Net Interest Margins and Product Diversification

Making a comeback!

JOHNSTON CARMICHAEL

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Setting the scene – Financial crisis and 'back to basics'

The financial crisis (2007-09) unearthed several fundamental issues in the UK banking market. These included an over-reliance on the volatile wholesale market to fund lending (Northern Rock depended on the wholesale market for 75%[1] of their funding), a lack of understanding of where risk lay (the securitisation of sub-prime mortgages 'sliced and diced' high risk loans and ultimately led to significant bad debt impairments), and mis-selling of payment protection insurance and investment products. The aftermath also revealed that banking institutions' capital was insufficient for them to remain viable without being propped up.

Post financial crisis, banks and the regulators identified the need to build a sustainable 'back to basics' banking business model. This gave us the business model that we see today, characterised by:

- Lower reliance on wholesale funding
- Increased reliance on Net Interest Income and moving back to basic banking products, savings and lending
- A general exit from investment, protection, and investment advice particularly as many faced remediation projects that ultimately ended with fines from the regulator and the bill for compensating customers
- Greater reliance on the intermediary market to advise consumers seeking a mortgage
- Increased liquidity (the large banks arguably have an excess of liquidity in their ring-fenced divisions that has increased their reliance on residential lending to utilise savings and current account credit balances)
- Higher capital buffers

The crisis and aftermath were triggers for banking institutions to significantly adjust their business models and earn a solid, although lower, return from taking in deposits and lending them out, making a percentage mark-up on the difference (Net Interest Margin). This has resulted in 51% of the world's banks having a return on equity that is below the cost of equity[2]. The recent hikes in the Bank of England (BoE) base rate have seen interest spreads and profitability increase however the forthcoming Consumer Duty regulation places price and fair value as a core requirement. This resurfaces an important question, **are interest income focused banking business models desirable going forward?**

Current economic climate: rising interest rates, surging inflation and the cost-of-living crisis

To mitigate the contractionary economic effects of COVID-19, the BoE reduced the base rate to a record low of 0.1% in March 2020, enabling businesses and households to access cheaper loans. However, the low interest rate environment is increasingly seen as unsustainable if the BoE is to control inflation caused by issues such as global supply chain disruption, the sharp increase in energy (oil and gas) prices and geo-political tensions.

The BoE initially increased the base rate to 0.25% in December 2021 and since then has made multiple increases taking the base rate to its current level of 2.25%, the highest level since the financial crisis.

The graph below illustrates BoE's base rate movement over the last ten years:

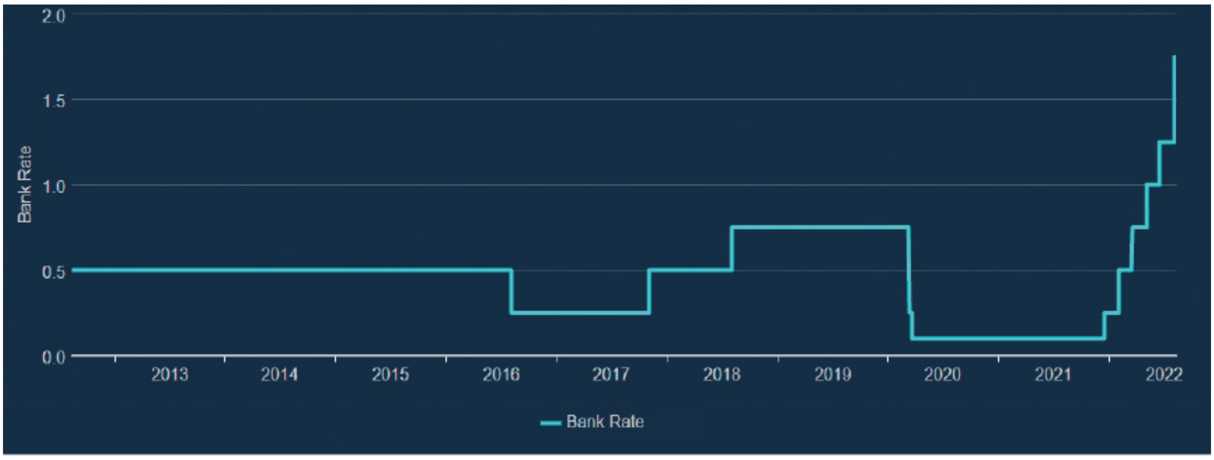

Figure 1: official central bank rate (July 2012 – July 2022)[3]

It is evident that every increase in the base rate represents a revenue opportunity to retail banks as they can increase their spread between interest paid (or not on deposits) and the rate they lend at. Additionally, higher LTV lending has seen higher increases to rates although an element of this will represent a risk premium to account for loss in the event of borrower defaulting and the corresponding impact on the revenue of UK high street banks.

