Banking & Capital Markets

UK Retail Banking Insights

Evolving Industry Observations*

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Welcome to the latest edition of UK Retail Banking Insights, PricewaterhouseCoopers[1] regular publication which focuses on topical issues facing the retail banking sector.

Our last edition was issued in the aftermath of the credit crunch starting to bite and yet seven months on, the market environment for retail banking organisations remains no less challenging. Our five articles each focus on current issues faced by retail banks arising from this changing environment: revenue replacement, liquidity risk management, changes to processing systems and managing credit risk through the receivables management sector.

In our lead article: 'The waterbed – is it about to burst?' we focus on whether banks can again make the waterbed effect work to maintain overall revenues following pressure on unauthorised overdraft charges and payment protection insurance income streams. The amounts at stake are much greater than was the case with the OFT ruling on credit card default fees and the article demonstrates that banks will need to have a good understanding of how competitors and customers will react to proposed price changes.

Our theme of dealing with the current market environment continues in 'Three steps to liquidity risk heaven'. Clearly, the management of liquidity risk is key in the current market environment and it is critical that banks get across the message to their stakeholders that they have the issue under control.

Transaction banking is the theme of our next article. The authors refer to the recent introduction of the Faster Payments Scheme but point out that there are plenty of further changes in the retail payments environment which need to be planned for to ensure that banks can continue to provide a great customer interface and experience for their retail transactions.

The implementation of Faster Payments is also relevant to the following article which argues that it has in part given rise to the end of proprietary retail banking systems. We focus on the changing environment for core systems and demonstrate that leading banks are moving towards a more customer rather than product centric view of systems development, with many banks choosing a vendor strategy rather than an in-house IT development model.

Our final article provides an in-depth analysis of the receivables management sector and considers what retail lenders can learn from recent and forthcoming changes in this growing market.

I hope you find this edition enjoyable and thought provoking. As ever, we welcome any feedback on topics you would like to see covered in future editions.

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[1] Unless otherwise indicated "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom).

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The waterbed – is it about to burst?

Banks in the UK are under threat from increased scrutiny by economic regulators. Ongoing interest in issues such as the interchange fees that underpin card payment networks has been augmented by a focus on unauthorised overdraft charges (UOCs) and payment protection insurance (PPI).

UOCs are now the subject of legal proceedings at the High Court between the Office of Fair Trading (OFT) and seven of the country's leading banks and the leading building society, as well as an ongoing investigation by the OFT. PPI is also being investigated by the Competition Commission. The stakes are high: it is estimated that the banks generate many hundreds of millions of pounds per annum in revenue from UOCs, and the Competition Commission believes that a similar amount is generated from PPI (the vast majority of which it considers to be excessive); and potentially fundamental changes to these markets are possible. The court case and/or OFT investigation could result in UOCs being in some way 'capped'. The Competition Commission might attempt to 'de-link' the sale of PPI from the sale of the underlying credit products. Future revenues could therefore be dramatically reduced. Add to this the potential back book exposure from, for example, being forced to refund past UOCs that are judged to have been excessive, and it is clear that the banks have some serious thinking to do.

Focusing on the subject of UOCs, the banks have three main challenges. First, is to mount an effective defence of their position to the court and/or OFT. The first phase of the legal proceedings is now complete and the judge has decided that the charges should be assessed for 'fairness' under the Unfair Terms in Consumer Credit Regulations (UTCCRs). While opinions appear divided over whether this assessment should be carried out by the OFT or the court, one thing is clear: it will not be a straightforward exercise. The banks will require a clear exposition of the business realities of the sector, together with robust economic and accounting analysis to quantify the costs that are incurred in servicing unauthorised overdraft positions.

Second, is to cut costs, but it is notoriously difficult to do this without undermining the underlying product and customer service proposition. Chances of success in this area are generally increased by a thorough analysis of management information on underlying processes and cost drivers, and the development of cost reduction plans that are fully consistent with the overall strategy of the bank.

Third, is to workout which revenue streams might be at risk from the ruling and to perform further analysis to identify any potential revenue upsides. In order to do this, the banks would be well advised to:

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- **Identify the most likely rulings that might be made** by the court and/or OFT, well in advance of these rulings taking place. Planning ahead will be crucial in gaining/retaining competitive advantage.
- **Understand how their competitors might react** to these court rulings: What might they do, how and when? Possibilities include more extended use of monthly management fees, per transaction charges, and various permutations of authorised and unauthorised overdraft interest rates. Different banks are likely to have different strategies. For example, those banks with heavy involvement in mortgage lending might be more reluctant to introduce monthly management fees (and, indeed, other potential charges) than other banks, if this will adversely affect their current account deposit base. This is likely to be particularly important given the credit crunch and race for retail funding. The strategy of different banks is also likely to depend on the type of customers they want to attract and retain. Certain groups of customer are considerably more profitable than others.
- **Understand how customers will react** to different price and product offers by themselves and by their competitors, and what impact these customer decisions will have on their own financial position.

This latter challenge is particularly complex and again presents banks with a number of options. Banks could make crude estimates of how customers will react and/or 'test the water' with a number of experiments. For example, we are currently seeing banks offer high credit interest rates on current accounts. However, adopting this strategy on a more widespread basis is risky: making crude estimates (even if guided by shrewd instinct and hard-earned experience) is a strategy unlikely to be well-received by senior management or shareholders; experiments can be unreliable (for example, the results of a specific experiment will depend on what other banks are doing with their own product and price propositions) and take time – which is far from ideal if your competitors are busy signing up your best customers.

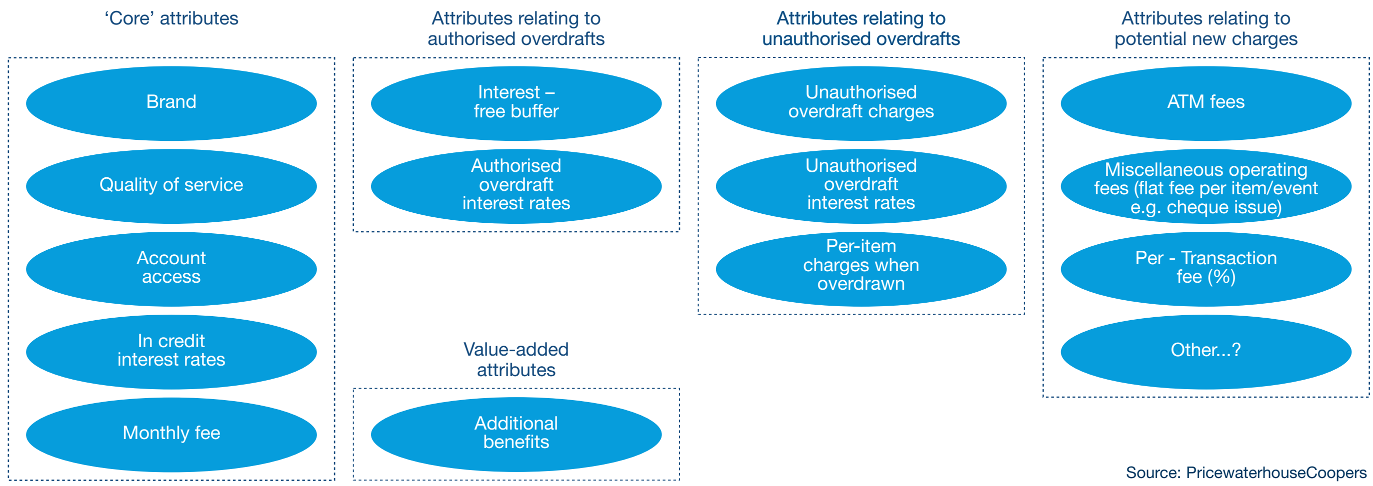
Banks could also analyse how customers have reacted to price changes in the past. This is better and sometimes works well, such as when considering marginal changes to existing price and product propositions. However, the past is unlikely to be a good guide to the future in this situation: customers have limited experience of the type and quantum of charges that might be considered (e.g. monthly account management fees, per transaction charges). The credit crunch also appears to be bringing about a general shift in the mindset of customers. In technical terms, little relevant 'revealed preference' data on customer reactions to such charges is available.

