

UK Retail Banking Insights

Evolving Industry Observations*

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

In recent months we have seen a vivid reminder of the consequences of mismanaging risk. In the increasingly complex and globalised world, risks may not be identified or may be inappropriately measured. You therefore won't be surprised to see that this edition focuses on topical risks being faced by the retail banking sector.

Unsurprisingly, we have two articles relating to the credit crunch – one on the cause and the other on the effect. In our lead article: 'After the crunch: What next?', Andrew Gray focuses on how industry players can be better placed to deal with the effects of the next financial shock. Robert Boulding, in his article, 'The US sub-prime story: Contagion or distraction?' focuses on the causes of the US sub-prime lending difficulties and whether these could be replicated in the UK lending marketplace.

The risk theme continues with our article on whether firms are seeing business benefits arising from Basel II, penned by Richard Barfield. His paper is based on the outcome of discussions he chaired at the PricewaterhouseCoopers¹ June Basel Executive Forum. Although these discussions took place before the credit crunch began to bite, his article demonstrates that despite the huge amount of work that banks have put into Basel II, there has been little impact to date on product pricing, and doubts remain about whether Pillar 3 will really provide the marketplace with comparable data on risk, which has clearly been lacking in recent months.

Our remaining two articles focus on the risk of Small and Medium Sized Enterprise (SME) customers switching to other banks and regulatory pricing risks.

Our paper on the SME business banking sector by David Wardrop-White argues that banks can differentiate themselves by focusing on the emotional aspect of their customer relationship rather than just the more usual product, service and price aspects.

Tim Ogier's article on economic regulation challenges whether industry players have sufficient focus on managing their relationships with the regulators and whether they are moving fast enough towards a customer, rather than product, profitability mindset.

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 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

After the crunch: What next?

The full effects of the much-predicted credit crunch are probably still to be felt, but what is certain is that more challenges will come. As events unfold, it is becoming increasingly clear that the impact on individual organisations is varying considerably. Businesses must take time now to prepare themselves for further shocks.

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One question still to be answered in the wake of yet another ‘once in a lifetime’ financial crisis is: how bad can it get? For some, the answer is ‘very’. Other businesses are more robust, or have been able to take preventative action. The ripple effect of the credit crisis on business (which, more accurately, is a shortage of liquidity and difficulties in pricing credit risk) that began to unfold in August 2007 could have the potential to be deeply damaging to the conduct of everyday business, to reputations and to attitudes to risk. And the full extent of the impact is still unfolding.

Yet this was a crisis long predicted, although the speed and severity caught almost everyone out. The roots of it go deep – into the dot-com crash of 2000 – when, around the world, the response was to keep interest rates as low as possible to encourage a return to economic confidence. Money became cheap and plentiful, and as a consequence, investors increasingly found themselves competing for assets, the pricing of risk became increasingly difficult as structures became more complex, and frequently investors underestimated the real risk. With low interest rates, benign inflation and rising asset prices, all was going well. As interest rates have risen over the past few years, the chickens have been coming home to roost. A combination of questionable lending practices of some US mortgage lenders, falling US property values and the consequential defaults by overborrowed mortgagees, has caused widespread credit losses on sub-prime mortgage portfolios.

This may have been a local difficulty for the US, except that many of these poor-quality assets were, when originated, bundled into various types of investment securities, so-called ‘asset-backed securities’ or collateralised debt obligations (CDOs), and sold to investors and financial institutions around the world, many of them respected household names. The initial shocks were significant, but also resulted in contagion into other markets. The problem was that the downside risk was not fully reflected in the asset prices. Some are now questioning the assignment of credit ratings. Nobody really knows who is left holding how many of these parcels of overvalued assets, hence the profound reluctance of financial institutions to lend to each other for fear of throwing perfectly good money after bad.



Further complications exist in the pricing of these assets for those that do hold them. In the absence of liquidity in the market and price transparency, the calculation of fair value of assets requires a far greater degree of management judgement. This is compounded by the fact that there are examples of holders of assets not having complete records of the actual assets backing the securities they have purchased.

Surprises are likely to continue for some time, driven by the lack of transparency of asset ownership, the complexity of the asset-backed structures, the differing degrees to which conduit vehicles can look to sponsors/managers for support, and the nature of risk transfer in today's complex financial world.

On the edge?

Market corrections can easily become crashes as confidence is lost. The threat goes deeper than the possible extent of credit losses on complex asset and derivative products. This latest financial crisis could seriously affect business revenues and costs more widely. However, the US Federal Reserve Bank has cut US rates, stock market values have remained

buoyant, and Bank of England auctions to provide liquidity, albeit at a price, have gone unused.

All firms will have to factor in the likely impact of a weakening economy and housing market on loan loss provisions and recoveries. Concerns remain that the liquidity crisis in the debt markets could spill over into the equity market and trigger a steep fall in prices (a fear that was unfounded at the time of writing this article as the FTSE 100 stood at over 6500, only 3% off the 12-month peak). For the moment, firms that hold good levels of cash and employ a spread of short-, medium- and long-term funding methods are largely unscathed by the credit crunch. In the short term there may be casualties across all sectors among businesses that are reliant on short-term funding from the debt markets. But if rising mortgage rates undermine High Street spending, businesses that depend on consumers' discretionary spending will be impacted. Ongoing evidence from the US points to problems in the housing market, and elsewhere consumers appear to be showing greater willingness to manage to lower personal debt levels.