The latest base rate rise will impact around 2.2 million households as they face an immediate increase in their monthly mortgage payments[4]. Those borrowers on variable mortgage rates and those on tracker rates (i.e. c. 25% of total homeowner mortgages[5]), are impacted as these products mirror the movement in the base rate. As an example, a 0.1 to 2.25% hike is the equivalent of an additional £3k pa (£250 per month) for the average customer borrowing £140k on a tracker or SVR mortgage. Add to that energy costs for the average household doubling to c. £2,500 pa in the same period (an additional £1,250 pa or £100 per month), this leaves a sizeable £350 negative adjustment to average household budgets.

The Energy Price Guarantee (EPG), which caps the energy bills at £2,500 a year from 1 October until the review in April 2023, together with a £400 discount announced as a part of Energy Bills Support Scheme (EBSS) should bring partial respite to UK households. That said, and despite the BoE's aim to bring inflation back to the 2% level, it is likely that we will continue to see further increases to the base rate, especially if revised fiscal policies do not suppress inflation in the short term[6].

Although the base rate increase has benefitted many banking institutions in the short-term, as can be seen from their recent financial results, a high interest rate environment carries the risk of slowing mortgage demand and increasing defaults, further damaging consumer confidence and increases the probability of the UK entering a recession.

Short-term profit boost

As mentioned earlier, UK banking institutions have been increasingly reliant on Net Interest Income (NII) post the last financial crisis. The figure below demonstrates the extent to which the 'Big 5' banks rely on NII:

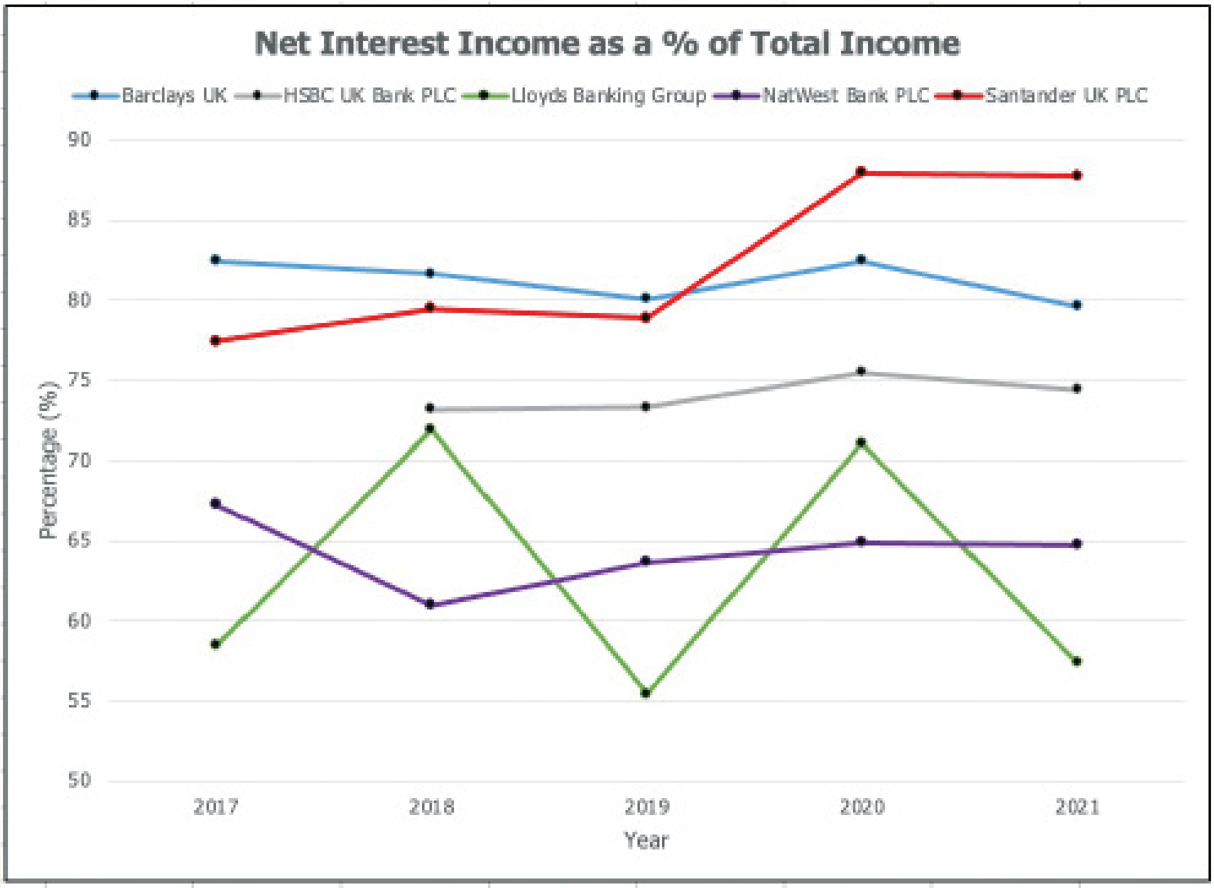

Figure 2: Net Interest Income as a % of total income

It is evident from the figure above that, in the last few years, some banks have more of their eggs in the NII basket than the others, e.g. in 2021 NII accounted for c.88% of Santander's total UK revenue vis-à-vis c.57% for the Lloyds Banking Group, with a more diversified product offerings in the UK market. Notwithstanding the individual differences, the overarching story is that the 'Big 5' banks earn the majority of their income from NII.

The sharp increase in the BoE base rate, after a lengthy period of sustained low interest rates, has enabled banking institutions to increase the spread between the rate they pay on savings balances and the rate they lend that money out at. However, the long-term disquiet amongst customers due to low returns on their savings has grown over the last few months as inflation rises and some banks and building societies have announced they will pass on some, if not all, of the base rate increase to their savers. Nevertheless, in the short-term, the NII spread along with the profitability of most banking institutions has increased as their funding cost is expected to increase less than the rates offered to borrowers.

Banks with a high proportion of current accounts (i.e. the 'Big 5') are likely to benefit more because of the low (or no) interest paid on creditor balances. Fewer building societies offer current accounts and given their mutual status, have passed on the increase in base rate to their savers, lowering their ability to increase their NIM (depicted in the figure below).

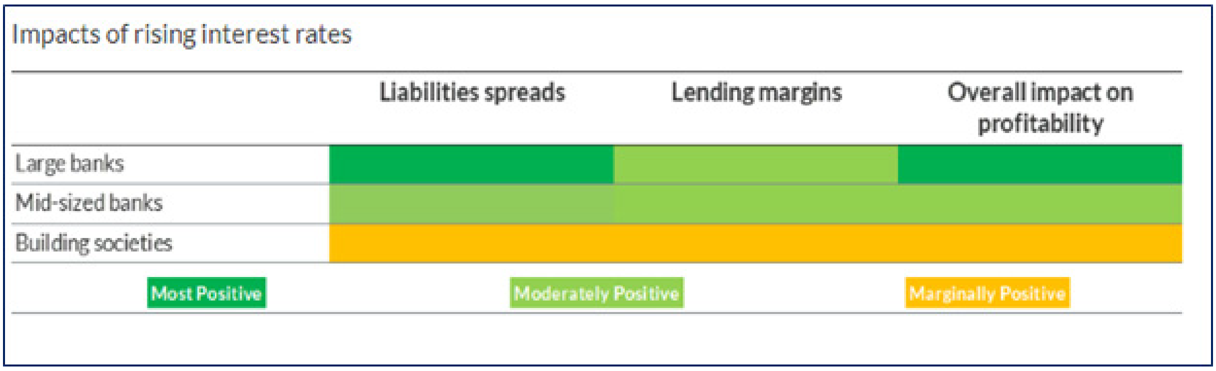

Figure 3: UK Banking sector profitability heatmap[8]

Note: Large Banks refers to banking institutions with asset size greater than £500bn.

