Keep it simple – that's what the customers want

Disillusion with stock market investments has not been dispelled by the rebound in share prices and investors have been keeping their savings in cash. Deposit accounts have seen huge inflows. Tanja Lindermeier analyses what this means in terms of products and prices for deposit taking institutions.

Volatile share prices have left investors feeling vulnerable and increasingly they have opted for the security of cash deposits, with the result that the deposit sector has outrun direct equity investment. Between 2001 and 2005, the value of the UK deposits sector grew by over 8%* annually, whereas direct equity investment remained near stagnant at 0.4%.

Net inflows indicate that consumer confidence in the stock markets has yet to be fully restored, while high deposit inflows attest to the continued attraction of this segment. Datamonitor' new report forecasts deposit balances to grow at a compound annual growth rate of 5.6% in the next four years.

In 2000, direct equity investment totalled close to £560bn, whereas the deposit sector stood at £520bn. Buy by the end of 2002, deposits accounted for more than twice the amount invested in direct equity. By year-end 2005, deposits had grown by a further 27% - yet the sector was still almost twice the size of direct equity investment, despite the fact that direct equity registered a stronger growth rate.

While there have been positive stock market trends, net inflows into direct equity have remained unstable. Net inflows for deposits, in contrast, have been continuously high in the last five years, peaking at over £40bn in 2004. Consumer preference for deposits is so far unbroken.

Compared with the volatility of the stock markets, the relative stability of interest rates has been a welcome source of security to consumers, offering much better transparency on the expected returns.

Datamonitor forecasts that deposit balances will show an increase of more than 30% over the period 2005 to 2010. Deposits will slightly lose market share relative to the other, faster growing, retail savings and investments categories. But it will be lost to collective investments rather than direct equity investment.

By 2010, investment in unit trusts/OEICS and Investment Trusts is forecast to make up almost a quarter of retail savings and investments. Direct equity investment is expected to show strong growth at a compound annual growth rate of 9.1% between 2005 and 2010, but that will not be enough for it to regain its market share.

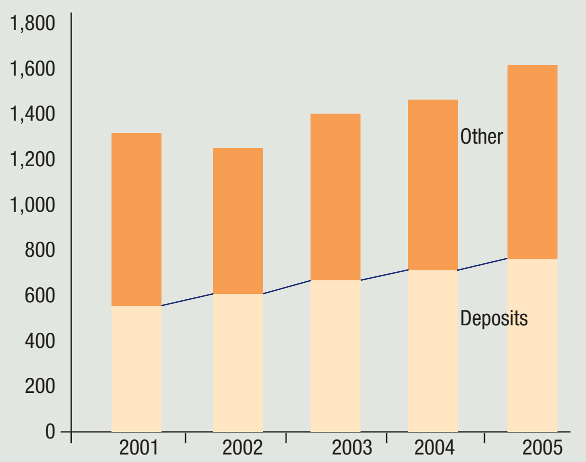
The UK has experienced a period of heavy consumer lending and over-spending, and the levels of indebtedness among consumers have been frequently discussed in the media. Combined with growing concerns about pension provision in the future it is expected that UK consumers will be concentrating more on rebuilding their savings in the coming years.

Regular savings accounts have come into the spotlight

With an abundance of products, ordinary savings accounts (as opposed to regular savings accounts) continue to dominate the market. However, regular savers and Mini Cash ISAs have been boosted by a number of new products.

In 2006, ordinary savings accounts constituted more than 60% of the products on offer. While the number of accounts has fallen slightly in the last two years, a further reduction would be welcome from a consumer point of view. "The abundance of products makes it difficult for consumers to find the forest for the trees and reach a well-informed decision. It is also debatable what percentage of products is truly aimed at a specific target market as opposed to relics that have remained from the past."

FIGURE 1: VALUE OF UK DEPOSITS AS PART OF THE SAVINGS AND INVESTMENTS MARKET, 2001-5



Note: 'Other' encompasses direct equity investments, bonds, investment trusts, unit trusts / OEICS and National Savings & Investments
Source: Datamonitor UK Retail Savings and Investments Database 2006
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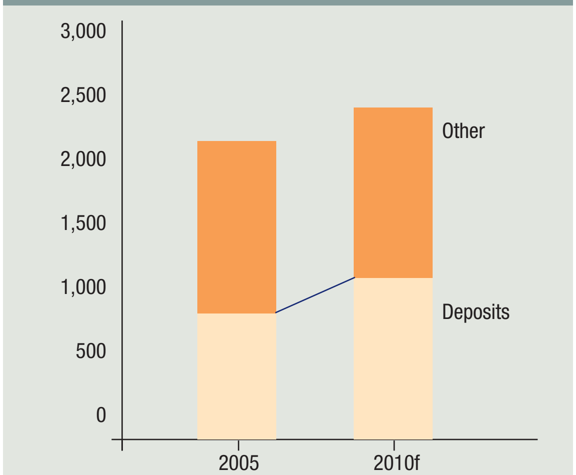
The huge number of savings accounts on offer is caused by the extensive product range of the UK building societies. While the banks slightly reduced the number of accounts they offer, some of the building societies have extended their product portfolio since 2004. On average, they now offer twice as many savings accounts as banks.

Recognising the potential for customer retention, which regular savings accounts can offer, a considerable number of providers have entered the market in the past two years.

So far, it is mainly the building societies that are pushing further into this niche market. The number of building societies offering regular savings accounts has increased by close to 90% in the last seven years. In contrast, the number of banks providing regular savings accounts has remained almost unchanged. Those which do compete in this segment have, however, been marketing their products quite aggressively over the last year.