Financial services companies will struggle with portfolio risk and complexity, the difficulty of fair valuing assets and the need to rapidly rethink strategy in the light of radically changed conditions. Banks and fund managers, in particular, face a rocky time working through the repercussions of investors' failure to fully understand the risks they were taking on. Far fewer are now prepared to buy securities such as the commercial paper and certificates of deposit issued by banks and building societies to raise short-term money. And more institutions are reluctant to undermine their own strength by lending to others. The most popular home for cash is overnight deposits held by banks with the strongest credit ratings and where the funds can be called at any time. The market has already begun to differentiate much more sharply between issuers, to the benefit of those with the strongest balance sheets.

Other difficulties include a reduction in securitisation and conduit administration fees, and underwriting fees for mortgage packaging. Some hedge funds could go out of business and lead to cuts in prime brokerage fees. Credit rating agencies are coming under significant scrutiny, and may

Alongside the threats to business, there are opportunities, and money is still available for good quality propositions. In the financial services sector, the short-term funding famine could accelerate the rate of consolidation.

well adopt a more cautious approach in the future. As a consequence, credit ratings may be affected, raising funding costs and regulatory capital related charges. The sheer volume of market activity still continues; some markets reported record volumes in August 2007. This will put companies under operational pressures too, such as in deal processing and settlement and account reconciliation. Not only might operational costs rise, but there could also be lapses of control leading to operational losses.

Opportunities

Potentially the most serious loss of all could be loss of reputation. Many consumers are already highly sceptical of the financial services industry and the recent events are another blow to reputations. There is also a danger of overreaction and some good assets may be marked down with the bad ones.

However, it's not all bad news. The fact is that corporate UK is still relatively lowly geared and companies are holding a fair amount of cash. This could be the moment to do deals. There is a backlog of deals to be done, as well as a great deal of money available to invest, with

Asian growth and Middle Eastern oil dollars adding to the funds needing to find a home. Alongside the threats to business, there are opportunities, and money is still available for good quality propositions. In the financial services sector, the short-term funding famine could accelerate the rate of consolidation. Certainly, from a long-term perspective, current market prices for bank stocks look low. And one consequence of the impact on the private equity sector of the credit markets turmoil is that backers of M&A deals are likely to be sitting on their hands. This gives strong trade buyers a chance to make strategic acquisitions without seeing prices driven up by private equity backers. Companies that have accumulated a war chest of funds for just such an eventuality will now be well placed.

What are the next steps?

Organisations can, and will, continue to make money where they manage risk effectively. Those that do well will be increasingly sophisticated, as discussed below. However, of critical importance is ensuring that there is adequate governance over the steps taken.

Stress testing

Whilst the wider economic picture remains unclear, the best advice for many firms across all sectors may be to take a wait-and-see approach – and a careful look at their businesses, stress testing them for both economic slowdown and full-blown recession. And it would be useful to factor in the wider commercial and operational impacts through combined risk, valuation, economics, operations and HR teams.

There are practical ways of approaching the problems. Certainly, for financial services firms, some crisis management may still be necessary in the form of asset and portfolio revaluation on a mark-to-model basis for both management and statutory accounting purposes – and this may need some independent validation.

Financial forecasting and strategy may need careful reappraisal. Many assumptions underpinning strategies, plans, budgets and transactions could well need revision and material change might also have to be disclosed under regulatory, statutory or stock exchange obligations.

In the medium term, detailed contingency plans for disaster recovery and business continuity need to be prepared to achieve a clear understanding of what to do in the case of a sharp market deterioration. A lot of work may need to be undertaken to implement changes to models, policies, processes and operations in response to lessons learned. Firms need to be well prepared for the next ‘once in a lifetime’ financial shock.

Reviews required

In the meantime, the crunch could well shake out further changes in regulation, or prompt further demands for change from stakeholders. Various reviews may be required and a simple checklist might look like this:

Reviewing risk model adequacy:

- Transparency of exposures;
- Back-testing of model assumptions, particularly on:

1. Asset volatility;
2. Asset liquidity; and
3. Asset correlation.

Reviewing valuation/reporting system adequacy, concentrating on:

- Transparency, validity and robustness of valuation models;
- Accuracy and quality of underlying reference data;
- Adequacy of controls on model use and maintenance;
- Consistency in the bases and assumptions of risk and valuation models (particularly as assumptions may not reflect recent experience); and
- Effectiveness of risk escalation procedures in the event of serious market volatility or disruption.

Reviewing organisational capacity:

- Check policies, procedures and availability of skilled people to respond quickly and effectively to serious market volatility or disruption to stem losses (or even make profits).

Also review the adequacy of:

- Limit framework;
- Reporting framework;
- Stress-testing procedures;
- Review operational capability to handle the situation, with particular focus on:
 1. Process effectiveness;
 2. Infrastructure effectiveness;
 3. Functional capacity (front, middle, back office);
 4. Straight Through Process/workflow evaluation.

For the moment, the market appears to be safe from multiple bank and building society collapses. Sooner or later, the scale and depth of the sub-prime crisis will be measured and liquidity will return to the short-term debt markets.

There is now a deeper, broader distressed debt and impaired asset market than ever before. Hedge funds, brokers, vulture funds and activist investors can price just about anything that smells like a deal, and there is more data on downside risks as well as upside. Certainly, there will be some ongoing discomfort, and some banks, funds and other investors may have to ride out the storm, but we now have markets that are more capable of trading their way out of just about anything.

