sight of the customer and business outcomes they are trying to deliver. Furthermore, in our experience a disproportionate emphasis is placed on resourcing large programme offices which further reinforces the overriding focus on process. What is often missing (or is not used appropriately if it is in place) from a governance perspective is a business Design Authority, and from a people point of view there is often a lack of a strategic architect to combine industry insight with delivery discipline to join the dots across the programme. We believe a new approach to programme management and change delivery is required that shifts the centre of gravity towards delivery of outcomes rather than milestones, and measures and manages delivery in these terms.

Making change everyone’s responsibility

While a programmatic approach will inevitably be required to some extent, the pursuit of good growth, good cost/bad cost and digital transformation is a journey which is likely to take years and will necessitate deeper cultural change. As opposed to tying delivery and success to a single overarching change programme, we would advocate instilling a good growth and good cost/bad cost mentality and culture across the entire organisation, and using this as the frame of reference for everything it does. This approach harnesses the entire organisation to deliver the change progressively and from within, rather than deferring to a programme.

Figure 34: Common factors on successful change programmes

<table>
<thead>
<tr>
<th>Prerequisites for success</th>
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<tbody>
<tr>
<td>1 Relentless and highly communicative leadership</td>
</tr>
<tr>
<td>2 Strong business ownership for change</td>
</tr>
<tr>
<td>3 Rigorous benefits tracking</td>
</tr>
<tr>
<td>4 Strong and business led governance</td>
</tr>
<tr>
<td>5 Realistic scope and scale</td>
</tr>
<tr>
<td>6 Clearly defined and characterised transaction states</td>
</tr>
</tbody>
</table>

Source: PwC analysis
An introduction to... Performance alignment

Reinforcing a shift towards more outcome-based programme management and change delivery is performance alignment.

Simply put, performance alignment seeks to ensure that ultimately employee performance is measured and incentivised both against the execution of the strategy and on acting in a manner consistent with it.

Executing the chosen strategy, be it identification and elimination of bad costs or a reorganisation of the business’s operating model, requires performance alignment. Performance alignment offers an alternative perspective to strategy execution. While not a panacea in its own right, used in combination with effective change management (see figure 34) it can be a powerful tool for improving the organisation’s chances of success. Defining critical behaviours and aligning performance drivers are the key steps in moving towards an aligned organisation. Performance alignment consists of four key stages (see figure 35).

Step 1: Define the strategic priorities (SPs):
For a new strategy to be embedded into the organisation, employees need to understand how it applies to their role, their day-to-day decisions and their actions. SPs break down the complexity of the overall strategy into sub-components that more readily inform the decisions, behaviours and responsibilities at all levels in the organisation. Not all SPs are equal – some are prioritised over others due to their influence over long-term value, their complexity or their criticality in addressing other performance aspirations. A well-articulated SP will acknowledge the specific choices or trade-offs that are inherent in the overall strategy. It is equally important to communicate what has been excluded as what has been included. If middle management cannot see and feel a clear picture of the future world then it is unlikely they will be able to drive change effectively into the organisation.

Step 2: Assess the strategic risks associated with each strategic priority:
Strategic risks represent both upside and downside potential associated with the defined strategy and its execution/delivery. This is different from the other risks (e.g. business, operational risks) that most organisations consider. Our experience suggests that executives very rarely articulate, let alone quantify their strategic risks. This lens helps them to identify the strategic risks and opportunities, understand the uncertainty around a strategic priority and its potential contribution to performance, map executives’ risk appetites, and articulate a risk-adjusted outcome.

Step 3: Defining critical behaviours:
To execute strategy effectively, organisations need to understand the critical behaviours at all levels of the organisation that drive value. These behaviours are also used as the lead indicators of whether an organisation is on track with respect to delivery of strategy and priorities.

Figure 35: The four stages of performance alignment

Performance alignment is an integrated and interactive approach to strategy execution that focuses on four critical lenses of the leadership model:

<table>
<thead>
<tr>
<th></th>
<th>Strategic priorities</th>
<th>How an organisation’s strategy is unpacked into specific executable actions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Strategic risks</td>
<td>How the key strategic risks to successful execution are identified, monitored and managed.</td>
</tr>
<tr>
<td>3</td>
<td>Critical behaviours</td>
<td>The critical changes in behaviour required to deliver the strategy.</td>
</tr>
<tr>
<td>4</td>
<td>Performance drivers</td>
<td>How the elements are integrated in a way that drives performance through the organisation.</td>
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</tbody>
</table>
Step 4: Aligning performance drivers:
Performance metrics should reflect the strategic priorities, extending beyond the purely financial and short term. Budgets and aspirational targets need to be set in the context of the company’s strategy. At a team and individual level, reward and performance management should reflect the strategic priorities and critical behaviours. In this context, reward encompasses not just pay and incentives, but extends to recognition, progression, working environment and opportunities for development.

Senior leadership have the key role in establishing performance alignment; they need not only to demonstrate the necessary behaviours, but to reinforce them and take action where staff are not acting in the correct manner. Furthermore, they need to determine how performance is monitored and assessed; with assessment covering both financial and non-financial metrics. There should also be clear direction from senior leadership on the actions taken against those not acting in a manner consistent with the critical behaviours.
About PwC

The consumer credit and payments markets continue to undergo significant change, demanding participants to be more competitive and innovative. The retail banking and consumer finance team at PwC is a leading adviser in this market. We offer a perspective derived from working with all types of market participants across multiple functions, including banks, card issuers, building societies and other non-financial institutions, specialist lenders and brokers. The team has extensive experience advising and assisting clients with:

- Strategy and business plan development
- Regulation and the business response
- Digital strategy and execution
- Strategic cost reduction (Good cost/Bad cost)
- Due diligence
- Risk
- Market and economic analyses
- Partnership strategies and contract negotiations
- Debt portfolio strategies
- Valuations
- Transactions and investment decisions
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