Longer term uncertainty

As energy prices continue to rise and the cost-of-living crisis deepens, consumer confidence is likely to diminish and those with the capacity to save will put more money away. The increased cost of borrowing is also likely to damage consumer confidence and Barclays pointed to this in their 2021 annual report saying:

"Further increases in interest rates, if larger or more frequent than expected, could lead to generally weaker than expected growth, reduced business confidence and higher unemployment."

Already, the Organisation for Economic Co-operation and Development (OECD) forecasts point to unemployment in the UK increasing in the coming months[8]. Experience suggests that when inflation is high and confidence falls, then unemployment increases, and affordability and ability to repay is impacted. Few UK banking institutions can afford to allow the profile of their lending book to materially deteriorate and consequently, we would expect lending criteria to be tightened and risk premiums to be increased within headline lending rates. The knock-on impact is then a reduction in demand, less customers seeking to borrow (households defer moving home and businesses consolidate rather than chase growth).

These worsening economic conditions are likely to intensify the competition amongst UK banking institutions for low to mid LTV mortgages, especially re-mortgages as the mortgage market cools, and competition could lead to reduced interest spreads for vanilla loans.

The future of banking business model

Hinged as they are to the UK economy, UK banking institutions currently walk a tightrope and short-term fortunes hang on whether the economy experiences a soft landing, one the BoE is working towards, or as seems more likely, a hard landing. If the UK moves into recession, which is more likely given the consequent fall in the UK GDP over the last two quarters, the outcomes present challenges to banking institutions reliant on NIM. Given the current reliance on residential property lending over the last decade, exacerbated by ringfencing and an unprecedented period of low and stable interest rates, banking institutions should consider diversifying their income sources to manage their business through more volatile future economic cycles.

The following should be on their radar:

1. Income diversification

UK banking institutions should continue to look to diversify their product and service offerings to reduce their reliance on NII from traditional interest-bearing products. This could see them move back to activities they exited from post financial crash (this time taking care that they do not pursue revenue at the expense of fair outcomes for their customers) and may well include exploring the following products:

- Higher margin unsecured personal lending products including loans, ethical and fairly priced credit cards, Buy Now Pay Later (BNPL) products, and microfinance to support financial inclusion.
- Fee and commission earning products such as insurance (personal and commercial), financial advice, simple investment solutions / robo-advice, asset management, and fair value monthly fee accounts.

Before the economic turmoil inflicted by the COVID-19 pandemic, we saw LBG partner with Schroders to launch 'Schroders Personal Wealth' with the ambition of becoming a top three financial planning business by the end of 2023[9]. Also, their acquisition of Embark Group, a deal first announced in July 2021[10], emphasises their enthusiasm for diversification and they are reported as targeting a top-three position in direct-to-consumer, self-directed and robo-advice business in the medium-term and a top-three position in the individual pensions and retirement drawdown market by 2025.

We expect many more banks to accelerate and implement income diversification strategies in the coming months.

2. Cost optimisation

UK banks have been striving for years to reduce their cost base. Even before the pandemic, only a handful of 'Big 5' banks had a satisfactory and sustainable cost:income ratio (refer to figure 4, below).