Sullen but not mutinous: Emotional engagement and bank switching amongst corporate SME customers

Business Banking – or Small and Medium Sized Enterprise (SME) – customers are an important segment of the customer base for many retail banks, and indeed the nature of these customers means that the key challenges in meeting their needs are very similar to those presented by personal customers. As such, the emotional and psychological aspects of the relationships between banks and their SME customers are coming under further investigation as banks work to maximise their ability to retain and attract customers.

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A number of UK banks are seeking to grow their share of the SME market. It is likely that the majority of this growth will come from customers who switch their business from a competitor. This market already faces two challenges: buyers who are less sophisticated than their counterparts in the major corporate banking environment; and limited resources with which banks can build relationships and tailor their products. This has led to the search for mass customisation at low cost.

Human factors

Around 15% of UK 'small businesses' switched banks in the period 2002-2003. 'Human factors' are significant in decisions about switching banks, as highlighted in the research commissioned in 2004 by the Federation of Small Businesses.¹ It identified the top six reasons for switching banks as:

- Avoid/reduce bank charges
- Poor quality of service received
- Search for better terms
- Poor quality of advice received
- Earn a higher rate of interest
- Change of bank personnel

The same research identified the six main reasons for not switching as:

- Happy with the services provided
- No real difference between banks
- Competence of bank staff I deal with
- Convenience of the bank's location
- Reliability of bank in meeting the financial needs of the business
- The bank understands my business

¹ Federation of Small Businesses 'Lifting the barriers to growth in UK small businesses', 2004

² Forrester Research Trends, 9 January 2006: 'Building stronger customer relationships'



Figure 1: Trust, promises and support: Statistics from retail banking

- Only 24% of UK customers expect banks to treat them fairly and honestly, compared with 34% of customers across seven European countries
- Only 37% of UK customers trust the advice banks give them
- Only 39% of UK customers think banks keep their promises to them
- Only 15% of UK customers believe the bank will take their side when things go wrong.

Source: Forrester Research Trends, 9 January 2006: 'Building stronger customer relationships'

These findings suggest that two key factors are at play: financial and human. Problems with fees may represent only the 'final straw' that fatally breaks a relationship. Our experience leads us to doubt whether banks manage the human factors as well as they do the nature and pricing of their products.

Many SME customers have had, or maintain, retail banking relationships, as do their families, friends and acquaintances, and it seemed sensible therefore to consider the picture in the retail market (see Figure 1).

Our interpretation of these figures suggests that, under stress, SME banking relationships may founder due to breakdowns in credibility, rapport and trust, most of which may be associated with the banking industry as a whole but not all of which will arise solely from SME

banking experiences. A high-profile public relations failure (for example, in the way a retail bank handled errors in customer accounts) or a customer experience retold in the pub or around the dinner table will, we contend, significantly influence SME decisions around switching banks.

How green is the grass?

If we compare the bank-customer relationship to the situation of a personal or work relationship, such as unfair treatment, unreliable advice, broken promises and an adversarial stance when things go wrong, we can see unhappy, sometimes fraught, often stagnant relationships.

There is little joy here, but the pain isn't great enough to overcome the effort required to change jobs, or partners. But a threat exists: if an attractive

alternative to this existence one day presents itself, and switching to it now looks easy, free of negative consequence and perhaps enjoyable...well, you can finish the story for yourself.

And back in the bank...

Some, perhaps many, bank-SME customer relationships are in the same condition as that unhappy personal or work relationship. Trust and emotional engagement between customers and retail banks seems to be low, and many apparently 'satisfactory' relationships are in fact at risk – compare the statistics for 'customer satisfaction': 70%+ UK retail customers were either very satisfied or satisfied,² with the figures for 'trust' above. Our experience leads us to wonder how far banks really understand what their customers value – and what it costs them to deliver that. Investing in understanding and developing this aspect of their service to customers is a parallel, not an alternative activity, to developing new products, services, markets and pricing strategies. We have summarised what we believe to be the factors affecting attraction, retention and switching in Figure 2.

Our experience leads us to wonder how far banks really understand what their customers value – and what it costs them to deliver that.

Figure 2: Factors affecting loyalty/switching amongst SME customers

Factors driving loyalty and inhibiting switching

Services adapted/aligned to company's needs

Fees/charges perceived as good value for money

Perception of consistent competence (can't recall many mistakes)

Trust at one-to-one and group-to-group levels

Consistent stream of positive 'moments of truth' (i.e. good experiences at a person-to-person level) in areas such as:

- Ease of access
- Speed of response
- Being listened to
- Given information that proves reliable/accurate
- Esteem and recognition
- Tailoring and personalisation of approach
- Courtesy and appropriate style
- Evident understanding of the business
- Location of the bank

Appropriate social interaction and bonding (a) on a one-to-one basis (b) across customer and bank teams

Appropriate 'soft ties' i.e. additional non-banking services offered to help the company's development, standing or success

Sense of shared values/beliefs/principles (e.g. ethics, social responsibility)

Positive brand association

Tradition/longevity of relationship

Age of the owner of the business (older less likely to switch)

Views on loyalty/switching of family members, social peers

Positive experience as retail banking customer with same bank (past and current, own and others')

Valued incentives to remain loyal

Perceived or actual negative consequences of switching (time, effort, cost, uncertainty)

Perception that there is no more attractive alternative supplier or that all banks are the same