Finally, banks could obtain a robust view of how customers value different aspects of the current account proposition by actually asking them. While this sounds obvious, it is difficult to obtain reliable and unbiased answers to questions unless they are asked extremely carefully. In our experience, and this is supported by Nobel prize winners, the best approach (used either on its own or in conjunction with other techniques) is to use a form of indirect questioning known as 'conjoint analysis'.

In this technique, the current account is broken down into each of its key 'attributes', such as authorised and

The stakes are high: it is estimated that the banks generate billions of pounds per annum in revenue from UOCs, and the Competition Commission believes that a similar amount is generated from PPI.

Figure 1 – Example conjoint attributes



Source: PricewaterhouseCoopers

unauthorised overdraft interest rates, credit interest rates, monthly management fees, access to branch, various types of UOC, and value-added extras such as travel insurance. Some examples are included in Figure 1.

Customers are then asked to choose between (or 'consider jointly', hence the term conjoint analysis) different combinations of these attributes. Some example conjoint questions are included in Figure 2. These questions can be asked in person (using a computer programme and, if appropriate, visual aids), or administered over the internet (an important recent advance, which makes it possible to carry out surveys in a relatively short space of time). The answers to these questions allow a reliable understanding of how customers value each of the current account attributes to be obtained, sophisticated modelling to be carried out, and accurate predictions of customer reactions to different combinations of these attributes to be formed – even if they have never experienced them before.

This then allows the financial impact of different price/product strategies to be modelled, against the backdrop of different potential rulings by the court/OFT and competitive actions/reactions by competitors. As shown in the illustrative analysis depicted in Figure 3, recovering revenues that might be lost if UOCs were capped at a number of different levels is relatively straightforward if customers do not react to what banks do – one simply introduces a charge, say a monthly management fee, and the much vaunted 'waterbed effect' works (i.e. a reduction in one price is compensated for by an increase in another, with no overall impact on the bank's revenues). This appears to have been what happened when the OFT provided guidance to the banks that late payment fees on credit cards should be no greater than £12. However, banks had considerably less revenue at risk on credit cards than they do on UOCs, and the issue was generally less high profile – the waterbed was subject to little more than a ripple.

When the responses of customers to the introduction of substantially higher and new charges is taken into account, the dynamics get more complex (customers are more inclined to switch away to other current account providers, which effectively adds to the amount of revenue which is 'at risk') and making the waterbed work becomes very much more difficult. Unless the banks play their pricing strategies very carefully indeed, it is far from clear that they will emerge from this episode with their revenues intact – remember, it is thought that the banks generate many hundreds of millions of pounds per annum in revenue from these charges and a potentially massive back book exposure may need to be recovered. In other words, we may be about to find out whether banks can really make the waterbed work and, if so, how. Or, whether it is about to suffer a multimillion pound burst.

Figure 2 – Example conjoint questions

If two were acceptable in all other ways, how important would this difference be to you when choosing a primary current account?

	Not important		Somewhat important		Very important		Extremely important
Account access Branch and remote access —instead of— **Account access** Remote access only	○	○	○	○	○	○	○

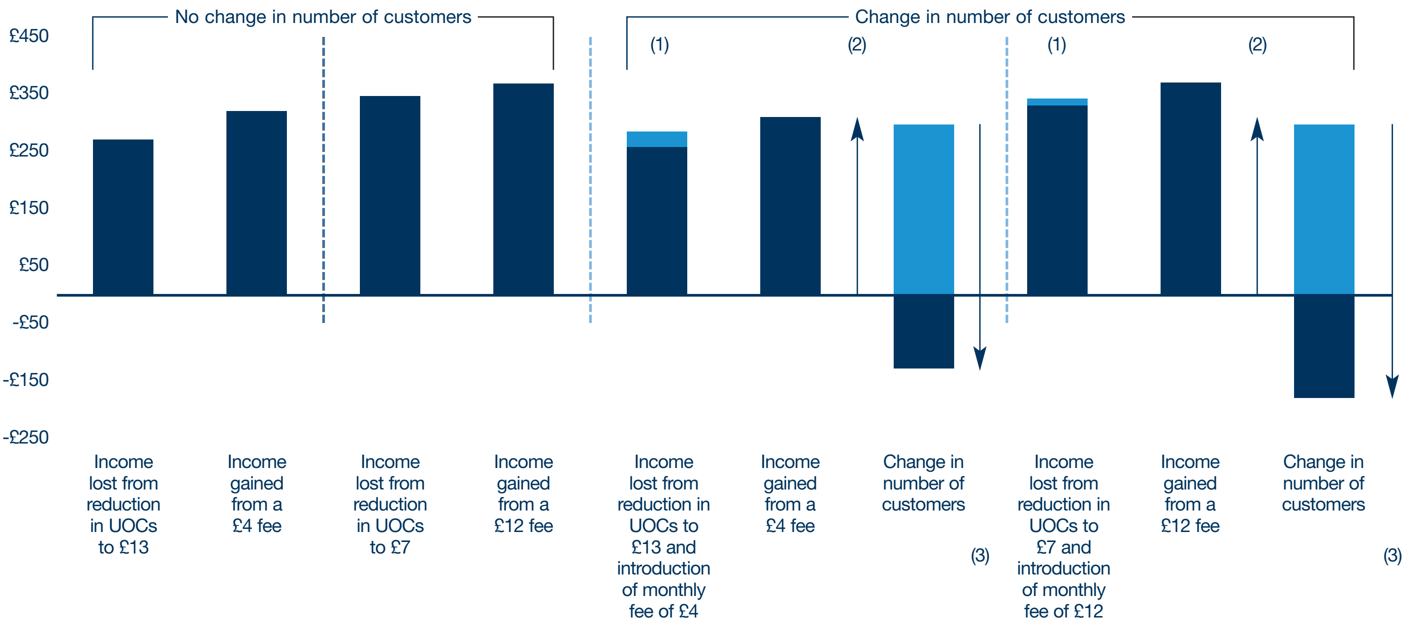
If these current accounts were identical in all other ways, which would you prefer?