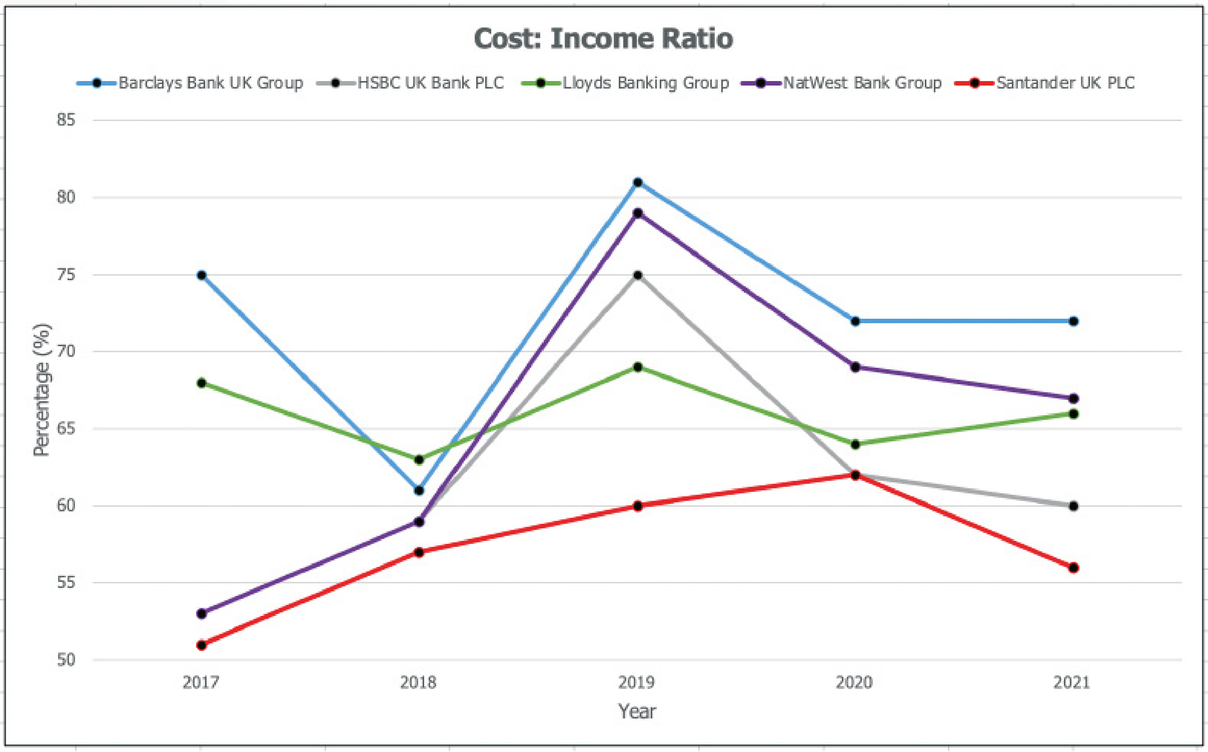

Figure 4: cost:income ratio

Years of cost initiatives have failed to generate sustained value[11], highlighting the flaw of those banking institutions who look at 'cost optimisation' as a purely 'cost reduction' exercise. The most successful cost optimisation programmes balance a reduction in costs in the short-term with an equal focus on avoiding imprudent removal of cost related to services that customers value to protect medium to long-term revenue.

We advocate viewing costs in two ways: good costs and bad costs. Maintaining or expanding good costs and investing in experiences that 'wow' customers. Good outcomes deepen customer relationships with loyal customers valuing their banking institutions continued role in their financial ecosystem, just as people seem to value Amazon. Bad costs often include over-investment in functionality that customers expect as standard, unnecessary steps or friction in the customer journey and cost misaligned to the strategic purpose of the business unit.

As banking institutions increasingly turn to digital to support efficiency initiatives, and particularly with Consumer Duty regulation due to come into force in June 2023[12], they should also consider how human escalation points seamlessly interact with the digital experience to improve and evidence good customer outcomes, avoid foreseeable customer harm, and lower costs. Only by doing all of this can both sides of the cost:income equation be improved.

3. Regulatory compliance management

Remediation costs and fines have cost banking institutions dearly over the past decade and part of their focus should be to ensure their actions or inactions today do not jeopardise their profitability in the future. Regulatory fines levied in 2021 and 2022 suggest that fair treatment of consumers, customer communication and financial crime are still hotspots. Moreover, regulation on 'Consumer Duty' and the recent roll-out of tougher 'Operational Resilience' requirements mean that a focus on regulatory compliance should continue to be a high priority.

In the previous section we outlined how the global financial crisis in 2007-2009 propelled banking institutions to retrench staff in order to sustain 'back to basics' business models. Similarly, the current economic climate, presents an opportunity for banking institutions to revisit their business model and to diversify their product and service offerings, optimise costs and ensure regulatory compliance.

If you are interested in discussing this whitepaper, or are considering seeking support with your strategy, target operating model development, cost optimisation or regulatory compliance, please don't hesitate to get in touch.

Ewen Fleming
Partner and Head of Financial Services

T: 07733 236559
E: ewen.fleming@jcca.co.uk

Ravi Malhotra
Consulting Senior

T: 020 4537 5665
E: ravi.malhotra@jcca.co.uk

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