Factors driving switching and inhibiting loyalty

Services poorly aligned/adapted to company's needs

Fees/charges perceived as poor value for money

Doubts about competence (can recall many mistakes)

Limited trust, breakdown of trust

Consistent stream of negative 'moments of truth' (i.e. bad experiences at a person-to-person level, opposite to the positive equivalents in column 1)

Inappropriate/lack of social interaction and bonding at one-to-one or across-team levels. Departure of key relationship holder (especially if to competitor)

Lack of/inappropriate 'soft ties' (see definition on left)

Sense of divergent values/beliefs/principles (e.g. ethics, social responsibility)

Negative brand association

Views on loyalty/switching of family members, social peers

Negative experience as retail banking customer with same bank (past and present, own and others')

Valued incentives to switch

Age of the owner of the business (younger more likely to switch)



Figure 3: Opportunities for differentiation

- Only 11% of financial institutions around the world have a single champion for customer service – this responsibility is usually dispersed across products or business units
- Only 35% collect customer loyalty data (as distinct from customer satisfaction data) with a further 15% saying they have no plans to do so.
- Only 36% use customer-related metrics such as feedback and satisfaction data to identify and prioritise the development of staff
- Investment in behavioural change programmes on attitudes to customers ranked only 8th out of 15 types of recent investment to improve people performance (It moves up to 6th when future investment is considered).

Source: Forrester Research Trends, 9 January 2006: 'Building stronger customer relationships'

A call to action

We believe that banks can differentiate themselves through focusing on the emotional aspect as well as the product, service and price aspects of their offering to SMEs. This makes it possible to begin to identify the kinds of changes a bank may wish to make to achieve greater emotional engagement with its customers. This will allow it to defend itself better against the loss of its own customers to banks who take a more traditional approach to relationships, and to improve its attractiveness to potential switchers.

We recognise that this is not an easy process. Some of the changes implied by improvement in emotional engagement and customer advocacy mean changes in the culture of the bank and the behaviour of hundreds if not thousands of staff. But there is some low-hanging fruit with which to commence the harvest (see Figure 3).

This is an exciting field, full of opportunities for innovation.

Unanswered questions threaten to weaken Basel II

As world financial markets grapple with the fall out from the unravelling of US sub-prime loans, it seems that the need for Basel II is vindicated. But many in the banking industry still believe that some fundamental questions remain unresolved as they work to embed Basel II in their businesses.

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Many firms say they are finding it hard to see the value of Basel II. Despite signs that many businesses, particularly in the retail sector, are gaining from the support to their decision-making that stress testing and better risk information is giving them, others are yet to be convinced.

In June, PricewaterhouseCoopers held a special forum in London on Basel II to which senior banking executives of UK-based domestic and international banks were invited. During round table discussions, it emerged that a wide cross-section of participants could see little advantage to their business from this body of regulation.

For a wide cross-section of banks, the answer to the question, 'What's in it for me?', critical to embedding any major change in a business, remains largely unanswered outside the risk management community. Admittedly, that was before the latest bout of financial instability hit the headlines, but in one of the world's most dynamic and innovative businesses, cultural attitudes may be slow to change.

There is a marked difference in approach between retail and investment banks. Risk managers in trading firms reported that they find it difficult to demonstrate anything other than compliance benefits from a Basel II programme. Trading businesses also question the value of calculating operational risk and credit risk capital.

Limited effect on pricing

Yet the answer to this all-important question of buy-in seems straightforward enough for a mortgage lending bank, in that it attracts a lower regulatory capital charge. And in contrast to trading businesses, risk managers in retail banking are becoming involved in the business planning process at an earlier stage as stress testing becomes a requirement for budgeting and long-term planning.

There is limited evidence across the sector that pricing is being affected by Basel II. The risk-based price is seen as a reference point for the commercial price, which relies on competitive considerations rather than regulatory capital being the key driver. Firms worry that the reduction of capital requirements to support certain portfolios might lead to



more aggressive underwriting practices to grow market share and thereby depress margins, especially in secured lending. But pricing strategy is complex. Banks are unlikely to take a mechanistic approach to price-setting, based on the required return on risk-based capital. So far, no forum participants present have changed their pricing policies fundamentally as a result of Basel II. However they do expect it to have an impact in due course.

Opportunity cost

The potentially high opportunity cost of Basel compliance is a major concern. Basel II projects, say some forum participants, are being funded at the cost of projects that would be more beneficial to the firm's risk management.

And Basel's Pillar 3 throws up some fundamental problems that could seriously weaken its impact as a source of market discipline:

- External reporting disclosures are unlikely to be comparable. Market discipline depends on comparability of data, but firms are likely to interpret the disclosure requirements differently and also choose differently between

accounting and risk sources for the quantitative data.

- A major issue is the lack of precision of some of the requirements and hence doubt over interpretation. This is one reason that firms have to make choices in many elements of the quantitative disclosures.
- A common view is that Pillar 3 is more about demonstrating that a firm has enough available capital relative to Pillar 1 requirements, rather than providing meaningful risk data.

Firms recognise the need to explain clearly the basis for disclosures, but there appears to be little appetite for disclosing economic capital data alongside Pillar 1 data and analysing the differences. At a minimum though, qualitative explanation of the differences between economic and regulatory capital will be needed.

FSA too flexible?