Monthly management fee £25 **Authorisation fee for an overdraft** none **Insurance benefits** none	or	**Monthly management fee** none **Authorisation fee for an overdraft** £20 **Insurance benefits** included

Strongly prefer left		Somewhat prefer left		Indifferent		Somewhat prefer right		Strongly prefer right
○	○	○	○	○	○	○	○	○

Source: PricewaterhouseCoopers

Figure 3 - Impact of the introduction of monthly management fees (illustrative example)



Notes: (1) Additional income first when monthly management fees are introduced
(2) Customers gained when all banks reduce unauthorised overdraft charges
(3) Customers lost when monthly management fees are introduced

Source: PricewaterhouseCoopers

Three steps to liquidity risk heaven

The International Monetary Fund (IMF) has described the current financial market turbulence as 'the largest financial shock since the Great Depression'. That may be true, but the eight decades since the Wall Street Crash have not exactly passed without incident.

Banking crises are in fact anything but a rare occurrence. According to an IMF study, no fewer than 133 countries experienced significant banking sector problems in the 15 years from 1980.

During the early 1990s, Finland's banking system went through turmoil following the collapse of exports to the former Soviet Union. In 1998, the Federal Reserve was obliged to organise the rescue of Long-Term Capital Management, a large and prominent hedge fund that was on the brink of collapse. In 2000, the Turkish government sought assistance from the IMF after a series of banking scandals caused interest rates to rocket to more than 1,700% in just a matter of days. Just a few years later, China's central bank was forced to intervene to save the state banking sector from insolvency after the property market became severely overheated.

The recent nationalisation of Northern Rock proves that British financial institutions are not immune from crisis. A sizeable bank with what appears to be a prime residential mortgage book, Northern Rock was balance-sheet-solvent and adequately capitalised. However, it was heavily reliant on the wholesale money market to fund its business and, following a significant fall in that market's liquidity, it was not in a position to refinance its payment obligations as they fell due on an economic basis. Had Northern Rock sought to generate additional cash by selling some of its assets, it would probably have been forced to incur substantial losses. Instead, it turned to the Bank of England for emergency liquidity assistance and eventually passed into public ownership.

The very nature of retail banking business – receiving short-term deposits but granting longer term loans – means that liquidity risk will always be an issue. To satisfy their liquidity needs, banks rely on ready access to the money and asset markets. However, problems can arise, even in a properly functioning market. On the one hand, doubts may arise about the creditworthiness of a bank or class of banks. On the other, a bank may prove reluctant to provide liquidity to another bank if it is uncertain about its own future liquidity requirements.

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Liquidity risks are notoriously hard to predict. Moreover, a liquidity crisis can rapidly escalate. As was seen in the case of Northern Rock, fears about a bank can soon result in depositors rushing to withdraw their deposits. In extreme circumstances, such a run can even spread to other banks.

Not surprisingly, banks take a keen interest in their peers' liquidity risk safeguards and, at times, exert pressure on them to improve those safeguards. Good liquidity risk management is, therefore, about more than just being effective: like justice, it should be done and be seen to be done. Banks need to ensure that their external communications are telling the world that they have the issue under control.

Crucially, banks need to get that message to the regulatory authorities, which are inevitably showing an increased interest in banking liquidity and its management. In December 2007, Clive Briault, managing director of Retail Markets at the Financial Services Authority (FSA), warned retail firms to adopt 'robust stress testing' of their liquidity risk. Published in March of this year, the FSA's internal review of the Northern Rock failure identifies a number of areas for improvement in the execution of supervision that will be advanced urgently by the FSA's management through a dedicated supervisory enhancement programme.

And there's much more to come. Later this year, the FSA, the Basel Committee of Banking Supervisors and the Committee of European Banking Supervisors will all be publishing their considered views on the requirements for managing and supervising liquidity risk.

For a number of banks, some aspects of those views are likely to prove uncomfortable reading. In 2006, a PricewaterhouseCoopers survey of European banks' assets and liability management concluded that:

- There was significant potential for improvement in banks' measurement of risk.
- Gaps still existed between some banks' practices and the guidelines in interest rate risk management laid down by the Basel Committee in 2004.
- Only 72% of small and medium-sized banks had limits to cover all entities with material liquidity risks.

The survey identified a number of recurrent themes. These included: neglected management tools, out-of-date contingency funding plans, deficiencies in the availability of quality data on expected cash flows (particularly for planned new business volumes), inappropriate limits to prevent excessive concentration of funding and a lack of internal challenge. All of these themes need to be evaluated in a broader market context. Most institutions also need to consider the liquidity risk management of the counterparties in their contingency funding plan.

But that is history. Whatever a bank's record for liquidity risk management, it should recognise that it faces a new, more challenging environment. In particular, it must accept that it will now be under far greater scrutiny from the regulators and begin to shape its behaviour accordingly.

Crucially, banks need to get that message to the regulatory authorities, which are inevitably showing an increased interest in banking liquidity and its management.

To enable banks to gauge where they currently stand in the liquidity risk management spectrum, a benchmarking tool can be used.

As a first step, banks should follow the FSA's lead and place increased focus on the diversity of their funding, stress tests and contingency funding plans. The FSA will want to see that a bank is not overly dependent on one or more sources of funding. It will want to see that stress tests (see Figure 1) employ realistic scenarios and have been properly executed. And it will want to see that a bank has established a contingency funding plan that contains a robust strategy for handling liquidity crises as well as procedures for making up cash-flow shortfalls in emergency situations. As ever, governance and cultural attitudes to risk will be important supervisory considerations.

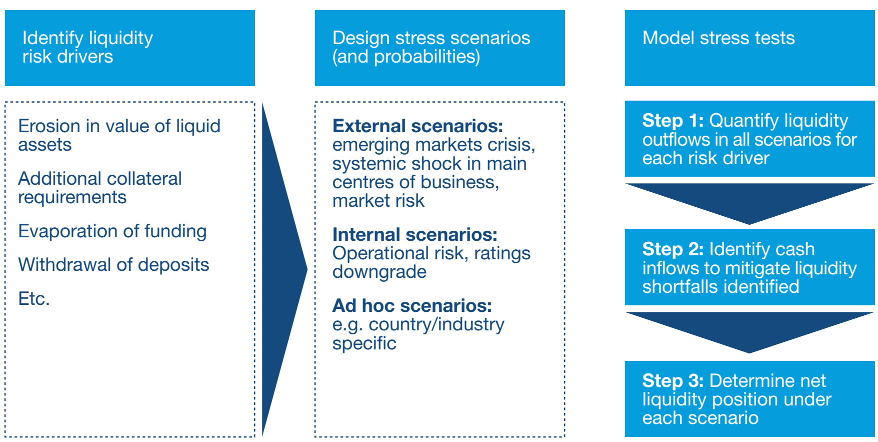
To enable banks to gauge where they currently stand in the liquidity risk management spectrum (see Figure 2), a benchmarking tool can be used, which would consider industry best practice and regulatory requirements to provide a multidimensional assessment of a bank's liquidity risk management framework. The objective of this assessment would be to grade banks against their industry peers and provide a list of prioritised management actions.