FIGURE 2: FORECASTED VALUE OF THE UK SAVINGS AND INVESTMENTS MARKET, 2005-10F



Note: 'Other' encompasses direct equity investments, bonds, investment trusts, unit trusts / OEICS and National Savings & Investments
Source: Datamonitor UK Retail Savings and Investments Database 2006
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Mini Cash Isas

Another growth segment in the deposit market has been Mini Cash ISAs, which form the second largest product category. The number of accounts on offer rose by 12% between 2004 and 2006, so that Mini Cash ISAs now constitute 14% of all available deposit accounts.

The increase has predominantly been driven by established providers expanding their offering as opposed to an influx of new entrants. But while more than 13 million new Mini Cash ISAs were opened in 2005, they have still to reach their full potential. MORI research from 2004 concluded that only 17% of UK savers made use of their annual ISA allowance.

Foreign Currency Accounts

USDollar accounts show the strongest growth rates among the foreign currency accounts. Between 2004 and 2006, their number increased to 39, a rise of 30.0%. The increase has mainly been due to established providers seeking to get a firmer grip in this niche, but there have also been some new entrants in the last two years. Offshore Euro accounts are, however, still the slightly larger segment among foreign currency products. In 2006, there were 48 accounts on offer.

No-notice and instant access accounts are gaining ground

There has been a clear shift from time to sight deposits, fuelled by the increased use of direct access channels. Sight deposits increased by 11%[1] annually. The share of time deposits, on the other hand, has notably decreased over the same period, with a compound annual growth rate of just 2.3%. The product segments, in which the shift has been most obvious, are ordinary savings accounts and Mini Cash ISAs. Here, the number of no-notice and instant access products on offer has visibly gained ground compared with notice accounts.

The shift has primarily occurred among banks. Building societies, in contrast, have seen a strong increase in time deposit balances. A key reason for the difference here lies in the fact that the banks have developed direct access channels, such as telephone and Internet, further than building societies.

The customer groups to which these channels have become increasingly important are often younger, experiencing more sudden changes in their lifestyles that require access to cash. To these customers, instant access to their savings is often more attractive than a higher savings rate, which notice accounts may offer.

Market leaders

The market concentration of the top five and top 10 competitors remains very high. But the current climate of growth allows clever competitors to gain a foothold in the market. In 2000 and 2001, several large scale mergers and acquisitions came into effect, which led to an even higher market concentration in the deposit sector. While the top five competitor market share is hovering around 62%, the top 10 competitors now hold close to 90%.

Nevertheless, ING Direct has been able to storm the top 10. At the end of 2003, after a mere 6 months in business in the UK, the bank had already rocketed to being the 11th biggest retail deposit taker. In the past two years, ING Direct has been able to increase deposits threefold. It currently holds the eighth place in the top competitor ranking – with just one product on offer.

The success of Ing's extremely straightforward no-notice savings account, which offers one savings rate for all, and for all levels of investment, and is accessible via telephone or Internet, highlights that there is substantial demand for uncomplicated, catch-free products.

Margins have increasingly come under pressure

The growing number of no-notice and instant access accounts has led to intensified competition, and competitors' margins have come under pressure. Between 2003 and 2005, the weighted average rate for household sight deposits has come closer to the base rate by 0.2%. In contrast, the margins for time deposits have increased over the same period.

More recently, competition has been particularly strong in the regular savings segment, and 2006 has seen a price war emerge. The highest savings rate of 12% gross per annum currently available through Alliance & Leicester, is set 7.25% above Bank Base Rate.

Other providers offer between 7% and 10% gross per annum. Typically, the accounts are packaged with a current (or other savings) account, have a fixed term of 12 months and set a ceiling on how much can be saved. The offers have considerably stepped up the pressure.

Nevertheless, the actual costs to the providers are manageable and the benefits potentially high. Given the immense advertising effect of the interest rates, the products should indeed allow their providers to successfully attract customers – and retain their business through the product package.

Pricing structures have changed

Squeezed margins have not been the only sign of intensified competitive pressure. The last years have also seen the pricing structures of ordinary savings accounts and Mini Cash ISAs change.

In 1999, three quarters of all ordinary savings accounts and Mini Cash ISAs offered interest rates tiered by level of investment. In 2006, this number fell below 50%, so that half the accounts on offer pay the same amount of interest irrespective of the level of investment.

The key drivers behind the changing pricing models are both competitive pressure and a necessary simplification to make the products more suitable for direct distribution channels. Small players force big banks to rethink their pricing structures.

By offering the same high level of interest regardless of the size of the deposit – and attracting consumer interest through extensive advertising campaigns – providers such as Egg, Virgin Money and ING Direct increased the pressure on traditional banks and building societies. The success of ING Direct's catch-free product certainly exemplifies consumer demand for a clearer pricing structure and fewer restrictions. □

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[1] CAGR – Compound Annual Growth Rate.

Product segments in the UK retail deposit market, 2006

	Market share
Ordinary savings accounts	62.6%
Regular savings accounts	5.6%
Mini Cash ISAs	13.7%
Current accounts (with and without overdraft facility)	8.8%
Offshore USD accounts	3.3%
Offshore Euro accounts	4.1%
Onshore Euro accounts and current accounts	1.9%
Total	**100.0%**

Source: Datamonitor, analysis of Moneyfacts data (February 2006)

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