That the FSA is seen as relatively flexible in its approach to Pillar 3 compared to other more prescriptive regulators is seen by some as a drawback; while others remain content. To date, the FSA has not provided any guidance or clarification on

definitions or interpretations of the requirements. Many firms worry that the FSA shows insufficient appreciation of the huge data and management reporting implications of making late changes to the FSA's Integrated Regulatory Reporting requirements. Currently, the FSA expects firms to make Pillar 3 disclosures during the calendar year 2008 (or during 2007 for the firms who adopt the Basel II rules in 2007).

Pillar 3 projects are typically resourced from risk, finance and investor relations functions, but many firms have yet to decide who, ultimately, owns the data and takes responsibility for it. But as with Pillar 2, Pillar 3 seems to be breaking down the barriers between risk and finance.

No 'feel' for the numbers

The main focus is on sourcing the quantitative data needed to comply, since there are substantial lead times involved. In contrast, qualitative disclosures are seen as comparatively quick to source. Yet there are major risks in disclosing data that senior management does not understand. A significant proportion of Pillar 3 disclosures are not used internally for risk management, so management has

A firm's score from the ARROW process on Governance and Oversight will be a key consideration for the FSA in arriving at Individual Capital Guidance that follows the Supervisory Review and Evaluation Process (SREP).

yet to develop a 'feel' for the numbers. For most firms there is also a mismatch between the Pillar 1 risk profile and the internally determined risk profile due to differences between regulatory and internal methods.

The problem is exacerbated by uncertainty over what is actually required to be disclosed. And disclosures may well give rise to unexpected or difficult questions from analysts or others, either about a firm's own disclosure or in comparison with peers.

According to our information, firms worry that:

- Complexity and comparability problems in Pillar 3 disclosures will confuse analysts.
- There is also a real risk to share prices if the data is not well understood.
- Some buy-side analysts are said to relish the prospect of more useful credit risk disclosure. This means that Pillar 3 disclosures will require careful presentation with a corresponding need 'to tell a coherent story'.

Understanding risk appetite

For most firms greater senior management involvement in the Internal Capital Adequacy Assessment Process (ICAAP) is a top priority. A firm's score from the ARROW process on Governance and Oversight will be a key consideration for the FSA in arriving at Individual Capital Guidance that follows the Supervisory Review and Evaluation Process (SREP). As part of meeting the use test, firms present identified a need to focus on plausible but severe stress events to engage senior management effectively.

There is broad agreement that risk appetite is an area of challenge. Executives outside the risk discipline need to understand the concept of risk appetite, specifically the totality of the firm's risk universe, agreed limits and paths of escalation. But as Pillar 2 is principles-based the FSA does not (nor is it likely to) give specific guidance on risk appetite nor detailed expectations to firms. It is particularly important for management to demonstrate its ability to manage the business under testing circumstances, particularly in managing reputation risk.



A commonly held view among the forum participants is that the FSA's distinction between Pillar 1 and Pillar 2 for stress testing remains unclear, as do its intentions for holistic stress testing. This is clearly an area where more dialogue would be beneficial.

Positive effects

Yet despite all the doubt and difficulty, Basel II is having positive effects. Enhanced stress testing is improving discussion with and engagement of, senior management and the business on risk issues. And it could be that the business will be less reluctant to embed strengthened risk management if, as now seems highly likely, external influences, such as investor requirements for more information on risk, have an impact and analysts latch on to the importance of strong risk management.

Basel II has forced banks to invest in a better data environment and strengthened decision-making processes on risk. The result should be a better-controlled

operating environment, in turn favourably influencing ARROW assessments. And, as Pillar 3 encourages more visibility of risk, more organisations could come under pressure to explain how they manage it to investors, rating agencies and the media: no bad thing in the present circumstances.

PricewaterhouseCoopers hosts an annual Basel Executive Forum in the City for clients who engage in roundtable discussions. The forum was chaired by Richard Barfield. The full report from the 2007 forum, 'Getting the most out of your Basel II efforts', is available at www.pwc.com/basel.

The US sub-prime story: Contagion or distraction?

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What has been happening in the US mortgage space?

The state of the US consumer lending market is changing day by day. Driven primarily by aggressive lending to sub-prime mortgage borrowers and investor demand for mortgage-related debt, the US mortgage market is now undergoing a significant correction which has impacted investor appetite for all forms of debt. We consider below whether the US story could have a contagion effect for the UK with specific reference to unsecured lending.

As of writing, US delinquencies have continued to rise across US prime and non-prime mortgage products, but are particularly pronounced in sub-prime. Delinquency rates on residential lending are at their highest levels since 2001. In addition there is a significant amount of uncertainty driving capital markets perceptions and appetite for consumer-related debt. There are concerns about house price depreciation, the estimated \$1trillion of Adjustable Rate Mortgages (ARM) resets coming over the next year and poor housing market statistics. Given that most forms of consumer lending in the US are funded through the capital markets rather than by the balance sheets of the issuing bank or financial institution, this has resulted in both contraction and higher prices for almost all consumer debt in the US today, including credit cards, auto loans and student lending.