The benchmarking tool can also help banks decide where they wish to stand in that spectrum. Do they simply want to satisfy the minimum requirements? Do they want to be seen as market leaders? Or are they happy to settle for somewhere between those extremes?

Some banks will no doubt fear that a commitment to higher levels of good practice will result in an unjustifiable increase in cost. However, good practice should reduce a bank's level of risk and that in turn should lead to lower funding costs.

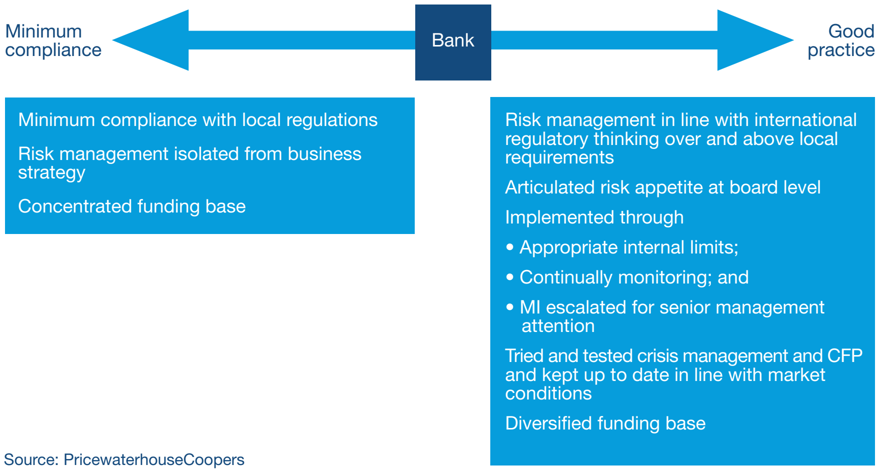
Second, banks should seek a fresh perspective by developing a 360° picture of how they manage liquidity risk. Because such a task is best performed by

Figure 1 – Stress testing approach – example



Source: PricewaterhouseCoopers

Figure 2 – Assess where you stand: minimum compliance vs. good practice



Source: PricewaterhouseCoopers

a fresh pair of eyes, input from an external advisor can be valuable.

Third, banks should recognise the advantages of adopting a strategic approach to liquidity risk management. Instead of waiting to be told what to do by the regulators, they should be pre-empting them.

In readiness for their forthcoming conversations with the FSA, banks should conduct a review of their liquidity policy statements, challenge their liquidity planning's underlying assumptions and re-examine the reporting processes that enable them to monitor and manage risk. By conducting a shadow 166 review, banks can uncover – and then remedy – exactly the types of problem the FSA is likely to be looking for.

A bank that has taken these measures will be in a much stronger and more credible position to hold constructive talks with the FSA. It is, for example, well-known that some members of the industry believe that the FSA's demands for stress testing liquidity go beyond what is reasonable. A bank that has not yet put its house in order will inevitably struggle to win the argument.

Banks should not postpone adopting a strategic approach until disaster strikes. If they do, they may find that they are too busy putting out fires to see the bigger picture.

In short, there is no time like the present. After all, as history makes plain, the next banking crisis is merely waiting around the corner.

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Transactions banking: kill two birds with one stone – less risk more value

The business of payments continues to be subject to sustained 'external change', and this trend shows no signs of abating. The current situation is one where multiple mandatory demands on scarce development capital combine with high-market visibility of important political and regulatory obligations. It is unsurprising therefore that some organisations are struggling to achieve their discretionary aspirations.

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The internal payments infrastructure of many banks is often old, usually difficult to change and therefore fragile to both demand and incident. New, complex and challenging industry demands, including the introduction of near-real-time payments under the Faster Payments Scheme (launched 27 May 2008), is keeping some chief executives, chief operating officers and compliance directors awake at night.

This need not be the case.

Transaction banking

Many banks have overcome the barriers to 'next level performance' by creating commercially oriented and transaction banking profit centres out of their payments areas, displacing the typically distributed, utility-oriented and cost-centre-driven predecessors.

Infrastructure investment is notoriously difficult to unlock in complex organisations. Transactions systems often support many different internal organisational structures, and externally originated change makes timely business cases hard to construct and harder still to agree. It is particularly difficult where transactions systems are run as a cost centre and the sponsorship of change needs to be collegiate. These factors often combine to result in underinvestment and scope curtailment.

By following the profit centre route and also the precedent set by the market leaders:

- Economic profit is easier to manage.
- It is easier to have key strategic issues debated at board level.
- Investment decisions are simplified.

- Accountabilities are clarified.
- Supply-side change can be better managed.

Customer-facing business requirements are also more easily accommodated, and if these principles are applied, operational productivity and operating performance can both be raised.

Retail customer expectations

Retail customers expect their banking service providers to get their transactional needs right – right first time, and right every time. With little tolerance for error, politicians and regulators championing consumer rights and 'red top' editors being ever ready to run headlines about banking mistakes, it is essential that banks have resilient, available and effective transactions processing and management systems. These systems and the change environments within which they are maintained must also be capable of meeting the needs of the current and emerging market needs.

The need to get it right can best be seen in what it means to get it wrong.

On 30 March 2007, the participants of the Bankers Automated Clearing Services (BACS) payments scheme were forced to issue a statement[1] to the market admitting problems with the processing of salary payments. On that particular Friday, *circa* 400k customers did not receive their payroll as they expected. The consequence for the affected customers was potentially significant; missed mortgage payments, bounced cheques, insufficient cash for weekend activities, overdraft charges and damaged credit rating implications.

The consequence for the affected banks was certainly significant: damage to their reputation, opportunity loss of future revenue and also the cost of mitigation and remediation. For the people involved in managing the incident it was an uncomfortable time: dealing with imperfect and incomplete data while trying to provide coherent and reliable information to many internal and external stakeholders.

There are clear, operational and business synergies to be obtained by bringing the transactions management together, and these scale efficiencies also apply to effective risk and incident management.

Retail customer demand

Customer demand at the basic level remains constant and it is the ability to undertake a transaction using an instrument of choice, in a channel of choice and at the time of choice. At the more advanced level, this means the ability to self-serve, transparency of key terms and information throughout the process. It also means being serviced in new channels and with new technologies such as mobile telephony or contactless payment cards.

The key to success is having a great customer interface and experience, especially something that:

- Recognises the need to offer people/individuals something they want to be identified with;
- Fits in with their own brand choices;
- Gives them a sense of control; and
- Is easy for them to use at the time that they want to use it.

