‘Free in credit’ banking is dying. BEN SNOWMAN considers what new retail accounts established bankers can invent to protect their market share.

CUSTOMER CHEMISTRY

Current accounts are the anchor product for retail banks’ relationships with their customers – with 88% of UK customers having a savings account and 53% having a credit card with their current account provider. However, profitability of the top seven UK retail banks has declined by £400m in net interest income since 2011 and current account revenue is also declining. In the UK, approximately 70% of current accounts are ‘free in credit’ meaning the service is free to use when the customer is in the black. For those who are not, banks indirectly make a profit through penalties and overdraft fees. In addition, by not paying interest to customers on balances, banks boost profits indirectly. These pricing levers are all under scrutiny by the Government, which is also calling for more comparability and transparency. Falling profits and comparable products means that there is a need to renovate the offering to remain competitive and readdress the revenue model and product offering for a sustainable future.

THE CURRENT (ACCOUNT) SITUATION

There are now 31 current account providers in the UK offering 122 different types of current account product, with 92% of the market dominated by the ‘big six’. To break this stranglehold and introduce more competition into the market, RBS and Lloyds Banking Group (LBG) have been forced to sell branches to redistribute share among other banking groups. The Co-Operative Bank has secured 600+ branches from LBG and will eventually become the seventh largest bank in the UK. In order to stimulate switching between banks, the UK Payments Council is investing in the Redirection Service (RDS) platform which will reduce the time it takes for customers to move current account provider, due to go live next year. The FSA hopes to boost today’s sub-10% level of switching by 5%. Together with the emergence of ‘challenger’ brands, the industry looks set to be shaken up in the coming 12 to 24 months. Because current accounts are so important, retail banks must invigorate their propositions in order to create a competitive advantage to both retain their current customer base and attract others.

Packaged current accounts have long been seen as the profitable alternative to traditional ‘free in credit’ accounts. There are now approximately 10 million packaged accounts in the UK, representing 20% of the market. The FSA’s ongoing investigation into the bundling of insurance

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'THERE ARE NOW APPROXIMATELY 10 MILLION PACKAGED ACCOUNTS IN THE UK, REPRESENTING 20% OF THE MARKET.'

products into packaged current accounts will result in a set of rules which will constrain the design and sale of packaged accounts. The rules must be implemented by March 2013.

Price transparency, comparability and fee predictability are also themes the Government is aiming to address. In addressing these, the industry may experience a drive towards a utility offering, reducing banks' competitive advantages.

Combined, these issues paint a bleak picture for the industry. Profits are declining, the market is sinking towards ubiquity, customer loyalty is set to decline and new brands are shaking up the status quo. What can the established banks do to protect their positions and boost profits? Five years on, what might a successful product line-up look like for the more established players?

SERVING UP OPTIONS

The traditional 'free in credit' model will eventually disappear. While all banks will need a free entry-level product to attract certain customer segments, such as students, also ensuring financial inclusion for the socially disadvantaged, the current model is not sustainable and an alternative must be sought.

Think Money (from Think Banking) is a salary account where, each month, money is put aside to cover direct debits and the remainder is available for spending via a debit card – with no overdraft facility. While this is currently a paid-for product (£14.50 per month), targeted at the non-standard segment, this model could serve as a basic, free entry-level account in the future for the major banks. As today, indirect profits would be made through interest foregone on balances. In addition, revenues would be made through interchange fees from card usage – higher fees could be generated if trading the debit card for a prepaid card. Additional income could arise through one-off fees to load additional funds onto the card. There would be no overdraft facility, eliminating issues of transparency from penalty pricing and removing risk-related constraints for offering current accounts to the non-standard segment.

While Think Money provides a service for basic customer needs, advanced accounts make provision for both 'needs' and 'wants'. Two of the UK's leading banks have recently launched 'needs and wants' based propositions. These are Barclays' Feature Store and Santander's 123 account. While different, they give customers unique opportunities. Feature Store allows customers to customise their account at the point-of-sale. A basic service sits at the core and customers can select bolt-ons (such as insurance products) based on their requirements. There are sufficient controls in the purchasing process to ensure these bolt-ons effectively meet the needs of customers and the terms and conditions are fully explained. This self-selection principle circumvents issues of bundling, such as the double-selling of products indirectly (travel insurance, for example). Santander's 123 account goes beyond a pure financial service. It recognises how customers use money and their needs from everyday living. For £2 per month, the account offers cashback on household bill payments as well as attractive interest rates on high balances.

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The benefits to customers are obvious. To banks, this increases market share and, importantly, increases their capital position by incentivising customers to hold higher balances. This provides capital to meet Basel III requirements and supports lending activity.

Both of these accounts break away from the traditional banking model. The principles of self-selection and understanding how money is actually used by customers will be core to development of accounts in the future. Combined with innovative mobile services, cross-generation propositions for families, joint ventures with retailers, affinity programmes, cross-product pricing incentives – there are countless opportunities for banks to renovate their offering in this area.

THE FUTURE OF BANKING

Brian Hartzer, when leaving his post as CEO of RBS Retail, declared that 'paid-for is the future', signalling the transition for UK retail banking – a point echoed subsequently by Andrew Bailey, Executive Director at the Bank of England. Free banking, however, is unlikely to disappear for at least a generation. Banks' need to grow profits, customers' need for financial inclusion and the Government's push to increase competition and transparency can be addressed by changing today's product line-up. Free, entry-level basic accounts will continue to offer customers an accessible banking service. Premium offers can be designed to align with customer needs and wants and present the opportunity to price for value. These high-value accounts will provide greater profit to banks and greater support for customers' everyday needs – a principle called 'fair value exchange'[1]. ◻

[1] Simon-Kucher & Partners: Rebuild Consumer Trust by Offering a Fair Deal. Published in American Banker, 2012

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