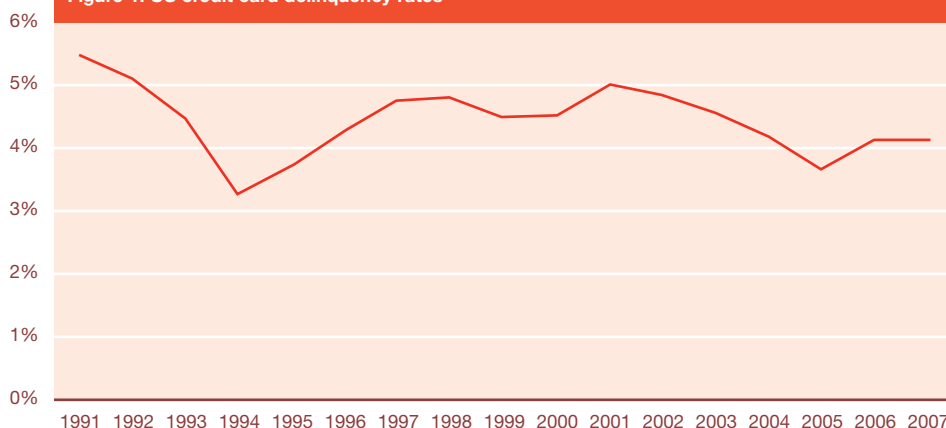
These concerns fuel speculation that consumer spending patterns are shifting enough to affect the issuers of unsecured debt and also drive a broader downturn in the economy. Data from Q2 2007 indicates, however, that debt-servicing problems were mostly confined to mortgage-related products for the first half of the year. Credit card delinquencies are still below levels witnessed during the early nineties, as highlighted by the graph (see Figure 1), and in more recent times have been steadily falling between 2001 and 2005. However, credit card delinquencies stopped falling in 2005 and between June 2006 and June 2007 they have remained steady. As a result, US companies that participate in the consumer lending market are on the one hand dealing with the fallout on their first and second mortgage portfolios and on the other reassessing their unsecured products in terms of risk profile, pricing and profitability.



But why would the above have repercussions for the global economy? Part of the problem is that the US mortgage portfolios were sold through securitisation vehicles and bought by global financial institutions. Uncertainty exists as to who the ultimate owners of these risks are. This has caused banks to be more cautious and hesitant when financing is requested from other banks. This in turn is limiting the supply of both secured and unsecured lending to consumers.

In the UK this has led to an increase in credit spreads, particularly on mortgages. Faced with a credit squeeze customers often review their debt on a hierarchical basis – with their mortgage repayment taking priority due to the obvious importance this asset holds for them. However, this can be at the expense of any unsecured lending they have. Delinquencies on US credit card lending appear to be steady but when the \$1trillion of mortgages re-price in the coming year we may see delinquencies rise in the US as people struggle to meet higher mortgage repayments.

Figure 1: US credit card delinquency rates



All data points are as at 30 June

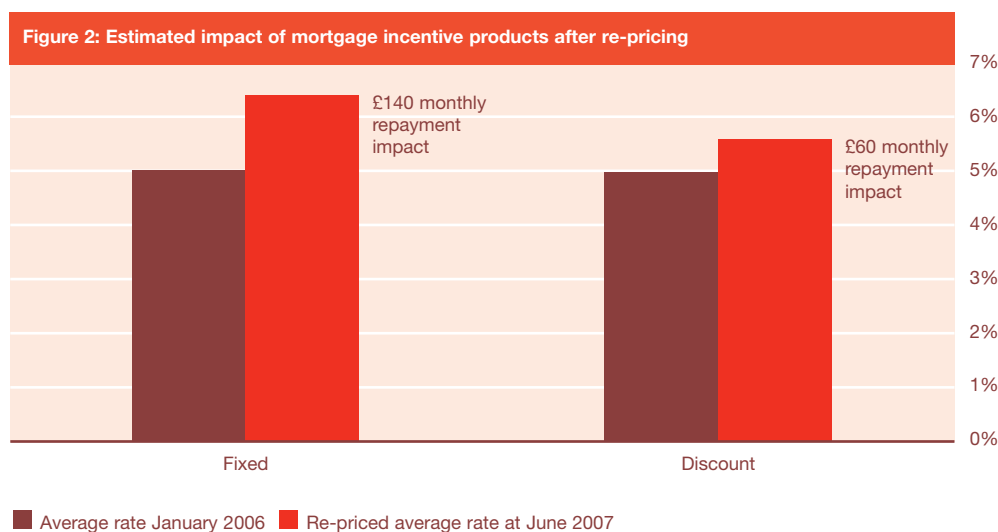
Source: Federal Reserve, PricewaterhouseCoopers analysis

Mortgage re-pricing in the UK could cost customers an extra £140 a month

Parallels between the UK and US markets have often been made, particularly in the consumer lending market. Similar to the US market, a developed sub-prime mortgage market exists in the UK, as well as established securitisation programmes. We have also witnessed a sustained period of house price appreciation and a period of competitive mortgage incentives

offered to customers which are due to re-price in the coming years.

There are two potential areas we should consider from the US sub-prime mortgage story. Firstly, the indirect impact has been a liquidity crunch which has resulted in higher spreads above base rates for variable rate mortgage products. In the UK, there is an expectation that the Bank of England will lower base rates early in 2008. However, there is doubt this will have any significant impact because



Note: Fixed rate re-pricing based on difference between average fixed rate January 2006 and SVR rate June 2007; discount rate re-pricing based on average discount margin compared to SVR for every month in 2006

Source: Federal Reserve, PricewaterhouseCoopers analysis

variable rate margins above base rate have increased significantly in response to the credit crisis. What is certain is that with consumers facing likely increased mortgage costs in the UK, there will be increased pressure on their ability to service unsecured lending repayments. In addition, from a lender's perspective there may be mounting pressure to offload consumer finance portfolios if willing buyers can be found. On first reflection one may think that in this context consumer lending would be subdued further, however there are indications that the opposite is true in the US. According to data published by the Federal Reserve, revolving credit usage increased post the sub-prime crisis as people borrowed more to fund normal living expenses, an unsustainable situation for both consumer and lender. It is too early to tell whether we will witness the same trend in the UK market but it clearly highlights some of the dilemmas faced by lenders in today's market.