There are clear, operational and business synergies to be obtained by bringing the management of transactions together, and these scale efficiencies also apply to effective risk and incident management.

[1] Association of Payments and Clearing Services press release – 30.03.07.

In mature markets, particularly markets with high barriers to entry and that exhibit stable market share, data mining can be immensely effective in generating new revenue streams and in establishing a differentiated service proposition.

Downstream business areas need to be freed from infrastructure issues to focus on segmented customer marketing, their commercial propositions and their relationship management.

Valuable customer data

All organisations understand how important it is to know their customers as individually and uniquely as possible. Typically, this means understanding individual needs and then being able to relate those individual needs to the actual priorities of each customer at any given point in time. Within a bank, few systems have an ability to provide insight into a customer lifecycle or into current customer priorities as transactions' systems do.

In mature markets, particularly markets with high barriers to entry and which exhibit stable market share, data mining can be immensely effective in generating new revenue streams and in establishing a differentiated service proposition. Successful data mining is not simply a data warehouse, the use of sophisticated interrogation tools and a periodic ad hoc analysis. Success is determined by integrated process management, detailed transactions analysis and alignment with a clear customer segmentation and strategy.

Non-banks are achieving very high levels of personalisation in their engagement with customers, and new entrants to the retail market such as PayPal have clearly raised the competitive standard. Although PayPal is now a bank, it achieved a financial performance to rival that of a global bank's transactions business. It has achieved this by providing an interface to bank services, having an effective launch strategy and giving to customers the things that they valued: convenience and the ability to keep their financial accounts private.

Customers are clearly happy paying for a compelling proposition.

Transactions banking, once formed, should be challenged to unlock the value in its possession. No other part of the banking business sees so much customer activity, or sees it as often as the transactional processor does.

The payments council in the UK

Retail transactions have been a particular focus of regulatory attention and review within both the UK and also more broadly within the European Union. The Payments Council undertakes a strategic role in the development of payments in the UK, and it was set up by the payments sector in response to a number of general reviews[2] in the UK, and to address specific recommendations of the Office of Fair Trading (OFT) Payment Systems Task Force.

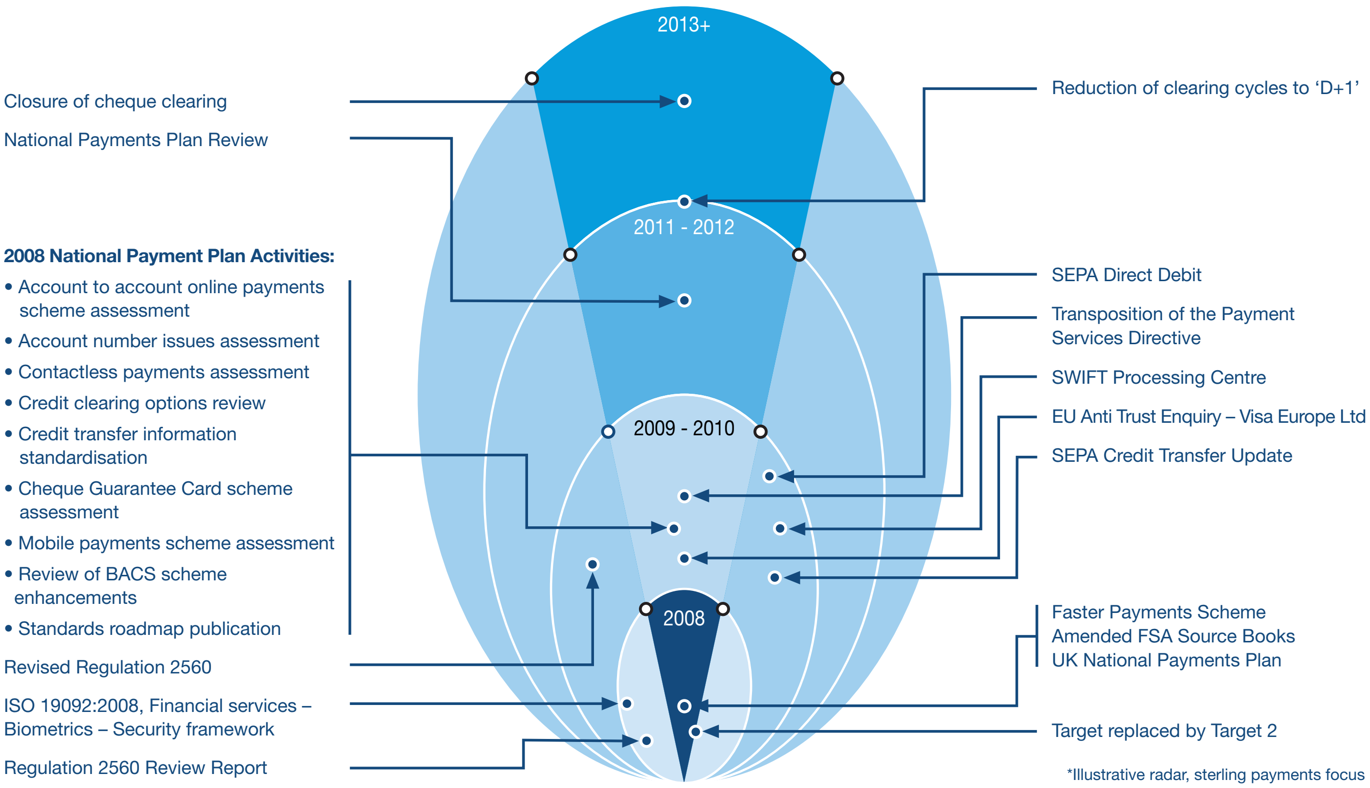
On 14 May, the Payments Council published the UK's first National Payment Plan, and this document sets out the way forward for payments in the UK to 2018. As retail banking leadership teams now assess their potential business strategies, the National Payments Plan sets boundaries and issues that must be understood and taken into account.

A burgeoning portfolio of change

The UK National Payments Plan is not the only agenda item that retail banks need to 'have on their radar'. Europe is a prodigious source of change and the implications of many interventions are being felt right across the transactions supply chain. This is particularly evident in both the vision and formation of the Single Euro Payments Area, which is redefining the European marketplace.

[2] Cruikshank D, Competition in UK Banking. A Report to the Chancellor of the Exchequer (2000); Office of Fair Trading, UK payment systems (2003)

Figure 1 – What's on the radar: retail payments*?



*Illustrative radar, sterling payments focus

Source: PricewaterhouseCoopers

Figure 1 provides a graphic illustration of the scope and scale of some of the changes that banks need to manage. Some changes will clearly be at the top of the management agenda, but all changes require effective governance, analysis and responses.

Regular review of a retail payments radar helps to ensure that nothing is missed, that decisions can be taken at the right time and that strategies can be optimised. 'What should I have on my radar?' is a common refrain of management.

By effectively linking industry, regulatory and public policy management to change management, there is no need for managers to be unclear about what they should have on their agenda and in their plans.

In short, early visibility and better linkage of change would allow more sleep to be had.

The beginning of the end for proprietary retail banking systems?

Many UK banks are struggling to maintain legacy retail banking systems, which have been developed over 30 years and are now increasingly difficult to maintain.

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The original purpose of these systems was to support the branch working day – a 1970s environment that the modern retail banker would barely recognise. Processes and systems were designed to support the movement, tallying and reconciliation of a flood of paper vouchers that moved between branches and banks. Each voucher was manually keyed into a computer terminal up to three or four times as it navigated across the banking network. Even ATMs were not excluded from this approach: the early cards were retained by the machine, attached to a paper voucher, manually keyed into a computer terminal and posted back to the customer.

The branch online day would typically span 8.30 a.m. to 5.30 p.m. Overnight, mainframe batch processes would capture data keyed during the day, perform reconciliation and post entries to customer accounts and ledgers. Charges, credit and debit interest would be applied quarterly or half-yearly. The systems were invariably mainframe-based and were typically heavily bespoke, with limited documentation and a restricted knowledge base.

Additional functionality was added over the years with the advent of radical changes to the retail business model. Predominant among these was the provision of cash management systems to the corporate world, which inevitably created a demand for real-time account data from corporate treasurers; meanwhile, the banks realised they had a similar need for real-time data to support an automated authorisation capability for ATM and point-of-sale transactions.

Another major driver was the arrival of new delivery channels such as telephone and internet banking and the associated customer demand for extended availability to support these new channels.

In both cases, the banks shied away from re-engineering their core systems and instead responded with tactical solutions that satisfied the immediate demand, but which added to their systems' complexity and which reduced stability.

Today, continued changes to the business model, along with changes in regulatory and reporting requirements and industry initiatives such as faster payments have stretched many legacy systems to their limits.

It is progressively more difficult to make system changes and the systems themselves can increasingly become a bottleneck in developing new customer products and service offerings.

Many major banks are seeking to address the challenges posed by their ageing core banking systems. However, while the challenges are consistent, the approach taken to move forward differs significantly.

The approaches that banks take can be broadly summarised by imagining a continuum (see Figure 1) where, at one extreme, legacy systems continue to be patched and updated, while at the opposite extreme, IT is outsourced wholesale. In-between, there are many intermediate options, including the use of multifunction third-party vendor application and third party application hosting.

There is no single 'right' answer. The appropriate model will depend in part on individual organisations' history. But the emergence of ambitious business and operating strategies is likely to play an increasing role.

A significant example is the trend towards bancassurance models.

Having recognised two decades ago that traditional banking and mortgage services should form part of the core product set, UK retail banks are now increasingly adopting the same attitude towards complex insurance products and the ability to leverage their respective customer bases to maximise cross-selling opportunities.

A more advanced form of this model aims actively to 'bundle' both banking and insurance products – either through offset pricing or through fully integrated products. Both have the ultimate aim of increasing the number of products that individual customers hold.

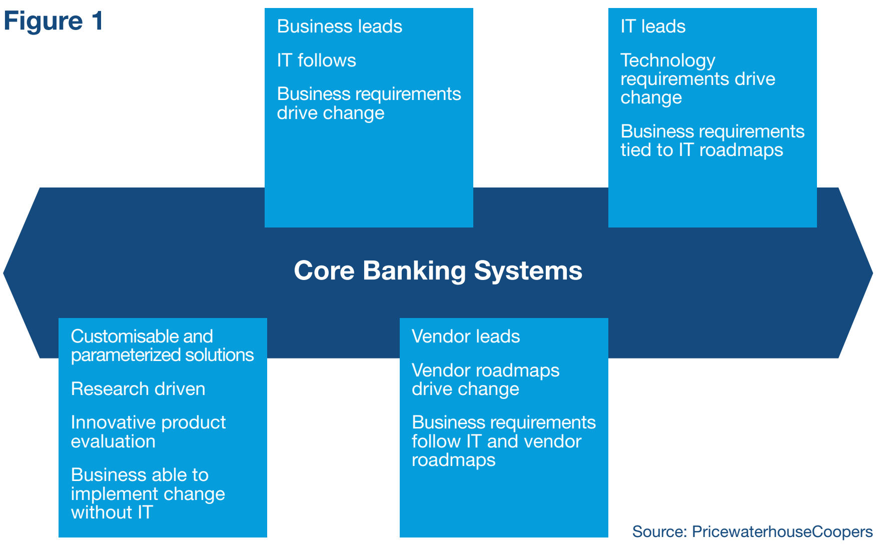
This approach necessitates a customer-centric view, rather than the more traditional product-focused view. The requirement for strong and reliable customer segmentation information has led to greater adoption of CRM (Customer Relationship Management) tools. The simplicity of this statement hides a complex range of operational and technology challenges.

Many banks have concluded that the complexity of these requirements drives a vendor strategy, which moves away from the internal IT development model that has historically been followed by the industry. This strategy recognises the existence of off-the-shelf products which have matured significantly in recent years as the market has expanded. They can provide multiple functions and help address both the short-term challenges faced by the existing systems, but also enable key components of new business strategies which demand a widening of the core business product set.

Our experience indicates that there are a number of important considerations when selecting a single (or in reality, primary) vendor strategy:

- The capability of vendors must be thoroughly assessed, both in regard to current capability and commitment to development and innovation going forward, which will allow the bank to develop its own products and service offerings further, in future.
- The need to establish efficient integration with the existing organisation and technical infrastructure early in the process.

Figure 1



Source: PricewaterhouseCoopers

- Contracts should be structured specifically to allow for change and growth in services.
- The impact of technology change on staff and customers needs to be planned for and understood.
- Robust business and benefit cases need to be established with the benefits/costs being tracked and addressed.

We see clients taking different approaches to adopting product bundling models. Typically, financial organisations with a greater emphasis on insurance, rather than banking, do less cross-selling. Various sources of research show customers of insurers having, on average, two or fewer products. The corresponding figure for banks is typically three or four products. Both of these figures are significantly lower than leaders in other industry sectors – for example, Microsoft and Vodafone, which are often held as examples of organisations at the forefront of cross-selling.

The more innovative financial services organisations are now looking to see how they can emulate the likes of Microsoft and Vodafone by intelligently linking products in common bundles. If this approach approximates to a client's business vision, this will impact directly on the choice of solution and architecture they face.

As little as five years ago, the business argument in favour of this approach would have been more than counterbalanced by the technical risk of radically re-engineering core systems towards unknown and largely unproven solutions.

It is now evident that the pendulum is swinging the other way.

So what has changed? We see three key factors. The first is that, for many, the crunch point for legacy systems is fast approaching. Many UK banks, particularly in the mid-tier and below, have concluded that continuing to support legacy systems presents a greater technical risk than to replace them. For several, the crunch point was the Faster Payments initiative, which stretched the older legacy systems and resulted in several postponements to the launch. For several UK banks, it was one tactical solution too far.