The second lesson we can learn from the US market is in relation to the \$1trillion of ARM mortgages (discounted) set to re-price in the coming year and the impact

on delinquencies. In Figure 2 we draw a parallel with the UK market and estimate the potential impact on those customers coming to the end of their discount or fixed rate period. The average mortgage loan over the last 18 months to June 2007 has been around £120k.¹ Fixed mortgages offered 18 months ago were on average 138 basis points below the average June 2007 Standard Variable Rate (SVR). For discounted mortgages the margin between the discount offer rate and the SVR rate in 2006 is less significant at around 60 basis points. Whilst some people will re-mortgage and others may have made capital payments against their mortgage, what the analysis shows is that mortgage customers are likely to face a significant increase in their monthly mortgage repayments (up to £140 on fixed rate mortgages taken out in January 2006). Over 1.4m fixed rate mortgages were completed in 2006 alone and a further 276,000 of discounted mortgages. When these re-price an individual's ongoing commitment to service mortgage repayments may result in unsecured lending arrears increasing or the use of unsecured facilities to fund the additional mortgage cost. It is not clear how

¹ Council of Mortgage Lenders Banksearch Regulated Mortgage Survey – 04.09.07



significant this will be compared to the US. However, when the \$1trillion of ARM mortgages re-price over the next year in the US, UK lenders should watch with a careful eye (see Figure 2).

Other contagion effects faced by lenders

Queues of people outside every Northern Rock branch in the UK highlights an important behavioural impact – the impact of consumer confidence and adverse publicity. Consumer confidence has been hit by market turbulence in the UK economy. This fear could result in lower spending on the high street and increased savings. Faced with the Northern Rock example, banks will look to close their funding dependency on the credit markets and this could result in higher savings rates offered to customers and further subdue consumer spending.

We are now in a period of economic uncertainty and the degree to which this will hit retail banks and their customers is subject to debate. Keeping a watchful eye on the US mortgage market and its impact on unsecured delinquency performance could become increasingly important in predicting and being prepared for what could happen in the UK market.

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Customer profitability versus product profitability: The impact of economic regulation

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What is happening?

In recent years the banking sector has seen increasing scrutiny from competition authorities assessing the reasonableness of prices and practices. This has been under both consumer and competition law and at the national and EC level. It is fair to say that banking is well and truly in the 'cross-hairs' of the competition authorities.

The UK has been at the forefront of this trend. The first foray by the UK competition authorities into this sector in 2002¹ led to the imposition of an onerous price control remedy. Since then, the UK authorities have challenged credit card interchange fees, credit card default fees, store cards, unauthorised overdraft charges (UOCs), home credit, payment protection insurance (PPI) and the general state of competition in both current accounts and credit cards.

There is a clear domino effect going on: in 2005 the Office of Fair Trading (OFT) wielded the Unfair Terms in Consumer Contracts Act in anger at credit card default fees, resulting in these fees being cut in half.² The OFT has since looked to 'cut and paste' this approach to regulate unauthorised overdraft charges: but mindful of potential knock-on effects, in particular the risk of ending 'free banking', it has widened this inquiry to look at competition in current accounts (an area already criticised by the Competition Commission (CC) in respect of Northern Ireland).³ The fairness of UOCs is now also being thrashed out in court. Meanwhile, the increase in APRs following the cut in credit card default fees has led to a further complaint to the OFT by Which?, bemoaning a general lack of competition in the provision of credit cards.⁴

Why is this happening?

There is undoubtedly a range of factors contributing to this trend. What is clear is that the consumer bodies (Which? and Citizens Advice) are increasingly influential in shaping the debate and the OFT in the UK is pursuing an increasingly consumerist agenda. This has been encouraged by the Enterprise Act. For some commentators, banks enjoy a quasi-utility status (everyone has to have a bank account), enjoy low switching in products like current accounts, and serve consumers who are not altogether savvy when it comes to financial products.

¹ 'The supply of banking services by clearing banks to small and medium-sized enterprises', Competition Commission – 14.03.02.

² 'Calculating fair default charges in credit card contracts, a statement of the OFT's position', OFT 842 – 05.04.06.

³ 'Personal current account banking services in Northern Ireland market investigation', Competition Commission – 15.07.07.

⁴ 'Which? ICM Supercomplaint', Which? – 30.03.07.



The apparent high profits of UK banks in recent years are also a factor. However, the true profitability of banking products is very difficult to identify due to the prevalence of intangible assets and significant common costs in retail banking. Often the authorities have taken an overly superficial approach – for example the OFT recently sought to infer PPI profitability using comparisons of claims ratios with products like pet insurance.⁵

More fundamentally, the banking business model is complex and interrelated, and does not lend itself easily to scrutiny of a single price. For example, some may regard UOCs as ‘poor value’ but lower UOCs would surely lead to increased bad debts, a cost that all non-defaulting customers must ultimately cover, and lower average deposits, the source of cheap finance which makes the banks’ loan products so competitive.