The second factor is the technical landscape itself. Irrespective of whether a vendor or an in-sourced approach is preferred, there is now a near-universal acceptance that the integration of new systems needs to be greatly simplified. Typically, each new banking system needs to interface with its upstream and downstream neighbours; the traditional solution to this was to install a complex series of point-to-point links, each with its own proprietary communications protocol. As a result, the incremental costs of implementing each new system spiralled upwards. This 'spaghetti' approach is no longer acceptable. There is now a convergence towards the use of high-performance middleware with standard communications protocols, enabling a rapid 'plug and play' approach to installing a new system using a single interface to the middleware. This facilitates a modular approach.

The third factor is the maturity of the vendor offerings. Vendors of core banking systems have long concluded that their products need to be architected in modules that can either combine with each other or can integrate with proprietary systems through standard middleware or bespoke integration. This, in itself, is not new. It was an argument that, for a while, was outweighed by the experience of several high-profile projects that encountered significant problems. But this is changing – vendors' ability to deliver is now being demonstrated and the banks' perception of the technical risks has now moved decisively. The remaining concern is whether vendor products will allow them to differentiate themselves competitively from their peers, particularly through: rapid design and delivery of new products to market; innovative pricing; and efficient servicing through a single customer view.

It is evident that the outlook has now moved beyond the debating phase. Several UK banks are now publicly committed to strategic banking systems replacement projects using vendor products at the core. While these are mainly at the mid-tier, we have seen at least one global player departing from its historic in-sourcing approach to consider a vendor approach for part of its product set. Others are keeping silent for the moment – but tellingly, perhaps, no-one is admitting to seriously considering the option of a full out-sourced replacement of core systems.

Every cloud has a silver lining: the receivables management sector across Western Europe

Over the last few years, the European outsourced receivables management sector (RMS) has been quietly undergoing significant change with 21 major M&A deals announced in the last five years.

There has been significant cross-border consolidation and an influx of capital into the RMS. Significant interest has been seen from private equity (PE) investors and increasingly from investment banks and alternative investors. Why is an industry that is so misunderstood by the public seen by professional investors as an attractive investment sector? What can lenders learn from the changing face of the market?

'Big guys with baseball bats' is the typical public misconception of a debt collector. In reality, outsourced debt collectors today are more likely to be call centre workers whose organisations use some of the most up-to-date information technology to identify, track and contact delinquent debtors. While the debt collection industry may have more work to do in correcting the public perception of their image, private and institutional investors have started to take an increasing interest in the sector. Lenders should now be reassessing their collections strategy as more options become available in the RMS.

M&A deals in the RMS space are significant

Key features of the 21 major M&A deals that took place in the Western European RMS in the period since 2003 are:

- Cross-border deals are the norm, 11 deals out of the 21 were true cross-border deals. In many cases these involved existing RMS businesses seeking to build geographic reach across Europe by purchasing smaller local operations.
- The trends in cross-border M&A deals reflect the relative development of the individual markets in Europe. Early attractive investments were found in the Scandinavian and UK markets in 2003 and 2004, reflecting their more developed nature.
- There has then been a trend of investment from Scandinavia into the UK and Germany during 2006 and 2007.
- Of particular note is the possible formation of an Anglo:Iberian axis where UK RMS businesses are seeking to capitalise on Spain's relatively high consumer finance

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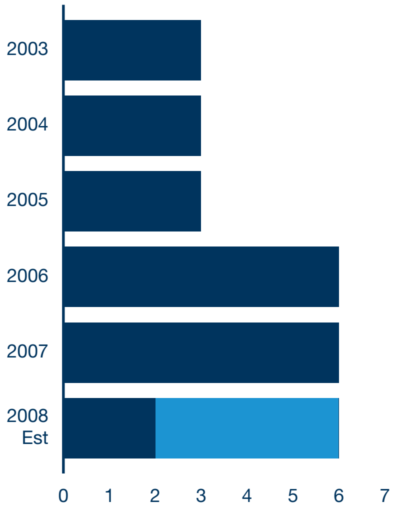
Figure 1 - Number of Deals per year



There has been a step change in the number of deals being done in the RMS sector

Source: PricewaterhouseCoopers

balances, its open investment climate and the beginnings of a debt purchase market in Spain. Both Cabot and 1st Credit of the UK have Spanish operations and other professional investors are testing the market.

Deals have tended to be domestic

Interestingly, nearly all the PE-backed deals done were domestic in nature, with Norwegian Altor's 2003 acquisition of Finland's Contant Oy being unusual as a cross-border deal, albeit in a region with close ties. The prevalence of domestic deals for PE house investments perhaps reflects the relative lack of knowledge of the RMS in the PE sector prior to 2008. In particular, they appear to have been many more PE deals done in the UK than in other countries, a factor that probably reflects the relative stage of development of the UK PE market, rather than just the development of the RMS in the UK.

National champions are being built

The established trade players of Lindorff and Transcom accounted for five deals and four deals apiece (of which one Lindorff deal was a PE investment in Lindorff itself). These deals were mainly cross-border, reflecting the growing internationalisation of the RMS industry. Further national champions are developing across Europe, challenging those businesses (e.g. Intrum Justicia) that already have a pan-European footprint.

Figure 1 sets out the number of major RMS M&A deals identified for the five-year period to 2008. There appears to have been a step change in the number of deals in the period, with the number of deals per year doubling from three to six. The 2008 figures are for the period to April 2008, with a pro rata indication of the potential year-end position.

Since the figures above were compiled, Investor AB has announced its acquisition of 50% of Lindorff. This deal valued Lindorff at €1.2bn suggesting that the RMS sector remains attractive to investors.

Why is the RMS attractive?

Indebtedness is rising and is proliferating

There is record indebtedness in the mature European lending markets combined with an expectation of rising levels of default. In less mature European markets there are rising levels of consumer indebtedness. Across Europe there have been increases in the availability of consumer debt and the proliferation of consumer debt (e.g. mobile telephony, pay-to-view TV and utility debts) is increasing the available pool of debts to collect. Potential recessionary environments across Europe may result in a temporary slowdown in the ability of debtors to pay, but this should be compensated for by the increased volumes of debt to collect in a recessionary environment.

The market is fragmented but is consolidating

The European RMS industry is largely fragmented. As an example, the Credit Services Association (CSA) – the UK industry trade body – has just under 300 members, with over 50 of these having turnover of over £5 million per annum. In other European countries the position is even more fragmented with over 500 RMS members of the German industry association and some 100 in each of France and Italy. Given the relative fragmentation of the market, there is an element of consolidation that must inevitably occur, as well as the competitive effects of smaller players potentially being squeezed on price and services by larger, more diversified competitors.

Delinquent debt purchasing is a key opportunity for investors
A facet of the market is the increase in delinquent debt sales taking place by regulated lenders. Lenders are selling delinquent debt increasingly as an element of good balance sheet management. Sophisticated sellers now make provision for delinquent debt to the estimated sale price and have rolling sales mandates in place with panels of potential debt purchasers.

In the UK, companies have specifically formed for the purposes of being pure debt purchase businesses, including Cabot Financial, Link Financial, Lowell and Thames Credit. Many large agency debt collection firms have also commenced activities in the debt sale area, having observed the significant returns that are earned by some of the pure debt purchasing businesses.

The development of a delinquent debt purchasing industry is occurring throughout Europe, with the UK and Scandinavia leading the way. In the UK the CSA reports that in 2006 some 29% of market participants purchased debts with a face value of £200 million or more during the year. While the UK and Scandinavian markets are relatively mature, the markets of Spain, Holland and Germany are rapidly developing their own debt purchasing industry, in part funded by external capital from PE-backed corporate purchasers and from alternative investors (e.g. investment banks).

What can lenders learn from the changes in the RMS market?

RMS businesses are attractive to professional investors, leading to market competition for lenders' collection business

In comparison to traditional financial services businesses, RMS businesses have relatively little regulation to follow and have no capital adequacy requirements and (in particular for debt purchase businesses) produce near-cash earnings before interest, taxes, depreciation and amortization (EBITDA). Typically, RMS businesses have low working capital requirements, with the exception of portfolio funding. In addition, in debt purchase businesses, virtually all of the EBITDA is cash-based income, as revenue is typically the collections made to date. Consequently, there are relatively low financial barriers to entry, other than obtaining funding to purchase delinquent debt portfolios. Interest in the RMS from professional investors continues unabated, with many professional investors looking for opportunities to acquire debt purchase businesses. Consequently, it appears that competition (caused in part by the interest of professional investors in the market) will offer some price protection to lenders seeking to sell delinquent debts.

Using outsourced RMS may offer cost savings to lenders
Many RMS businesses offer a significant cost saving in the collections process. In practice, it can be cost-effective for lenders to outsource the collection of those debts that are known to be 'gone away' or require an element of debtor tracing to specialist RMS businesses who have developed in-house systems to aid finding debtors. In these cases, agency debt collection allows lenders to manage their cost base as commissions are only paid on a successful collection or, in certain cases, on a successful trace.

Debt sale strategies may allow banks to reduce the size of their in-house debt collection teams or to refocus existing teams on curing early stage delinquency rather than the recovery of later stage delinquency. In some cases, significant IT expenditure, associated with building in-house collections capability, can be avoided if outsourced RMS or debt sale strategies are pursued. Both reshaping the collections department or avoiding large scale IT investment can have beneficial effects on lenders' results, although it seems unlikely that any lender will completely outsource collections.

Debt sale may also offer benefits to lenders
Lenders are increasingly seeing debt sales as part of the normal cycle of debt recovery, with some lenders providing delinquent debt to its estimated sales price. Auction processes, using a preapproved panel of debt purchase companies and a regular cycle of debt sales are becoming the norm for large consumer finance and unsecured lenders. With sales happening regularly (every month or every quarter), lenders have become more comfortable in that the reputational and ethical concerns over using debt sales have diminished. Lenders who are required to hold capital under Basel capital adequacy regimes may find that selling fully provided debt from their balance sheets frees up capital by exchanging delinquent debt for a small cash amount.

In addition, lenders may find that by dividing delinquent debt into tranches, which better reflect the differing appetites of debt purchasers, achieves higher prices. For example, lenders are now separating debt that requires an element of trace work from that where trace is less important in order that debt purchasers who believe they have a competitive advantage in trace can acquire that element of the sale portfolio. Over time further portfolio segmentation may emerge, perhaps identifying and separating tranches that require more legal execution or those where execution will be through charging orders.

Some debt purchase companies are already actively pursuing secondary sales of unprofitable debts to specialist collectors – suggesting that lenders should consider whether they follow suit.

Debt sale strategies can be hard to reverse once implemented

Debt sales, once commenced, can be hard to reverse or stop, as the effects of debt sale are felt in the profit and loss (P&L) account and in the systems of the lender. The small positive impact that debt sales can have on the P&L account are largely immaterial. Harder to reverse are any prior resizing of the in-house collections team and any reduction in investment in the team's systems, people or controls, as a result of a debt sale strategy being pursued. In some of the M&A deals seen in the RMS, lenders have sold their collections business with the delinquent debt portfolio as a package and have concluded agreements to outsource the collection of future delinquent debts.

Debt sales are currently national but could become European

At present debt sales tend to be organised on a national basis, with pan-European banks selling separately in each jurisdiction. Over time, and assuming that pan-European RMS businesses emerge, banks may move towards centralised debt sales to improve the efficiency and standardisation of debt sales and hopefully to increase prices.

Debt sales should be part of the M&A process for lenders

Generally, fully or heavily provided delinquent debts in a lending business are valued at close to zero by potential purchasers of that lending business. Lenders are increasingly using debt sales prior to, or as part of, the M&A sale process. The use of debt sale in M&A has two principal objectives:

- It provides value for fully or heavily provided delinquent debts and by taking these debts off the balance sheet of the target.
- It helps reduce debate on the appropriate level of provisioning in the target.

In-house collections teams may have an intrinsic value

Where a lending business has been purchased with an in-house collections team, M&A synergy assessments may assume cost savings in the target's or the acquirer's in-house collection team. In the past, lenders have often assumed that cost savings will be achieved through a combination of natural attrition or redundancy. Going forward, the growth in the RMS and the number of deals taking place within it may mean that lenders should re-examine the potential of collection teams being acquired through M&A activity. In particular, collection teams acquired as part of M&A activity might be sold, or transferred into a joint venture with those PE-backed RMS businesses seeking entry into other geographies.

What does the future hold?

What does the future hold for European RMS businesses?

Further consolidation is inevitable in the RMS industry as the larger businesses seek a true pan-European footprint. In many cases, the pan-European footprint will be obtained by purchasing or partnering with a local RMS player in order to get the benefit of the existing collections processes and data held by the local business. Lenders should re-examine whether collections teams (either in house or acquired as part of other M&A processes) could be sold to or partnered with the expanding RMS market.

Once the pan-European businesses are established, we may see smaller infill acquisitions designed to exploit specific niche segments of the debt market. Specialist in-house collection teams may become targets for these infill acquisitions.

Increasing price pressure will be felt by debt collection agents who will be squeezed by both lower commissions caused by an oversupply of small RMS firms and by a lower supply of agency debt collection mandates (as debt sales increase throughout Europe). Lenders should be ready to take advantage of price pressures and might get keener commission rates by seeking pan-European arrangements.

We may see debt sales becoming more institutionalised in major European lenders, leading to panels of debt purchasers who are able to work with the lender 'across Europe'. The result will be a concentration of the market into bigger and better known debt purchasers who may therefore wield greater market power. However, in the short term, competition between debt purchasing firms for volume will continue to drive pricing on the sale of delinquent debt portfolios.

The business will become increasingly data-driven. Staff with statistical backgrounds will help the business understand how and why efforts should be focused on specific portfolios or account types. Behavioural scoring will become commonplace. As a result, lenders may see increased competition from RMS businesses in the employment of experienced risk and statistical employees.

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