The banks have not always explained this kind of thing very forcefully or in a consistent manner. In fairness, the banks could be forgiven for not always knowing what to aim at, as often the authorities’ position has been quite muddled. The recent review of SME terms concluded

that price regulation was no longer required as competition had improved, but in truth price regulation would have hampered this process. The likely increase in APRs following the cut in credit card default fees was welcomed by the OFT as ‘providing greater transparency’ but has been criticised by the consumer bodies and led to further complaints.⁶

What impact is this having and what should the banks be doing?

Assessing the impact of these trends is also difficult. Perhaps the most damaging aspect of these inquiries relates to the bad press that they generate; for example take up rates on PPI have fallen dramatically since the launch of the Citizens Advice complaint, yet the CC has only really just begun its review and the banks have only now started to engage properly in the debate. More proactive engagement earlier on could have helped address this customer holdback. The reality is that the banks’ engagement strategies have varied widely and often been fragmented along product lines, reflecting perhaps the hitherto piecemeal nature of the regulatory creep the sector has witnessed and a feeling that there may be bigger threats to

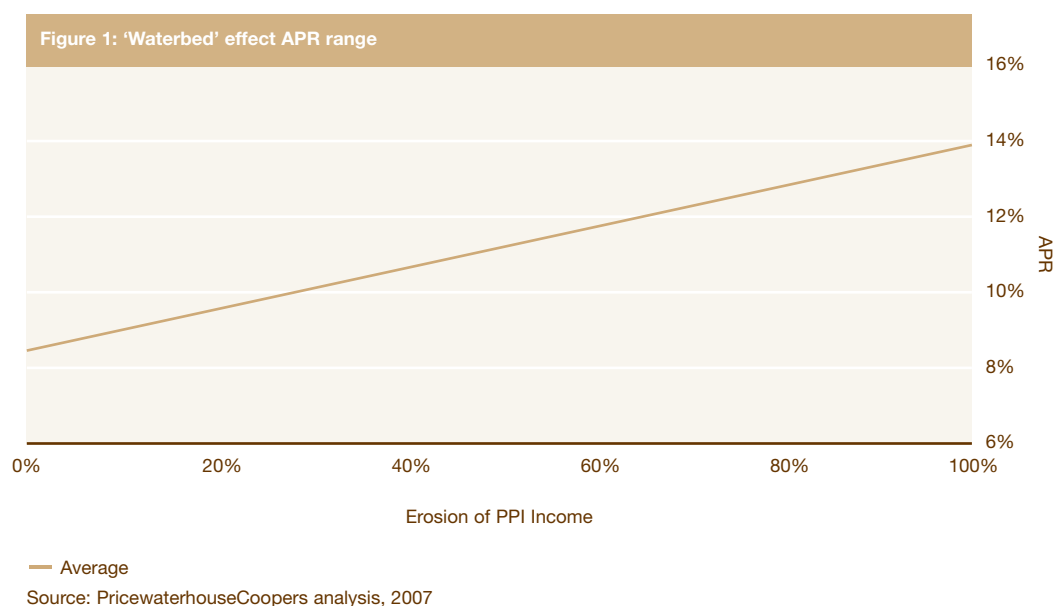
manage (e.g. the ‘back book’ risk).⁷ Going forward, the banks may do well to learn from other sectors that experience regular interaction with economic regulators, such as telecoms, where regulatory strategy has greater priority, is more centrally co-ordinated and has high board-level sponsorship.

The financial impact of interventions will vary considerably according to the nature of the product and depending on the commercial position of individual players. Some interventions may allow banks to tweak other aspects of their products. For certain we have seen evidence of a ‘waterbed’ effect, where direct intervention in one area of pricing has led to others going up. For example, cuts in interchange fees and credit card default fees have led to significant changes in APRs, especially for cash withdrawals. This reflects the fact that if price cuts reduce the value of customers, firms will compete for them

⁵ ‘Payment protection insurance: Report on the market study and proposed decision to make a market investigation reference’, OFT869, (paragraph 6.49 et seq) – 19.10.06.

⁶ See footnote 4.

⁷ i.e. the risk of having to reimburse customers for historic transactions.



less aggressively. However, as intervention threatens more core areas of bank activity, such as current accounts and personal lending, damage limitation strategies may be harder to achieve. Figure 1 shows the implications if reduced profits on PPI were to be fully recovered through loan APRs (assuming no effect on loan take-up).

What is clear is that an across-the-board, rebalancing would not be achievable for material cuts in PPI profits. To minimise the impact of further interventions, the banks will need to target any rebalancing, whilst being mindful of how individual customer groups might respond and based on an understanding of which customers they really need to keep and which ones they can afford to lose. The focus therefore will be more on customer profitability as opposed to product profitability. This will require a move to tracking customer profitability more closely and developing more sophisticated systems to allow more complex charging structures to reduce the impact on total profits.

A similar story is likely to emerge with respect to any interventions on UOCs. The banks could not afford to impose annual fees on all accounts as not everyone would follow, exposing the banks to churn risk for their best customers. Rather, the banks need to assess quickly the underlying profitability of different customer groups in a reduced UOC world to understand which customers they must keep and those they can risk losing. This would imply developing a range of current account products as a coherent competitive response to intervention.

The challenge, therefore, is that in addition to managing the regulatory process better, the banks need to understand, and respond to, the changing economics of their customers in a more sophisticated manner.

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